

International Law Association

LISBON CONFERENCE (2022)

International Securities Regulation Committee

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Mr Paul Stevens (USA): *Rapporteur*
Ms Federica Agostini (UK): *Co-Rapporteur*

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FOURTEENTH REPORT

Introduction

Since the 2020 Kyoto conference, market and regulatory trends have continued clustered around the issues explored at the Committee's conference meeting: the COVID-19 pandemic, sustainable finance and environmental, social and governance issues ('ESG'), as well as financial technology ('Fintech') and the use and monitoring of technology in the financial industry ('RegTech'). Thus, there was a continuing focus on these topics during the Committee's 2021 and Q1 2022 interim meetings.

The COVID-19 pandemic remains virulent, albeit with some abatement and adjustment of responses – but still has a profound influence on markets and regulatory supervision and regulation.

Separately, but in parallel, sustainable finance (investment and ESG have grown in influence as a policy tool and investment drivers at both the institutional and retail level. And Fintech and RegTech are a topic of interest to regulators and the markets with new issues on the horizon. Thus, the Committee agreed to continue its review and analysis of these topics in its 2022 Biennial Report for its 2022 Lisbon meeting.

Part I - Regulatory responses to the COVID-19 crisis

(Mr. Webb, Professor Follak, Professor MacNeil, Mr. Willis)

Key Issues:

- a. Nature and scope of measures adopted and variations by country/region.
- b. How will pandemic-era issues and reforms contribute to financial markets regulation in the longer term?

The Committee has continued to review the response of securities market regulators internationally to the pandemic. It has also explored overlaps and collaboration opportunities with the concurrent work of the ILA MOCOMILA Committee¹, resulting in a joint event at the 2022 Lisbon conference.

Since the onset of the pandemic, regulatory responses can be broadly categorised into three phases. The first, particularly in 2020, involved regulators endeavouring to assess the nature and implications of the crisis, and what its effects on financial markets and the world economy would be. Regulators were having to deal with both the known/unknowns and unknown/unknowns of the crisis at the time. A key focus in that phase was identifying threats to financial stability and individual firms' positions and putting in place temporary measures to address them. The priorities and work programmes of regulators themselves were altered.

The second phase, particularly from 2021, was to assess the continuing need for temporary measures. The third phase, and current primary focus of regulators, can generally be seen as identifying lessons from the crisis for financial market stability and resilience, with COVID-19 being understood as another example of extreme events which put regulatory systems to the test.

In contrast to the 2008 Global Financial Crisis ('GFC'), the COVID-19 pandemic has not so far exposed further major weaknesses in the financial regulatory regime such as to require significant regulatory reform. Indeed, the changes made to financial market regulation as a consequence of the GFC, particularly in relation to the resilience of financial institutions and providing regulators with increased authority, have assisted in mitigating the consequences for financial markets of the COVID-19 crisis.

Comments as to the position in particular countries follow by way of illustration of these themes.

1. United Kingdom

There have been a range of interventions in the UK in response to the pandemic.²

Mortgages and lending

The Financial Conduct Authority of the United Kingdom ('FCA') issued guidance in March 2020 instructing mortgage lenders to provide a 3-month payment holiday where a customer was experiencing or reasonably expected to experience payment difficulties as a result of circumstances relating to coronavirus.³ The guidance was updated in May 2020⁴, providing that where a customer indicated that they could not immediately resume full payments, firms should offer them a further full or partial payment deferral for 3 monthly payments, based on what the customer considered they could currently afford to repay.

¹ On the work by the MOCOMILA committee, see the report drafted for the 2022 Lisbon Conference.

² For more details see Iain MacNeil, Irene-Marié Esser, 'The Pandemic Response in the UK in the Context of Corporate and Financial Law – within and without Law' (2021) available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3636292.

³ See FCA, Mortgages and coronavirus: our guidance for firms (20th March 2020), available at: <https://www.fca.org.uk/firms/mortgages-coronavirus-guidance-firms>.

⁴ See FCA, Mortgages and coronavirus: updated guidance for firms (22nd May 2020), available at: <https://www.fca.org.uk/publications/guidance-consultations/mortgages-coronavirus-updated-draft-guidance-firms>.

The European Banking Authority also issued a statement⁵, in less explicit terms than those of the FCA, calling on lenders to act in the interests of consumers, and regulators in various EU countries followed up with more specific measures.

Relaxation of Pre-emption rights

Pre-emption rights ensure that equity shareholders in at least public listed companies are protected against dilution of their proportionate shareholding when new share issues take place. The principle is a key element of UK and EU corporate law.⁶ As a means of permitting greater flexibility for companies to raise capital to strengthen their balance sheets and in the face of concern about convening meetings of shareholders that might otherwise be necessary, the FCA issued a Policy Statement permitting share issues without pre-emption rights up to 20% of share capital (compared with the standard authorisation of only 5%).⁷ In so doing, the FCA adopted the recommendation of key institutional investors speaking as the 'Pre-Emption Group' which recommended that shareholders support such changes. That relaxation came to an end on 30 November 2020.

Relaxation of rules on Financial Reports and General Meetings of Shareholders

The FCA temporarily relaxed the normal rules on publication of annual and interim reports and the holding of general meetings of shareholders, including the option to hold meetings online.⁸ These changes were formalised in the *Corporate Insolvency and Corporate Governance Act 2020* (UK) and ran until 30 March 2021.

Rationale and legal basis

While the rationale for all these interventions can be linked to the need to respond to the crisis, the legal basis for FCA action provides an illuminating perspective. None of the actions represented a formal exercise of rule-making powers. The mortgage intervention took the form of guidance, which could not impose obligations, but may be relevant for the regulator deciding to take enforcement action and for the interpretation of principles if such action is taken. Moreover, and contrary to normal practice, the guidance had the effect of disrupting private law obligations.

The pre-emption statement was an endorsement of the recommendation of an influential institutional shareholder body.

In the case of annual reports and general meetings, the initial intervention was in the form of a Statement of Practice, which in effect provided a waiver of enforcement or safe harbour to firms from enforcement action. The law was then formally amended.

In contrast with *prudential regulation* (where regulation may use policies, such as the counter cyclical buffer, designed to be adjustable by the Financial Policy Committee), *conduct regulation* has traditionally lacked explicit provision for general adjustment of rules by reference to changes in market context (waivers of rules were possible only for firms on application). Thus, in the United Kingdom, pandemic interventions were *ad hoc*, and were framed without the benefit of an *ex ante* framework for crisis management. While some commentators saw that as problematic, in terms both of the nature of interventions and the process for agreeing action between multiple regulators, others pointed to the need to subordinate considerations of formal legal process and accountability in crisis situations.

Business Interruption Insurance Test Case

As a result of the pandemic many businesses were disrupted, by closure of workplaces, staff or customers being unable to attend, and loss of income. This raised the issue of whether such losses

⁵ See EBA, Statement on consumer and payment issues in light of COVID 19 (25th March 2020), available at <<https://eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures>>.

⁶ The principle is not universal: it can be disapplied with shareholder approval; some other capital markets (such as the US) do not adopt it as such; it is part of the listing rules of the Australian and New Zealand stock exchanges.

⁷ See FCA, Listed companies and recapitalisation issues during the coronavirus crisis (8th April 2020), available at <<https://www.fca.org.uk/news/statements/listed-companies-recapitalisation-issuances-coronavirus>>.

⁸ Ibid.

were covered by business interruption insurance. With a view to providing clarity and legal certainty to the market, the FCA brought a test case focusing on 21 types of policy issued by 8 insurers.⁹ The FCA's role was to put forward policyholders' arguments to their best advantage in the public interest. The test case was not intended to encompass all possible disputes, but to resolve some key contractual uncertainties and 'causation' issues to provide clarity for policyholders and insurers.

At first instance, the High Court held that most of the 'disease' clauses and certain 'prevention of access' clauses (12 policy types from the sample of 21, issued by six insurers) provided cover and that the pandemic and the Government and public response caused the business interruption losses. The six insurers appealed those conclusions for 11 of the policy types, but the Supreme Court dismissed those appeals, for different reasons from those of the High Court.¹⁰ Following the Supreme Court ruling, the FCA issued guidance clarifying how policyholders could make claims and how insurers should respond.¹¹

2. Australia and New Zealand

The Australian Prudential Regulation Authority ('APRA'), responsible for the prudential regulation of banks and other lending institutions, insurers and pension funds, and the Australian Securities and Investments Commission, responsible for the regulation of all securities and investments markets and of licensed financial market participants, worked together to identify risks, share information and adjust regulatory priorities. Particular areas of focus included liquidity monitoring of financial institutions and of licensed professionals, the disclosure obligations of listed companies and issuers of securities and other investment products, and some dispensations in terms of reporting obligations and directors' duties.

