CLIENT BREIFING NOTE – 8th November 2022

IOSCO: Good Sustainable Finance Practices Call For Action

On 7th November 2022, the International Organization of Securities Commissions (IOSCO) released a call for action relating to good sustainable finance practices[1]. The aim is to engage with industry associations and voluntary standard setting bodies to help prevent greenwashing by implementing good practices amongst asset managers, ESG rating agencies and data providers.

It's almost a year since IOSCO last published two papers to help address greenwashing:

1. **The Report on Sustainability-related Practices, Policies, Procedures, and Disclosures in Asset Management industry (FR08/21)[2]**. Within this report, IOSCO provides a series of recommendations for asset managers, including disclosure at the firm and product level, regulatory and supervisory expectations, terminology, and financial and investor education. For those with an eagle-eye, a lot of the recommendations resonate with the new FCA Sustainable Disclosure Requirements.

2. **The Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers (FR09/21)[3].** IOSCO explore the developments and challenges relating to ESG ratings and data providers (ESG solution providers) and consider the implications of their increasingly important role. Most jurisdictions do not have regulatory oversight of these solutions, therefore the report recommends more attention is given as well as consideration of whether sufficient oversight is in place. Importantly, there is a specific set of recommendations relating to governance and internal processes for solution providers and transparency on the methodologies that underpin ratings.

The IOSCO Good Sustainable Finance Practices (IOSCO Good Practices) are aimed at both asset managers and ESG solutions providers, split into two distinct sections. As with other recommendations, they are both voluntary and should not conflict with national or regional legal and regulatory frameworks. IOSCO provides 5 Good Practices for asset managers and 7 for ESG Rating and Data Providers. Further detail is provided in Appendix 1.

Jurisdictions are now beginning to establish or build upon existing regulatory frameworks for asset managers and the use of ESG ratings and data in the context of sustainable finance. IOSCO highlight that it is now 'critical that asset managers now push forward to improve sustainability-related practices, policies, procedures, and disclosure in their industry and that ESG ratings and data providers improve the reliability, comparability, and interpretability of their ESG ratings and data products'.

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD717.pdf
[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD688.pdf
[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

Devlin Mambo View:

It is positive to see the push for good practice from IOSCO and, from the perspective of in-flight regulation, the EU SFDR and UK SDR contain key elements of the Good Practices recommendations.

When considering your ESG strategy, and direction of travel in a more general basis, looking toward IOSCO will likely lead your firm to a sensible and well-positioned place. The Good Practices highlight sensible steps for the industry but will require to be supported by further work and analysis by those trade associations and voluntary standard setting bodies.

For particular interest to Devlin Mambo is 'Good Practice 5' for asset managers. This highlights what asset managers should consider through the due diligence process over ESG solution providers. From our research, and industry interaction, we still believe there are challenges with transparency of methodologies, scope and coverage, as well as convergence to some of the 'big players,' despite the coverage not aligning as well as it could to the product offering.

Interesting points on due diligence raised by IOSCO in FR09/21 were from the fact-finding exercise, leading to the creations of their recommendations, and subsequent Good Practice. IOSCO found that:

- Users do not generally conduct any formal verification of ESG ratings and ESG data products, largely only engaging when there are inconsistencies between in-house research and the provider
- Most firms indicated a lack of transparency of methodologies, including the scope of underlying data, definitions of materiality, the timing of data collection, and the frequency of review or update
- Concerns were raised for improvements to corporate disclosures, specifically on the underlying data
- Firms generally conduct an assessment on the ESG solution providers, rather than the specific products, and
- Importantly, regardless of the sequencing of the due diligence exercise, users of ESG solutions providers could benefit from evaluating whether the criteria utilised in the assessment process are science based, quantitative, verifiable and aligned with existing reputable standards and taxonomies. These due diligence processes could be expanded to include an evaluation of the relative weighting of these criteria in the process as well as the extent of the qualitative judgement exercised by the ESG ratings or data provider.

At Devlin Mambo, we have been following IOSCO developments closely and have developed a platform, DM ESG Insights, to help our clients meet recommendation 7, which states:

"Market participants could consider conducting due diligence, or gathering and reviewing information on the ESG ratings and data products that they use in their internal processes. This due diligence or information gathering and review could include an understanding of what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used."