Some of these matters were addressed under temporary enabling powers granted by wide-ranging legislation, passed by the federal Parliament as early as March 2020.¹² These included power to the relevant Minister to disapply or modify any provision of the legislation governing securities and investments shareholder meetings, issues of securities and reporting; additionally there were temporary alterations to insolvency and bankruptcy triggers.¹³ Initially in place for 6 months, these powers were extended several times. Other amendments permitted execution, witnessing and attesting of formal legal documents by electronic means, and the conduct of shareholder meetings by video or other electronic means similarly.¹⁴ These latter changes were made permanent in early 2022.¹⁵

The systemic lessons to be drawn from the COVID-19 pandemic are reflected in a regulatory discussion paper, "*Strengthening Crisis Preparedness*" released in December 2021 by APRA, accompanied by two draft prudential standards, which if adopted have the force of law. The topics of these standards, Financial Contingency Planning and Resolution Planning, are of pre-existing concern for securities and financial market regulators. They require regulated institutions to set out an approved plan for how to the institution would respond to a stress that threatens its viability, and correspondingly, how to resolve the institution if it is not viable. The standards are relatively brief and reflect a 'principles-based' philosophy, of the kind this Committee has studied in the past. While the purpose of each standard is

⁹ *Financial Conduct Authority v Arch Insurance (UK) Ltd* [2020] EWHC 2448 (Comm); [2020] Lloyd's Rep IR 527 (15 Sept 2020). The proceedings were heard in July 2020 on an expedited basis under the Financial Market Test Case Scheme set out at Practice Direction 51M of the Civil Procedure Rules.

¹⁰ *Financial Conduct Authority v Arch Insurance (UK) Ltd (Hiscox Action Group intervening)* [2021] AC 649; [2021] UKSC 1 (15 Jan 2021) and for a summary <<https://hsfnnotes.com/insurance/2021/01/15/supreme-court-hands-down-judgment-in-fcas-covid-19-business-interruption-test-case/#more-2194>>..

¹¹ See <<https://www.fca.org.uk/firms/business-interruption-insurance>>.

¹² *Coronavirus Economic Response Package Omnibus Act 2020* (Australia) ('Omnibus Act')(March 2020), schedule 8 ('Providing flexibility in the Corporations Act')

¹³ Omnibus Act, Schedule 12 ('Temporary relief for financially distressed individuals and businesses').

¹⁴ *Coronavirus Economic Response Package Omnibus (Measures No. 2) Act 2020* (April 2020) and *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Australia) (December 2020).

¹⁵ *Corporations Amendment (Meetings And Documents) Act 2022* (Australia) (February 2022).

clearly expressed and confines the regulator accordingly, the generality of the outcomes to be achieved give the regulator considerable power over the detail.

In New Zealand, initial securities regulatory responses to COVID-19 included intervention through guidance and formal exemptions, and legislative intervention. Examples were temporary standstill arrangements, modification of directors' duties, and relaxation of statutory deadlines. The temporary measures have generally ended. There is a general recognition that entities have been, and will continue to be, affected differently during the crisis, with current legislative and regulatory structures generally providing sufficient mechanisms to address issues arising, rather than significant regulatory reform being required.

The Council of Financial Regulators, comprising the Reserve Bank of New Zealand, Financial Markets Authority, Commerce Commission, Ministry of Business, Innovation and Employment, and the Treasury, continues to meet regularly to discuss the impact of COVID-19 and consider ways to support financial markets in addressing the challenges COVID-19 may continue to present. COVID-19 issues are tending to be considered in the context of particular regulatory themes such as conduct and governance, digital and innovation, and regulatory burden, rather than as a major workstream or focus in itself.

3. International regulatory initiatives

Consistent with the third phase of regulatory response noted above, COVID-19 is continuing to be an important case study in assessing the effectiveness of financial market regulatory frameworks and the resilience of the financial system. Examples of current work being undertaken by international agencies include the continuing work of the International Organisation of Securities Commissions (IOSCO) in its examination of the operational resilience of trading venues and market intermediaries during the COVID-19 pandemic as well as on financial markets infrastructure business continuity planning.¹⁶

4. Linkages

As noted in the Committee's 2020 report, the legal and regulatory responses to COVID-19 continue to demonstrate that securities market regulation cannot be siloed from broader financial market regulation, domestic and internationally; and that securities market regulatory law cannot be considered separately from financial markets law, contract law and company and insolvency law in particular.

Part II - Sustainable finance and ESG

(Professor MacNeil, Mr. Grebler, Professor Kuronuma, Ms. Levine, Professor Andenas, Mr. Webb, Mr. Stevens, Professor Follak, Ms. Agostini)

Key Issues

- a. Regulatory initiatives at the national, regional and global level.
- b. Sustainability issues at entity level: corporate due diligence requirements
- c. Sustainability issues at market level: capital markets and regulatory responses to ESG
- d. Green bonds – classification and use of proceeds

¹⁶ Board of IOSCO, Thematic Review on Business Continuity with respect to Trading Venues and Intermediaries, Final Report (May 2021) FR03/21, available at: <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD675.pdf>>; Committee on Payments and Market Infrastructures, and Board of IOSCO, Implementation monitoring of PFMI: Level 3 assessment of FMI's business continuity planning (July 2021), available at: <<https://www.bis.org/cpmi/publ/d197.pdf>>.

1. Introduction

In the global context, “ESG” stands for environment, social and governance. Traditionally, asset management was focused on maximizing risk-adjusted financial returns. Now, ESG investing has been adopted by both institutional investors and retail savers. According to Bloomberg Intelligence, ESG assets surpassed \$35 trillion in 2020 up from \$30.6 trillion in 2018 and \$22.8 in 2016, reaching a third of total global assets under management.¹⁷ Assuming 15 per cent growth, half of the pace of the last five years, ESG assets could exceed \$50 trillion by 2025.¹⁸

This growth has been driven by both policy and market demand. “Sustainable Finance” – the process of “taking account of ESG considerations when making investment decisions in the financial sector, leading to increased longer-term investments into sustainable economic activities and projects”¹⁹ – now drives economic policy, with policymakers looking to investors and other financial institutions to support environmental and social impact. The European Union (with the United Kingdom as a member) was a thought leader in this arena; it has continued to push the boundaries. The UK is following a separate but equally ambitious path.²⁰ In the US the Biden White House is taking climate seriously,²¹ with regulators starting to focus on ESG – particularly disclosure.²²

At the beginning of the COVID-19 pandemic, there were questions about whether the focus on climate change and social considerations would endure. But the pandemic only seems to have reinforced the public’s appetite for ESG investing and placed a new emphasis on social alongside environmental issues – the new mantra is “Build Back Better”.²³

Part of the emphasis on Sustainable Finance has centred on the ESG bond market – and raising funds with a sustainable purpose, i.e. committed to financing “green” and social projects. Green Bonds as a sub-category are defined as bond instruments committed to financing environmental or climate-related projects. Although Social Bond issuance is accelerating, the ESG bond market is dominated by the “green” segment with a volume of over €1tn outstanding, approx. 550bn thereof issued by entities located in the EU. The private sector’s share is estimated above 50%, dominated by the financial industry.²⁴ Actually, it all started in the EU with the world’s first Climate Awareness bond issued by the European Investment Bank (EIB) in 2007.²⁵

In 2020 UK Chancellor Rishi Sunak announced the UK’s intention to extend its global leadership in green finance and financial technology – including plans for a Sovereign Green Bond.²⁶

The UK “Green Gilt” was highly successful. Sales in September and October 2021 raised a total of £16 Billion to help fund green projects, drive progress to net zero, and create jobs across the UK. The order

¹⁷ Bloomberg, ‘ESG Assets Rising to \$50 Trillion Will Reshape \$140.5 Trillion of Global AUM by 2025, Finds Bloomberg Intelligence’ *Bloomberg* (London and New York, 21 July 2021) <www.bloomberg.com/company/press/esg-assets-rising-to-50-trillion-will-reshape-140-5-trillion-of-global-aum-by-2025-finds-bloomberg-intelligence/>.

¹⁸ Ibid.

¹⁹ EU Commission, ‘Overview of sustainable finance’ <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en>.

²⁰ Jim Pickard, Daniel Thomas and Mathew Vincent, ‘Rishi Sunak to announce UK’s first green gilts’ (*Financial Times*, 9 November 2020) <www.ft.com/content/54a81c62-bcf7-431b-81ac-63ad22637363> accessed 25 January 2022

²¹ Mathew Daly and Lisa Mascaro, ‘On climate change, Biden \$3.5T plan making up for lost time’ (AP, 29 September 2021) <<https://apnews.com/article/climate-change-joe-biden-business-environment-and-nature-environment-e9b976d57b1b8b35e459c9950b34fca0>> accessed 25 January 2022

²² US Securities and Exchange Commission (SEC), ‘The Division of Examinations’ Review of ESG Investing’ (9 April 2021) 2 <<https://www.sec.gov/exams/announcement/risk-alert-esg>>.

²³ See Part II, Section 4 below.

²⁴ ESMA, ‘Report on Trends, Risks and Vulnerabilities 2021 No. 2’ (2021) 95, available at: <https://www.esma.europa.eu/sites/default/files/library/esma50-165-1842_trv2-2021.pdf>.

²⁵ See EIB, ‘Evaluation of the EIB’s Climate Awareness Bonds’ (April 2021), 47 available at: <https://www.eib.org/attachments/ev/ev_report_evaluation_eib_climate_awareness_bonds_en.pdf>.

²⁶ HM Treasury, ‘Chancellor sets out ambition for future of UK financial services’ (9 November 2020) <<https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services>>.

book for the first sale was ten times oversubscribed and for the second was 12 times oversubscribed showing the large demand for green investment.²⁷ The Green Gilt also reflects the concept of a Just Transition – with its additional focus on “social co-benefits.”²⁸

2. Global regulatory context

Much of the new regulation to date has focused on disclosure and process, rather than prescription. The Financial Stability Board (‘FSB’) took up the subject in 2015 with its Task Force on Climate-Related Financial Disclosures (‘TCFD’), publishing a final report in 2017, including a set of key recommendations.²⁹ IOSCO and the market regulators followed with a Sustainability Finance Task Force to come up with recommendations about sustainability-related practices, policies, procedures and disclosures in the asset management industry, published in November 2021.³⁰ These recommendations can be classified as soft law in the sense of “expectations” on asset managers.

In 2018, the EU Commission adopted an Action Plan on financing sustainable growth, drafted by a High-Level Expert Group on Sustainable Finance. From this base, three key regulations with direct force of law in all Member States have been issued:

- Regulation (EU) 2019/2088 on disclosures relating to sustainable investments and risks (so-called “Sustainable Finance Disclosure Regulation”);
- Regulation (EU) 2019/2089 on benchmark requirements for EU Climate Transition Benchmarks (so-called “Low Carbon Benchmarks Regulation”);
- Regulation (EU) 2020/852 (so-called “Taxonomy Regulation”) to create a sustainable taxonomy, to be specified by delegated acts adopted by the Commission.

The launch of the EU Green Deal has accelerated the EU’s commitment to sustainability objectives, culminating in a Renewed sustainable finance strategy presented in July 2021.³¹

The UK followed with its Green Finance Strategy announced in July 2019.³² The strategy focuses on global and domestic climate and environmental objectives – and recognises the role of the financial sector. The strategy encompasses two objectives: (i) aligning private sector financial flows with clean, environmentally sustainable and resilient growth supported by Government action, and (ii) strengthening the competitiveness of the UK financial sector.

With the COVID-19 pandemic, the EU Green Deal and UK Green Finance Strategy were translated into Green Recovery policies. Both the EU and UK have included a pledge on climate change in their recovery plans.

The UK’s leadership of the G7 and co-chair role with Italy of COP26 resulted in an extensive COP26 programme of events in Glasgow in November 2021, and the formation of a new Impact Investing Task

²⁷HM Treasury, ‘Second UK Green Gilt raises further £6 billion for green projects’ (21 October 2021) <<https://www.gov.uk/government/news/second-uk-green-gilt-raises-further-6-billion-for-green-projects>>.

²⁸ Impact Investing Institute, ‘Green+ Gilt’ <<https://www.impactinvest.org.uk/project/green/>>.

²⁹ TCFD, ‘Final report – Recommendations of the Task Force on Climate-Related Financial Disclosures’ (2017), available at: <<https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf>>.

³⁰ IOSCO, Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management - Final Report (2021) FR08/21, available at <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD688.pdf>>.

³¹ Communication From The Commission To The European And The European Economic And Social Committee And The Committee Of The Regions Parliament, The Council, ‘Strategy for Financing the Transition to a Sustainable Economy’ (2021).

³² HM Treasury and Department for Business, Energy and Industrial Strategy, ‘Green Finance Strategy’ (hereinafter “UK Green Finance Strategy”) (2 July 2019) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf>.

Force (“Impact Task Force”).³³ In addition to the meetings and agreements discussed below, the Glasgow COP26 saw unprecedented participation by the financial services sector with a full programme of Sustainable Finance events. These included the Green Horizon Summit hosted by the Green Finance Institute and The City of London Corporation, which tackled key barriers to mobilising capital, how to finance transition and growth, how to build a global green finance playbook, how to price carbon and nature, and how to meet the \$100 Billion international climate finance challenge.³⁴

There are also significant developments in the US and Japan which are discussed in the sections below.

3. EU Regulatory Framework

The EU Taxonomy

The cornerstone of the EU 2018 Sustainable Finance Action Plan is a classification system for economic activities and financial products which contribute to sustainability objectives (“Taxonomy”). The Renewed Sustainable Finance Strategy has emphasized the central role of the Taxonomy in advancing the EU sustainability agenda and in supporting the recovery from the COVID-19 pandemic.³⁵ It rests on a series of general principles, enshrined in a Regulation, as well as on a set of technical criteria, which will be laid out in various Delegated regulations.

The Regulation 2020/852 (‘Taxonomy Regulation’)³⁶ lists six specific sustainability objectives: climate change mitigation, climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems. “Sustainable” economic activities and financial products will be those that substantially contribute to at least one of these objectives while “not significantly harming” any of the other ones.³⁷ They will also have to observe minimum safeguards laid out in international soft law instruments like the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

More importantly, they will have to comply with a series of technical screening criteria, established by the EU Commission on the basis of the recommendations of a multi-stakeholder group (the “Platform on sustainable finance”).³⁸ So far, they have only been introduced for economic activities that contribute to climate change mitigation and adaptation, but not to the other four, objectives.³⁷

Their scope is broad, encompassing different macro-sectors like 1) agriculture and forestry, 2) manufacturing, 3) electricity generation, 4) water, sewerage, waste and remediation, 5) transportation and storage, 6) information and communication technologies (ICT) and 7) buildings. In so doing, it is expected to cover the economic activities of roughly 40% of the companies listed in EU.³⁸

The Delegated Regulation not only contemplates fully-aligned activities, but also “transitional” ones. While these do not fully comply with the technical criteria, they would still be in line with the

³³ Impact Investing Institute, ‘Press Release: UK backs Impact Taskforce under its G7 presidency led by the Impact Investing Institute and the Global Steering Group for Impact Investment’ (12 July 2021) <<https://www.impactinvest.org.uk/press-release-uk-backs-impact-taskforce-under-its-g7-presidency-led-by-the-impact-investing-institute-and-the-global-steering-group-for-impact-investment/>> accessed 25 January 2022; United Nations Climate Change, ‘The UK-Italy Partnership’ (UN Climate Change Conference ‘COP26’) <<https://ukcop26.org/pre-cop/>>.

³⁴ City of London Corporation, ‘Green Horizon Summit at COP 26’ (17 December 2021)

<<https://www.cityoflondon.gov.uk/supporting-businesses/economic-research/financial-and-professional-services-digital-events/green-horizon-summit/>>.

³⁵ *ibid.*

³⁶ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

³⁷ EU Commission Delegated Regulation 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives.

³⁸ EU Commission, ‘Frequently asked questions: What is the EU Taxonomy and how will it work in practice?’