Our platform is based on a standard taxonomy for the assessment of ESG data and FinTech solution providers. The IOSCO Good Practices further highlights the requirement for due diligence and/or the gathering and reviewing of information on the ESG ratings and data products that asset managers use in their internal processes. It remains to be seen which trade associations will look to build upon these however, as shown in the past, being on the front foot may leave you in a better place in the future.

Appendix 1: Good Practice in detail

a) <u>Section 1: Asset Managers</u>

IOSCO Good Practices highlight 5 areas that industry associations and voluntary standard setting bodies should develop and promote among their members:

Good Practice 1: <u>Clear expectations for asset managers regarding the: (a) development and implementation of practices, policies and procedures relating to material sustainability-related risks and opportunities; and (b) related disclosure.</u>

The practices, policies, and procedures relating to material sustainability-related risks and opportunities and the disclosure thereof should cover the following areas, as detailed by the Task Force on Climate-related Financial Disclosures (TCFD) and further elaborated by International Sustainability Standards Board (ISSB) standards: Governance; Investment Strategy; Risk Management; and Metrics and Targets.

Good Practice 2: <u>Clear expectations regarding product-level disclosures to help investors better understand: (a) sustainability-related products; and (b) material sustainability-related risks and opportunities for all products.</u>

Specifically, the product-level disclosure should cover the following areas: Naming; Labelling and classification; Investment objective disclosure; Investment strategies disclosure; proxy voting and shareholder engagement disclosure; Risk disclosure; Marketing materials and website disclosure; monitoring of compliance and sustainability-related performance; and, periodic sustainability-related reporting.

Good Practice 3: <u>Common sustainable finance-related terms and definitions, including those relating to ESG approaches, to ensure consistency throughout the global asset management industry and comparability mong sustainability related products.</u>

IOSCO highlight the lack of consistency around terminology which, in turn, increases the potential for investor confusion around sustainability related products, contributing to greenwashing. There is a call for common global sustainability-related terms which go further than product types, considering ESG approaches (such as ESG integration, or negative screening) and commonly used terms (such as 'green').

Good Practice 4: <u>Promoting or participating in financial and investor education initiatives relating to sustainability.</u>

Financial and investor education initiatives may include promoting sustainability-related risk awareness and improving investor comprehension. Initiatives could include tools, methodologies, guidelines and orientations that focus on retail investors as well as the larger public. These initiatives should seek to overcome barriers to access, mainly using the internet and, where applicable, could include partnerships with other institutions.

Good Practice 5: <u>Clear expectations regarding due diligence and/or the gathering and reviewing of information on the ESG ratings and data products that asset managers use in their internal processes.</u>

This due diligence or information-gathering and review should include an understanding of what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used. Asset managers should consider evaluating the published methodologies of any ESG ratings or data products that they refer to in their internal processes. This evaluation should cover:

- the sources of information used in the product, the timeliness of this information, whether any gaps in information are filled using estimates, and if so, the methods used for arriving at these estimates;
- an evaluation of the criteria utilised in the ESG assessment process, including if they are science-based, quantitative, verifiable, and aligned with existing standards and taxonomies, the relative weighting of these criteria in the process, the extent of qualitative judgement and whether the covered entity was involved in the assessment process; and
- a determination as to the internal processes of the financial market participant for which the product is suitable.

b) Section 2: ESG Rating and Data Providers

Voluntary standard setting bodies and industry associations should promote among their members the following Good Practices (GP):

Good Practice 1: Adopting and implementing written policies and procedures designed to help ensure the issuance of high quality ESG ratings and data products based on publicly disclosed data sources, where possible and other information sources where necessary, using transparent and defined methodologies.

Good Practice 2: Adopting and implementing written policies and procedures designed to help ensure that their decisions are independent, free from political or economic interference, and appropriately address potential conflicts of interest.

Good Practice 3: Identifying, avoiding, or appropriately managing, mitigating, and disclosing potential conflicts of interest.

Good Practice 4: Making adequate levels of public disclosure and transparency a priority for their ESG ratings and data products, including their methodologies and processes.

Good Practice 5: Adopting and implementing written policies and procedures designed to address and protect all non-public information received related to their ESG ratings and data products.

Good Practice 6: Improving information gathering processes with entities covered by their products.

Good Practice 7: Responding to and addressing issues flagged by entities covered by their ESG ratings and data products while maintaining the objectivity of these prod