<https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-faq_en.pdf>

Taxonomy if i) they provide a contribution to climate change mitigation objectives, ii) their GHG emission levels correspond to the best performance in the sector and iii) there are no low-carbon alternatives.³⁹ “Enabling activities”, which do not directly contribute, but rather enable other activities to further environmental objectives (e.g. manufacturing and research for the creation of renewable energy), are also in principle in line with the Taxonomy.⁴⁰

In parallel, work is ongoing to expand the scope of the Taxonomy beyond the current focus on climate change mitigation and adaptation. A Subgroup of the multi-stakeholder Platform has advised the Commission on the steps towards the development of a potential “Social taxonomy”. Its focus on social objectives should facilitate a “just transition”.⁴¹

A recent report also assesses different possibilities to design additional technical criteria related to environmental objectives (“Extended environmental taxonomy”). It is worth noting that the Platform on Sustainable finance has recommended a classification system not merely identifying what is “green”, as the current Taxonomy, but rather potentially covering the entire economy. It would classify economic activities on the basis of their different environmental impacts, categorising them as “green” (if they substantially contribute to environmental objectives), “red” (if they do significant harm), “amber” (if they have an intermediate impact) or “grey” (if they neither substantially contribute nor do significant harm).⁴²

The Taxonomy forms the basis for a series of other measures advancing the EU sustainable finance agenda. First, financial and large non-financial undertakings as well as asset managers are required from January 2022 to disclose the proportion of their turnover, capital expenditures, operational expenditures and total assets in line with the Taxonomy.⁴³ A proposed Corporate Sustainability reporting directive may further extend the scope of the companies subject to this obligation.⁴⁴

Second, the Sustainable finance Disclosure Regulation requires financial products that claim to be promoting social or environmental objectives among other characteristics or that have ‘sustainable investment’ as their main objective to disclose their alignment to the Taxonomy.⁴⁵ The Multi-stakeholder platform has recommended aligning these reporting obligations to the ‘Extended Environmental Taxonomy’ criteria. This should allow a more thorough disclosure of the impact of all market participants on sustainability objectives.

Third, the EU and member states willing to introduce new public measures, standards or labels to identify “sustainable” economic activities will have to apply the same criteria.⁴⁶ As a result, the recent proposal for a Regulation on a EU Green Bond Standard (EuGB) defines these securities as “green” when all the proceeds are used in accordance with the Taxonomy criteria.⁴⁷

General comments on the Taxonomy

The science-based approach applied in the design of the taxonomy seems a very ambitious first step to address “greenwashing”. However, several commentators, investors and activists have raised concerns about the reliability of this classification system after the introduction of additional technical

³⁹ Art 10 (1) Delegated Regulation 2021/2139.

⁴⁰ Art 10 (2) *ibid.*

⁴¹ Platform on Sustainable finance, ‘Draft Report by Subgroup 4: Social Taxonomy (July 2021) available at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf’.

⁴² Platform on Sustainable finance, ‘The Extended Environmental Taxonomy: Final Report on Taxonomy extension - options supporting a sustainable transition’ (April 2022) available at:

https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/220329-sustainable-finance-platform-finance-report-environmental-transition-taxonomy_en.pdf.

⁴³ EU Commission Delegated Regulation 2021/2178 of 6 July 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation.

⁴⁴ Proposal for a Directive Of The European Parliament And Of The Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting.

⁴⁵ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

⁴⁶ Art 4 Taxonomy Regulation.

⁴⁷ See below section on the EuGB.

criteria for gas and nuclear activities in February 2022.⁴⁸ The link between the taxonomy and public expenditures in support of a “green” recovery from the COVID pandemic is also unclear.⁴⁹

EU Green Bond Standard and Green Bond Regulation

As part of the EU Commission action plan on Sustainable Finance, the Technical Expert Group on Sustainable Finance drew up recommendations for an EU Green Bond Standard. In June 2021, the Commission started formal procedures for an inception impact assessment in respect of the establishment of an EU Green Bond Standard. In July 2021, the Commission published a legislative proposal for a Regulation with direct force of law in all Member States with the title “Regulation of the European Parliament and of the Council on European green bonds”⁵⁰ - a “common framework of rules regarding the use of the designation ‘European Green Bond’ or ‘EuGB’ for bonds that pursue environmentally sustainable objectives within the meaning of the Taxonomy Regulation discussed above.”⁵¹ As of May 2022, the EU Council has agreed its position in relation to the development of the Standard and it is ready for the negotiations with the Parliament.⁵²

In essence, the Green Bond Standard is a harmonized voluntary standard for a green bond at Union level, a uniform framework for all green bond issuers (public and private entities, including financial and non-financial undertakings) that voluntarily wish to use the designation: “This Regulation lays down uniform requirements for issuers of bonds that wish to use the designation ‘European green bond’ or ‘EuGB’ for their environmentally sustainable bonds made available to investors in the Union, and establishes a registration system and supervisory framework for external reviewers of European green bonds” (Art. 1). It covers all types of bonds, including covered bonds and securitisations, the securities of which are issued by a special purpose vehicle and backed by a portfolio of assets.⁵³ It was unclear at the time of the Proposal whether there would be room for a stand-alone framework for sustainable securitisation, differing from the EuGB.⁵⁴ The European Banking Authority (‘EBA’), instructed to draft a report on the matter,⁵⁵ concluded that it would be premature for the time being. While it agreed on the application of the EUGBS to securitised bonds, it also recommended adjustments to the wording of the Proposal to take into account the peculiarities of these financial transactions.⁵⁶

The Regulation comprises the following components including the standardization of sustainable market practices, enhanced disclosure, and a system for the registration and supervision of external reviewers validating allocation of proceeds and environmental impact:

Requirements related to issuers and issuance

- Basic principle: “The designation ‘European green bond’ or ‘EuGB’ shall only be used for bonds that comply with the requirements set out in this Title until their maturity” (Art. 3).

⁴⁸ EU Commission Delegated Regulation of 9.3.2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities, available at: <https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2022-631_en.pdf>.

⁴⁹ see “*The EU sustainable finance taxonomy will guide investment in Europe’s recovery to ensure they are in line with our long-term ambitions.*” Communication From The Commission To The European Parliament, The European Council, The Council, The European Economic And Social Committee And The Committee Of The Regions - Europe’s moment: Repair and Prepare for the Next Generation (2020) 456.

⁵⁰ COM (2021) 391 final

⁵¹ Ibid., Explanatory Memorandum.

⁵² European Council, Regulation of the European Parliament and of the Council on European green bonds - mandate for negotiations with the European Parliament (8 April 2022) ST 7379 2022 INIT - NOTE, <<https://data.consilium.europa.eu/doc/document/ST-7379-2022-ADD-1/x/pdf>>.

⁵³ Ibid., Explanatory Memorandum.

⁵⁴ Ibid, fn 11.

⁵⁵ Art 45a Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 crisis.

⁵⁶ EBA, ‘Report on developing a framework for sustainable securitisation’ (2022) EBA/REP/2022/06 available at: <https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf>.

- Allocation of bond proceeds fully in accordance with the EU Taxonomy Regulation.
- Prior to public offer: publication of a specific fact sheet with pre-issuance assessment by an external reviewer (Art. 8).
- Annual allocation reports and post-issuance review by an external reviewer of the first allocation report following full allocation of bond proceeds to be published (Art. 9).
- Impact report after full allocation of proceeds (Art. 10).
- Supervision of bond issuers by national competent authorities in respect of the above requirements.
- In addition, the regular EU prospectus requirements under Regulation (EU) 2017/1129 apply as the case may be.
- Sovereign issuers may use bond proceeds to indirectly finance economic activities that are aligned with the EU taxonomy framework, e.g. through the use of subsidy programmes.
- For securitisation transactions, the EBA has proposed adjusting the wording of the Proposal and assessing whether securitisation deals are in line with the EuGB on the basis of the originating entity. In other words, the Regulation should allow to use the EuGB designation even when the underlying portfolio is not "green" as long as the operation leads to the implementation of projects in line with the EU Taxonomy (in line with the general "use of proceeds" approach already emerging from the Proposal).

Regulation on providing review services related to EuGBs

- Establishment of a centralized registration system and supervisory framework for external reviews and reviewers of European green bonds, coordinated by the ESMA (Title III), including provision of services by third-country external reviewers. Related supervisory powers are entrusted to the ESMA.

European Passport

"Furthermore, the framework is intended to be usable by issuers both within and outside the Union, when making bonds available to Union investors".⁵⁷ "The Commission may adopt a decision in relation to a third country stating that...the legal framework of that third country provides for an effective equivalent system for the recognition of external reviewers registered or authorised under third-country legal regimes"(Art. 32).

Conclusion

The proposed EU Green Bond Regulation seems to be well suited to promote climate and environmentally-friendly investments and protect investors from the risk of "greenwashing".

4. UK Sustainability Regulation

The UK has made good on its commitment to create an ambitious framework for sustainability regulation. Most recently, the UK government announced its intention to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant proportion of mandatory requirements in place by 2023. The UK Taskforce's Interim Report and accompanying Roadmap⁵⁸ set out a pathway to do so, based on the TCFD.

In October 2021, in advance of COP26, the UK Government released its "Greening Finance: A Roadmap to Sustainable Investing" with concrete plans to roll out TCFD disclosure across the financial and pensions sectors.⁵⁹

⁵⁷ Ibid., Explanatory Memorandum.

⁵⁸ HM Treasury, 'A Roadmap towards mandatory climate-related disclosures' (November 2020) available at: <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf>.

⁵⁹ HM Government, 'Green Finance: A Roadmap to Sustainable Investing' (October 2021) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1031805/CCS082110272-2-006_Green_Finance_Paper_2021_v6_Web_Accessible.pdf> accessed 25 January 2022

The paper states that:

- Products will need to set out their impact, and justify their sustainability claims;
- Asset managers will need to set out how they incorporate sustainability into their investment strategies;
- There will be expectations around the publication of transition plans to net zero; and
- Financial firms and pension schemes will be expected to use this information to shift financial flows to align with a net zero economy.

TCFD rules

It also outlined plans for TCFD-aligned Listing Rules for UK listed issuers, and Sustainability Disclosure Requirements (“SDR”), including entity- and product-level disclosures by asset managers and asset owners, and in respect of investment products. By the end of December 2021, the UK Financial Conduct Authority (“FCA”) put in place climate-related disclosure requirements reflecting a “double-materiality” approach and aligned with the TCFD’s recommendations covering companies, asset managers and other financial firms, and pension schemes and providers.⁶⁰

Disclosure and Labels

FCA set out the rules for investors in its policy statement entitled “Enhancing climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers”.⁶¹ It also set up a Disclosures and Labels Advisory Group (‘DLAG’), an expert advisory group made up of key financial market stakeholders and subject matter experts to provide independent advice to FCA on the development and implementation of new sustainability-related financial disclosure requirements and a sustainable classification and labelling system for investment products (or “labels”) aligned with the Roadmap.⁶² Part of this work will be considering how the new UK SDR will sit with the EU Sustainable Finance Disclosure Regulation (SFDR), which is a parallel body of legislation.

Stewardship Code

Finally, no discussion of UK governance standards would be complete without a mention of the UK Stewardship Code.⁶³ The UK Stewardship Code is aligned with UK company law and contains principles for institutional investors to follow in engaging with companies. It is a voluntary code for asset managers, asset owners and service providers and comprises a set of “apply and explain” principles for asset managers and owners, and a separate set for service providers. The first version was released in 2010. The most recent revision of the Stewardship Code covers environmental (in particular, climate change) and social factors, in addition to governance, as material issues for investors to consider when making investment decisions and undertaking stewardship.

5. US Regulatory Framework

While consideration of ESG factors are not new considerations in US markets, there have been limited regulatory developments to date. Neither reporting companies nor shareholders, as of this writing, are subject to ESG-specific regulatory requirements. However, the U.S. Securities and Exchange Commission (“SEC”) under Chair Gary Gensler has put on the SEC’s long-term agenda a potential rule-making that would impose uniform climate risk disclosure standards for reporting companies. As of this writing, the SEC has not publicized formal proposals, but it is widely expected to impose sweeping

⁶⁰ FCA, ‘Climate-related reporting requirements’ (17 December 2021) <<https://www.fca.org.uk/firms/climate-change-sustainable-finance/reporting-requirements>>.

⁶¹ FCA, ‘PS21/24: Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers’ (December 2021) <<https://www.fca.org.uk/publication/policy/ps21-24.pdf>>.

⁶² FCA, ‘Disclosures and Labels Advisory Group (DLAG), ‘Terms of Reference’, available at: <<https://www.fca.org.uk/publication/fca/dlag-terms-of-reference.pdf>>

⁶³ Financial Reporting Council (FRC), ‘The UK Stewardship Code’ (2020) available at: <https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Final2.pdf>.

requirements on reporting companies to disclose information about the impact of their operations on the global climate as it relates to a contribution to global warming.

As formal rulemakings are pending, the SEC has increased scrutiny of the use of ESG factors and disclosures. The regulatory focus has so far been directed at examinations and enforcement actions against companies for misleading statements by asset managers about investment processes and adherence to global ESG frameworks, proxy voting practices that may be inconsistent with proxy voting policies and ESG frameworks, and internal policies and procedures that are inadequate to ensure the accuracy of disclosures. In addition to the pending regulatory developments at the SEC, the U.S. Department of Labor (“DOL”), which imposes rules that apply to workplace investment and pension plans, has taken steps to facilitate the inclusion of ESG investments on retirement plan menus.

6. Recent Developments in Japan

Regulatory Initiatives and responses to ESG

In Japan the Corporate Governance Code, which was revised in June 2021, states that companies listed on the Prime Market of the Tokyo Stock Exchange should enhance the quality and quantity of disclosure based on the Task Force on Climate related Financial Disclosures’ (TCFD’s) recommendations or an equivalent framework.⁶⁴

In addition, statutory disclosure of ESG items in corporate annual reports is under discussion at Financial Services Agency. The IFRS Foundation, the International Reporting Standards setter, released recommendations in 2020 and it is currently advancing its efforts to set up a new standard setter (International Sustainability Standards Board (ISSB)) to develop uniform reporting standards on sustainability for companies. Japanese reporting standards of ESG items would be developed in accordance with those of ISSB in the near future.

As to Transition Finance, the Taskforce on Preparation of Environment for Transition Finance was set up in January 2021. This taskforce formulated basic guidelines to clarify the concept of transition finance in the climate change field in May 2021.⁶⁵

Sustainability issues at entity and market level

In Japan, the revision of the Stewardship Code in 2020 has positioned the consideration of medium- to long-term sustainability including ESG factors as consistent with stewardship responsibilities of institutional investors. It is considered that taking into account ESG factors based on the meaning of sustainable finance can be positioned as a desirable measure in fulfilling fiduciary duty, even in Japan.⁶⁶

Although there is no statutory requirement on institutional investors in Japan, 309 of them endorse the Stewardship Code, 93 of them sign the Principles for Responsible Investment (PRI) and 86 of them disclose information based on TCFD recommendations as of the end of 2021.

Since 2018, the numbers of new ESG-related funds greatly increased. The problem is that there has not been enacted any taxonomy on which funds can be called ESG funds.

Green bonds

In January 2018 the Japan Exchange Group has established a platform for disclosing information on securities listed as green or social bonds on the Tokyo Pro Bond Market, a bond market intended for professional investors. The platform aims at promoting issuance and trading of green/social bonds by providing those bond issuers a place to disclose on voluntary basis the use of proceeds, annual reports, the reviews by outside auditors, and other related information. It is desirable to develop a standard which provides objective certification of eligibility of ESG related bonds in Japan.

⁶⁴ Supplementary Principle 3.1.3 of Corporate Governance Code, available at: <<https://www.jpix.co.jp/english/equities/listing/cg/tvdivq0000008jdy-att/20210611.pdf>>.

⁶⁵ Financial Services Agency, Ministry of Economy, Trade and Industry, and Ministry of the Environment, Basic Guidelines on Climate Transition Finance, available at: <https://www.fsa.go.jp/news/r2/singi/20210507_2/04.pdf>.

⁶⁶ Report by the Expert Panel on Sustainable Finance (June 2021) at 5, available at: <<https://www.fsa.go.jp/news/r2/singi/20210618-2/04.pdf>>.

7. New Zealand – Mandatory Climate-related Disclosures

In October 2021, New Zealand enacted the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021.⁶⁷ This legislation designates the largest financial market participants as ‘climate reporting entities’ with obligations to keep climate-related disclosure records and to prepare climate statements that comply with the climate-related disclosure framework mandated under that legislation. This statutory framework requires the largest financial market participants in New Zealand to disclose information about the risks and opportunities climate change presents to their businesses, on a clear, comparable, and consistent basis. The legislation gives the External Reporting Board (XRB), New Zealand’s financial reporting standard setter, the function of issuing climate standards under the climate-related disclosure framework, and guidance on environmental, social and governance (ESG) matters.

The XRB is undertaking consultation on what will be its first climate standard, *Aotearoa New Zealand Climate Standard 1: Climate-related Disclosures (NZ CS 1)*. NZ CS 1 is the main disclosure standard and will be based on the recommendations of the Task Force on Climate-related Financial Disclosures. The first phase of consultation has focused on governance and risk management aspects, and the second phase is focusing on standards for the strategy and metrics and targets.⁶⁸

After the issue of NZ CS1, the XRB intends to issue two further instruments, NZ CS2, which will be an adoption standard, and NZ CRDC, which will be an authoritative notice containing key concepts, such as materiality. The XRB is anticipating issuing a standard by December 2022. On this basis, climate reporting entities will be required to disclose for accounting periods that start on or after 1 January 2023.

8. Further reflection on Fiduciary Duty

Two forms of fiduciary duty operate to control the extent to which corporate strategy and operations could focus on sustainability or ESG related outcomes.⁶⁹ The first is the duty owed by directors to the company (and in some instances to shareholders). The second is the duty owed by institutional investors to their underlying investors. It might well be argued that in an ideal world, both forms of fiduciary duty would be aligned so as to reflect the underlying logic that they serve the same purpose. But that perspective conflates the interests of the company and the shareholders in a manner that is inconsistent with the (increasing) role of stakeholders in many systems around the world.

Thus, if stakeholders are to have a meaningful role in corporate governance, it seems inevitable that corporate fiduciary duty would have to adjust to accommodate that role. On the other hand, that adjustment would not carry direct implications for fiduciary duty in the investment chain since that duty is focused primarily on financial risk and return and the relationship between institutional investors and their underlying clients. The different focus of the two forms of fiduciary duty means they have different objectives and represent different interests. Even if they share an overarching objective of promoting the success of the company, their respective framing of the role of shareholders and stakeholders is quite different and so they are unlikely to operate in unison.

In the light of this asymmetry, it was inevitable that, as the momentum of public policy moved towards sustainability, a choice would have to be made as to which form of fiduciary duty would be prioritised in pursuit of those goals. While elements of each approach (financial or entity) were present under the older model of corporate social responsibility that pre-dated ESG and would likely persist whatever option was selected, it was inevitable that a choice of approach would be necessary for a coherent

⁶⁷ Available at <<https://legislation.govt.nz/act/public/2021/0039/latest/whole.html#LMS479781>>.

⁶⁸ XRB, ‘Climate-related disclosures’, available at: <<https://www.xrb.govt.nz/standards/climate-related-disclosures/>>.

⁶⁹ See for a more detailed treatment Iain MacNeil, Irene-Marié Esser, ‘From a Financial to an Entity Model of ESG’ (2022) available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3834529>.

system to evolve. The development of ESG suggests that there was little or no explicit debate around this choice, but that does not in principle exclude the possibility of choice. In hindsight it seems that the absence of debate is itself evidence of the ‘financialized’ version of ESG having been in the ascendancy from an early stage and having effectively precluded debate around the ‘entity’ option. It would also tend to suggest that the public policy ‘push’ towards the financialized version represented by initiatives such as the UN SDGs and the endorsement of the PRI paid more attention to the ‘what’ (sustainability) rather than the ‘how’ (which would likely have led to a more explicit focus on policy choices). And while the global financial crisis (GFC) might have been expected to generate some pushback against the financialized model, reflecting the more general pattern of reaction to the global financial crisis, the trend was already well established by then and so less amenable to change. On the contrary, the boost to ‘stewardship’ provided by the GFC, driven by the perception that it exposed weaknesses in corporate governance, likely solidified the financialized model by opening up a clearer process for investor activism and engagement and by linking it to ‘intermediary’ fiduciary duty.

Legal uncertainty would likely affect both corporate and intermediary fiduciary duty. Thus, the presence of such uncertainty might suggest that neither would be better placed than the other, from the perspective of legal risk, as a conduit for developing ESG. However, three factors suggest otherwise.

- *Individual vs collective action.* In widely dispersed ownership systems such as the UK and US, which were the main drivers of ESG, individual investors could not effectively influence boards to ESG actions without collaboration. Even if that were legally possible (and it might not always be), it would be more costly and less effective than ESG portfolio techniques undertaken unilaterally ‘in house’ through the techniques identified above. The portfolio approach would in principle distribute ESG effects more broadly across (listed) companies and would gain traction as points two and three below started to ramp up.
- *Mitigation of legal uncertainty through opinions and standards.* While some academic opinion supported an interpretation of fiduciary duty that would enable boards to implement an ‘entity’ model of ESG, they tended to be minority views and were not back by influential legal opinions or powerful NGOs. The opposite was the case for the financialized model and intermediary fiduciary duty, which was supported at an early stage by an influential legal opinion (the Freshfields Report⁷⁰) and standards (the PRI Principles for Responsible Investment) endorsed by the UNEP FI.⁷¹
- *Data.* The accumulation of evidence on the financial performance of ESG strategies⁷² lent credibility to the financial model of ESG, whereas there was no comparable data to support operational activities undertaken by companies through ‘CSR’ initiatives. In that sense the available ‘evidence’ supported the financialized model.

Thus, in terms of the context in which ESG operates, legal uncertainty posed less risk to a financial model of ESG than it did to an entity model. Viewed in those terms, investors were better placed to develop the financial model than directors were to develop an entity model of ESG that might have more closely resembled the model of CSR from which ESG emerged.

From a broader perspective, several other influences supported the choice of the financial model of ESG. In the first instance, the financial model provided a global conduit for investors to influence board decision-making indirectly through the supply of finance, irrespective of the relative distribution of power between the shareholders and the board. That model could likely be mobilised more rapidly and effectively at a global level than one which had to pay greater attention to substantial differences in national legal regimes in terms of the respective powers of shareholders and directors. Secondly, the financial channel provided exclusive access for shareholders to corporate decision-making, with stakeholders being marginalised, even if they were indirectly the beneficiaries of ESG actions. Thirdly,

⁷⁰ It was issued by the UNEP Finance Initiative in 2005. For background see: <https://www.unepfi.org/about/background/>.

⁷¹ For background on both the PRI and UNEP FI see <https://www.unpri.org/pri/about-the-pri>.

⁷² See ICGN Guidance on Investor Fiduciary Duties (2018): http://icgn.flpbks.com/icgn-fiduciary_duties/ at p 16 for a concise summary of some key academic studies.

the entity model would have run counter to the prevailing ethos in the public and private initiatives through which the transformation of CSR into ESG was underway. That ethos focused on the global aspects of sustainability, stressed the common challenges that were faced and the shared responsibility for developing solutions. Finally, innovation in the supply of ESG-themed funds tapped into increased awareness of and demand for ‘green’ investments without the need to resolve the legal uncertainty issues discussed above.

It remains to be seen how ESG investing will develop. While there are many funds with specific ESG mandates and a proliferation of initiatives in terms of reporting and metrics, the fundamental problem of legal uncertainty in fiduciary duty remains unresolved. A workable solution to or mitigation of that problem would likely see more extensive ‘mainstreaming’ of ESG investing into standard investment practice and as a result more extensive ‘real world’ effects on sustainability.

Part III - Fintech and RegTech – encompassing digital assets, currencies, securities tokens and exchanges

(Ms. Berry, Professor Follak, Mr. Stevens)

1. Security token offerings and investor protection

Many regulators across the globe have sought to provide greater clarity on the treatment of digital assets in response to the growing market interest in these types of assets. There is broad consensus among international regulators and practitioners that crypto assets as an emerging new asset class and related distributed ledger technology (“DLT”) will have an immense potential for innovation and efficiency gains in the financial sector. Crypto assets and tokenization might revolutionise the financial markets in similar ways as has securitization in the past.⁷³

In our last conference report we would have examined how technology was driving the transformation of financial services and discussed, amongst other things, the rise of initial coin offerings (“ICOs”), a mechanism used by blockchain start-up companies to raise funds for the purpose of building their networks. The ICO marketplace has however had a number of cases involving purchasers being the targets of scams and large cyberthefts. As ICOs faced these multiple challenges, start-ups and companies sought to find more satisfactory means of funding where there is more security to potential investors, less uncertainty and less fraud. Security token offerings (“STOs”) have been regarded as providing a more secure path to blockchain companies seeking to raise funds.⁷⁴ In this section of our report, we will discuss the regulation of security tokens, some of the latest developments in various jurisdictions with particular focus on the EU and how investor protection is being addressed.

Classification of security tokens

A security token has been widely defined. Essentially, it is “a digital representation of an investment product, recorded on a distributed ledger, subject to regulation under securities laws”.⁷⁵ Security tokens are therefore governed by securities laws which are implemented by the relevant regulator. STOs have occurred in a number of countries but are more concentrated in jurisdictions with a securities and tax law framework which is accommodating.

It is essential that regulatory authorities focus on the substance of the underlying asset and its associated rights to determine if a digital asset involves a security token. The classification framework for digital assets is usually based on these assets being token-oriented and operating on open and permission-less

⁷³ Peter Follak, ‘Crypto Assets under Private Law and Supervisory Regulation: European Perspectives’, ÖBA 2020, 712.

⁷⁴ Nicola Berry, “From ICOs to STOs: Structuring a Security Token Offering from Barbados”, (31 May 2019), <<https://businessbarbados.com/trending/structuring-a-security-token-offering-from-barbados/>>.

⁷⁵ Thomas Lambert, Daniel Liebau, Petr Roosenboom, ‘Security token offerings’ (2021). Small Business Economics, <<https://doi.org/10.1007/s11187-021-00539-9>>.

networks. These typically consist of three types: (i) payment/exchange tokens used as a digital means of payment or exchange, (ii) utility tokens which grant holders access to a digital resource, and (iii) security tokens which exhibit an investment purpose.⁷⁶ The Cambridge Centre for Alternative Finance (“CCAF”) has found in its recent research that existing digital asset frameworks tend to focus primarily on the asset form and the underlying technology as they tend to assume the use of DLT and cryptography as the dominant criteria. According to CCF there are alternative mechanisms to represent assets in digital form which do not involve DLT based concepts. They take the view that digital asset classifications should instead be a function of their nature and substance, i.e. according to the rights and obligations they confer on the holder, as well as their main economic purpose and the function of the asset.⁷⁷

Investor Protection

Bringing digital assets securities under the jurisdiction of the existing legal framework, to the extent possible, does allow for greater protection of investors but is not sufficient. There is still not enough investor protection in crypto and it is still considered the “wild west”. There are however efforts being made to address this in the regulation of such assets.

2. EU Legislative Package – latest developments

In the EU crypto asset regulation is treated as an integral part of the European Commission’s digital finance strategy.⁷⁸ The EU expects a significant contribution from the crypto asset sector towards tackling the economic effects of the COVID-19 outbreak.

On 24th November 2021, the EU Council adopted its position in respect of regulatory proposals on crypto assets and mandated its Presidency to initiate formal “Trilogue” procedures with the Parliament and the Commission to finalize the legislative process.⁷⁹

In summary, a token issue is intended to link values or rights with an entry in a digital register. A security token is not a deed laid down in a written document. Rather, it can be seen as dematerialised security that is issued through distributed ledger or similar technologies.⁸⁰ It is effectively a means to represent ownership of security assets via DLT by saving information through a distributed ledger, i.e. a repeated digital copy of data available at multiple locations, such as Blockchain. As opposed to traditional book-entry securities, security tokens use an alternative way of recording ownership through the use of cryptography, DLT or similar technologies, rather than recording ownership through the account of a central securities depository /CSD/custodian. Commonly, they refer to a right existing outside the blockchain. As asset/investment tokens, they represent assets such as shares in real values, companies, earnings, or debt securities and are normally issued for capital raising through ICO procedures and show similarities to traditional debt and equity instruments, or refer to traditional securities or other assets that have been registered on a blockchain (“tokenization”).⁸¹

Current EU regulatory treatment

The European Securities and Markets Authority’s (“ESMA”) guiding principle in qualifying crypto assets as financial instruments is “substance over form”; they would have to be standardised, transferable and tradable in financial markets. Under Directive 2014/65/EU (Markets in Financial

⁷⁶ The Cambridge Centre for Alternative Finance (CCAF) at the University of Cambridge Judge Business School, Legal and Regulatory Considerations for Digital Assets, Jason G. Allen, Michel Rauchs, Appoline Blandin and Keith Bear, p. 10.

⁷⁷ Ibid, p. 11.

⁷⁸ EU Commission, ‘Communication on a Digital Finance Strategy for the EU’, COM (2020) 591 final.

⁷⁹ EU Council press release 886/21 of 24/11/2021, available at: <<https://www.consilium.europa.eu/en/press/press-releases/2021/11/24/digital-finance-package-council-reaches-agreement-on-mica-and-dora/pdf>>.

⁸⁰ Basel Committee on Banking Supervision, ‘Consultative Document: Prudential treatment of cryptoasset exposures’ (June 2021), 2, see footnote 9, available at: <<https://www.bis.org/bcbs/publ/d519.pdf>>.

⁸¹ Robben Houben, Alexander Snyers, ‘Crypto-assets – Key developments, regulatory concerns and responses - Study for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies’ (April 2020) PE 648.779, 21, available at: <[https://www.europarl.europa.eu/RegData/etudes/STUD/2020/648779/IPOL_STU\(2020\)648779_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/STUD/2020/648779/IPOL_STU(2020)648779_EN.pdf)>.

Instruments Directive II - MiFid II) Art 4(1)(15)/Annex I sect. C, these are typically transferable securities, money market instruments, units in collective investment undertakings and certain derivatives. In case a crypto asset qualifies as a financial instrument, a set of specific regulatory frameworks is applied:

- Markets in Financial Instruments framework (MiFID – Directive 2014/65/EU and MiFIR Regulation (EU) 600/2014);
- Alternative Investment Fund Managers Directive (AIFMD – Directive 2011/61/EU);
- Prospectus Directive and Regulation (Directive 2003/71/EC and Regulation (EU) 2017/1129);
- Transparency Directive (2013/50/EU);
- Market Abuse and Short Selling Regulation (EU) 596/2014);
- Investor Compensation Directive (97/9/EC);
- Settlement Finality Directive (2009/44/EC); and
- Central Securities Depositories Regulation (EU) 909/2014.

Draft EU package on crypto asset regulation

On 24 September 2020, the EU Commission finally published a package of legislative proposals with the aim to create an EU framework on markets in crypto assets, tokenization of traditional financial assets and the use of DLT in financial services as part of the EU's digital finance strategy.⁸² This regulation can be characterized as a MiFID-type framework to cover crypto assets falling outside existing EU financial services regulation, as well as e-money tokens. Hence, it is meant to:

- “establish uniform rules for crypto-asset service providers and issuers at EU level...”, and
- “establish specific rules for so-called ‘stablecoins’, including when these are e-money...”.⁸³

It includes:

- an addendum to the “MiFID II” Directive 2014/65/EU clarifying that the existing definition of “financial instruments” includes “instruments issued by means of distributed ledger technology”;
- a proposal for a Regulation on Markets in Crypto-Assets (“MiCA regulation) to cover crypto assets falling outside existing EU financial services regulation, including “stablecoins” as well as e-money tokens;⁸⁴
- a proposal for a Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology;⁸⁵ and
- an “EU passport” for crypto assets.

By way of addenda to the “MiFID II” Directive 2014/65/EU,⁸⁶ the proposal includes:

- an amendment to Art. 4 (1) point 15 of Directive 2014/65/EU (MiFID II) clarifying the existing definition of “financial instruments” as specified in Annex I sect. C: “including such instruments issued by means of distributed ledger technology”; and
- amendments to Art. 16 para. 4 and 5, Art. 17 para. 1 and 7, Art. 19 para. 3, Art. 47 para. 1 and Art. 48 para. 1, 6 and 12 of the MiFID II Directive defining requirements in respect of systems, ICT and other technologies to ensure compliance with the proposed Regulation on Markets in Crypto-Assets and the proposed Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology.

⁸² Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets (COM(2020) 593/3, = 2020/0265(CO) – “MiCA Regulation”, Explanatory Memorandum, 2.

⁸³ MiCA Regulation, Explanatory Memorandum, 10.

⁸⁴ Ibid, at footnote 10.

⁸⁵ EU Commission, ‘Proposal for a Regulation Of The European Parliament And Of The Council on a pilot regime for market infrastructures based on distributed ledger technology COM (2020) 594 final, 2020/0267 (COD).

⁸⁶ Amendment to Art. 4(1) point 15 of Dir. 2014/65/EU, EU Proposal of the European Parliament and of the Council, COM (2020) 596 final, 2020/0268 (COD), Art. 6.

Security Tokens within the future system of EU Crypto Asset regulation

Due to the intention to fill regulatory gaps, the scope of the MiCA Regulation is limited by Art. 2, excluding assets qualifying as financial instruments under Art. 4(1) point 15 of the MiFID II Directive 2014/65/EU, electronic money as defined in Art. 2 point (2) of Directive 2009/110/EC, and certain other instruments.

The MiCA regulation includes assets and activities as defined in Art. 3:

The generic asset category is determined as ‘crypto asset’ – “a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology⁸⁷ or similar technology” (Art. 3 para.1 (2)). The Commission’s draft definition of a ‘crypto asset’ so far includes, inter alia, ‘asset-referenced tokens’: “a type of crypto-asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities or one or several crypto-assets, or a combination of such assets” (Art. 3 para.1 (3)). Commonly, this asset type is referred to as “stablecoins” and has to be clearly distinguished from tokenized securities classified as financial instruments by amendment of the MiFID Regulation.

As a result, security tokens would be normally captured by and integrated into the MiFID II Regulation rather than being regulated by the MiCA framework. Nevertheless, the proposed EU Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology would also apply to crypto assets that qualify as financial instruments/transferable securities under MiFID II, as specified and limited in Art. 3 of the draft regulation, and insofar to security tokens.

According to the general principles of EU legislation, private law such as national classification as property, integration into bankruptcy and heritage estates, enforcement as collateral, seizure, trust etc. is not harmonised and hence subject to national legislation. In particular, Liechtenstein – an EEA Member State which will have to adopt the draft EU regulatory package - has successfully enabled the full deployment of crypto assets and their underlying technology. Insofar, EU legislators will have to take care with a view to existing comprehensive national regulations to avoid any setback.

3. Other Jurisdictions

In the United States, it has been noted⁸⁸ that the Department of Justice (“DOJ”), the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”) continue to make announcements and show interest in regulating cryptocurrency and enforcing laws relating to cryptocurrency. The DOJ has launched the National Cryptocurrency Enforcement Team (“NCET”) to undertake investigations and prosecutions involving the criminal misuse of cryptocurrency, and to assist in the tracing and recovery of assets lost to these crimes. The NCET’s mission is to deter, disrupt, investigate and prosecute criminal misuse of cryptocurrency. The SEC has signaled that it will become more active in policing the cryptocurrency market. Under the existing regulations, creators of digital assets try to avoid the risk that their tokens will be designated as “securities” under US law because this could terminate their product. The SEC has not provided clear guidance on what counts as a security in this area. This, however, has not prevented the SEC from bringing investigations and enforcement actions. Moreover, the new SEC Chair has been calling on the US Congress to grant the SEC more authority to regulate tokens – whether or not they are classified as “securities”.

Most of the developments in the US in the last two years have been in the enforcement area involving court cases brought against sponsors of tokens, alleging they were in fact securities and did not comply with existing securities laws.

Boutros et al. see an uptick in enforcement in the US and recommend that companies and participants in the cryptocurrency space put in place an effective policy and procedure to comply with applicable

⁸⁷ Distributed recording of encrypted data as defined by Art. 3 para. 1. (1) of the MiCA Regulation.

⁸⁸ Dechert LLP, Andrew Boutros, et al, ‘The Cryptocurrency Market – Prepare for an Uptick in Enforcement Activity’ (20 October 2021), available at: <<https://www.jdsupra.com/legalnews/the-cryptocurrency-market-prepare-for-9674963/>>.

laws and regulations, conduct a gap analysis to identify any material weaknesses with internal controls that are focused on the cryptocurrency space, implementing and strengthening controls to mitigate risks identified in the gap analysis and investing and building out compliance functions.⁸⁹

4. Cryptocurrency Exchanges

Cryptocurrency exchanges have been plagued with much controversy. A number of cryptocurrency exchanges remain unregulated and have been investigated for their trading practices. In March 2021, for example, the CFTC issued an order filing and settling charges against digital asset exchange operator Coinbase Inc., for reckless false, misleading, or inaccurate reporting as well as wash trading by a former employee on Coinbase's GDAX platform. The order required Coinbase to pay a civil monetary penalty of US\$6.5 million and to cease and desist from any further violations of the Commodity Exchange Act or CFTC regulations.⁹⁰

Institutional participation in cryptocurrency exchange activities is considered to be largely absent. The Barbados Stock Exchange, which is a regulated recognized stock exchange, is seeking to bring more institutional participation into cryptocurrency exchange activities by focusing on security tokens and pairing both accredited and institutional investors with investments which comply with the relevant requirements. The general view however is that more investor protection is needed on crypto exchanges.

5. Recent Cases on cryptocurrencies and cryptoassets

Some of the recent cases have demonstrated a flexibility in some jurisdictions, particularly the common law jurisdictions, to interpret their laws to become applicable to cryptocurrencies and cryptoassets.

In the Singapore case of *B2C2 Ltd v Quoine Pte Ltd*⁹¹, the Singapore International Commercial Court determined the question of whether bitcoins qualified as "property" under the applicable law. This case involved a claim for breach of contract and breach of trust. B2C2's claim arises out of an incident that occurred on the currency exchange platform owned by the defendant when, as a result of a series of events, trades for the sale by the plaintiff of Ethereum for Bitcoin were effected by the platform at a significantly higher rate than the previous going rate. The proceeds of the sale were automatically credited to B2C2's account by the platform. However, when the defendant became aware of the trades the following morning, it considered the exchange rate to be such a highly abnormal deviation from the previously going rate and reversed the trades.

In determining the issues of whether there was a breach of contract and a breach of trust, the court referred to the classic test from the English case of *National Provincial Bank v Ainsworth*,⁹² in which the House of Lords held that an object must be "definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability" and found that bitcoins did qualify as an object of property rights. The court held that "cryptocurrencies" met all these requirements and that the defendant was not entitled to reverse the trades on the basis of an express term of the agreement. This ICC decision has been widely quoted in the common law world and some have taken the view that it may indicate the direction of travel in common law systems.⁹³

In the English case of *AA v Persons Unknown*⁹⁴, the High Court of England and Wales found that cryptoassets were prima facie capable of being "property" in English law in considering an application to grant a proprietary injunction.

In *Ruscoe v Cryptopia Ltd (in Liquidation)*,⁹⁵ the New Zealand High Court held that cryptocurrencies are a form of "property" for the purposes of their corporate law legislation. The court also held that

⁸⁹ Ibid.

⁹⁰ CFTC, 'CFTC orders Coinbase Inc. to Pay \$6.5 million for false, misleading, or inaccurate reporting and wash trading' (19 March 2021), available at: <<https://www.cftc.gov/PressRoom/PressReleases/8369-21>>.

⁹¹ [2019] SGHC(I) 03.

⁹² [1965] 1 AC 117.

⁹³ See footnote 3 above at p. 21.

⁹⁴ [2019] EWHC 3556 (Comm.).

⁹⁵ [2020] NZHC 728.

cryptocurrencies are capable of being held on trust by a company for its accountholders and consequently out of reach of the company's creditors.

These common law courts therefore interpreted the laws broadly and made them applicable to these cases.

6. Conclusion

Security tokens offer a promising path to transforming the financial services using DLT. Some jurisdictions are able to bring such securities under their existing legal frameworks and this offers some measure of protection to investors. The EU has developed detailed proposals for their future regulation of crypto assets. Other jurisdictions are seeking to do the same. There is currently not enough investor protection in crypto/digital assets but stricter regulation and enforcement appear to be forthcoming.

END OF REPORT