



How can compliance help you compete?

Financial services CCOs have an important role to play in driving sustainable growth



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Introduction

Globally, regulation around sustainable finance¹ – including environmental, social and governance (ESG) matters – is certainly moving quickly, as shown in the recent EY report on regulatory trends on climate change.² We are all striving to keep track of the many new commentaries, consultative documents, and rules and regulations. It’s hard to see the pace abating. The train hasn’t just left the station, it’s picking up momentum.

Initial attention with how to better address sustainable finance fell onto heads of sustainability, chief risk officers and, in some cases, heads of business driving new products or even general counsels.

But, increasingly, chief compliance officers (CCOs) are asking, “What is my role?” Intuitively, they know they could – or should – have one, but the lack of clear regulations means they are asking, “What obligations do we have on ESG?”

In dialogues with CCOs across financial services, it is clear there is an emergent, and increasingly important, role for CCOs. At a minimum, it is incumbent on CCOs to build a stronger understanding on what’s happening in sustainable finance and ESG within their firm, on the pace and direction of travel for regulation, and on the complexity of the issues sustainable finance and ESG now present to their company. Working with others, they should enhance understanding across the organization.

The compliance group needs to be integrated within the firm’s overall sustainable finance operating model. CCOs need to be active leaders in ESG, identifying emerging regulatory trends, working closely with risk and legal, clearly articulating what constitutes compliance, having a seat at the ESG leadership table, and asking tough questions on strategy and execution.

¹Sustainable finance can mean different things in different contexts. EY defines sustainable finance as any form of financial service that incentivizes the integration of long-term ESG criteria into business decisions, with the goal of providing more equitable, sustainable and inclusive benefits to companies, communities and society. Embedding ESG concepts into investing is perhaps the highest-profile manifestation of sustainable finance, alongside the rising prominence of stakeholder or inclusive capitalism.

²https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/banking-and-capital-markets/ey-climate-change-and-sustainability-global-regulators-step-up-the-pace.pdf



Are we comfortable with how we operate?

There is a brewing issue in the US related to greenwashing – one that is already fully in the sights of European regulators.³ While the term “greenwashing” originally connoted links to the environment, more recently it has been used for a broader set of products, such as those linked to COVID-19 resilience, gender and racial justice matters, and so on. In Europe, there is also increasing investor action and public scrutiny around inconsistencies between sustainability strategies and operational decisions.

The significant increase in green or social products and services has raised new concerns. Retail and institutional investors are not getting what they expected. For example, it wasn't lost on market participants that the fund names proposal from U.S. Securities and Exchange Commission (SEC) in March 2020 was targeted at this very issue. In effect, the SEC was asking, if you call a fund ESG, in some way, how do you validate a large majority of the assets (e.g., at least 80%) were acquired with ESG in mind and that the fund name does not confuse investors?⁴

CCOs recognize these concerns as their own: “How do we validate that we are operating as we say in our disclosures?” asked one CCO. “The lack of standards means we are all doing our own determinations on what constitutes ESG or what is green,” said another. CCOs are scratching their

heads on this one: “How do we verify that the assets are climate-friendly?” This creates risks for regulators to identify violations of law or regulation, and for attorneys to litigate because their clients were misled by disclosures or representations.

The fact that so many financial services firms are making bold commitments to sustainable finance – commitments that, in time, will actually need to increase significantly to meet sustainable development goals – creates risk. As one compliance executive put it, “How do we evidence what we are committing to, so we walk the walk, not just talk the talk?” Firms need reliable data to chart progress against commitments accurately and consistently, and need to validate whether the disclosures on progress are well controlled.

³Greenwashing is where an organization provides misleading or unsubstantiated information about how its products and services are more environmentally sound than they are. Recently, the term has been broadened in use to cover products and services that are positioned as being more socially oriented than is the case.

⁴Request for Comments on Fund Names (sec.gov)

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A product's ESG focus should be clearly stated in its name. And then reflected consistently in its objectives, its investment strategy and its holdings. This is all about ensuring that a product really does do what it says on the tin and matches consumers' expectations.

Richard Monks

Director of Strategy, Financial Conduct Authority⁵

Since CCOs can't solve the standards by themselves, they need to focus on where compliance risk presents itself:

- ▶ **ESG-related investment funds:** How can firms validate specific funds, active or passive, operate in line with commitments in prospectuses, marketing materials and website information? How can they validate ESG is factored into stock selection, proxy voting and company engagement across the fund complex? How does the fund complex manage different voting patterns on the same issues across funds, and make sure voting across funds align the complex's overall voting policy and stance? See *Managing ESG compliance risk in investment funds*.
- ▶ **Sustainability-linked loans, green or social bonds:** How will firms validate that the criteria used in defining the composition of the assets or judging impact or performance are appropriate, measurable and achieved? They need methods to verify that the funds are used for intended purposes.

- ▶ **ESG-related investment advice:** How can firms validate that the advice being given to clients – or suggested investment portfolios – are properly informed by ESG factors? Whether the data used in informing advice is appropriate and accurate? Do the clients recognize potential financial implications (positive and negative) of emphasizing ESG factors in investing? How is this advice being marketed and positioned to the client and is it in line with relevant regulatory standards, where applicable?

Compliance can pose these questions and assess if the firm has the right controls in place to address the risks. They can make sure there are high levels of understanding across the organization on ESG-related regulatory and potential compliance risks, and press the organization to have the right skills in place in key areas to manage these risks.

⁵Building trust in sustainable investments, FCA

Emerging areas of compliance risk

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Portfolio managers and analysts need to be upskilled with the knowledge and capabilities to execute and evaluate sustainability investment strategies. They must develop a keen understanding of climate risk and its various possible effects. They must be able to design innovative ESG scoring methodologies, investment strategies, and product offerings. They must acquire the expertise needed to mitigate the risk of greenwashing.

Ravin Menon

Managing Director,
Monetary Authority of Singapore⁶

Regulatory and supervisory expectations are in a state of transition, and in many places are still nascent, fairly ill-defined or still principles-based. As such, over the next few years – without a sea-change in regulation – compliance will need to routinely evaluate ESG-related regulatory risk against existing rules to determine which current rules are or could be linked to ESG. This also includes assessing what amendments or additions, procedures and controls are needed.

That said, globally, there are emerging areas where ESG-related compliance risk may come under scrutiny:

- ▶ **ESG in the context of suitability:** The lack of global standards on what constitutes a green and social product creates real vagaries in the context of suitability. Customers increasingly want a more “sustainable” investment portfolio and will seek advice on how to achieve that, while also accruing financial growth. Firms will need to develop approaches to deliver advice that meets customers’ financial and sustainability needs, but in a way that captures mis-selling or mislabeling risks associated with evolving regulatory and market definitions of types of green and social products.
- ▶ **ESG in the context of product development:** Beyond suitability, there is a broader emerging internal governance

risk associated with the design, pricing and distribution of products and services. Questions need to be asked as to how new products, initiatives or transactions align with the firm’s broader ESG commitments; who has provided input into that discussion and what modifications need to be made to the product approval governance process to properly incorporate ESG-related risks? These questions need to be asked at the inception and design stages, and compliance, along with risk and legal, needs to be actively involved.

- ▶ **ESG in the context of client onboarding:** Some regulators have flagged that they will expect firms to factor ESG considerations into their client acceptance procedures. The considerations include, for example, the use of enhanced due diligence on environmentally high-risk transactions, factors related to human rights or factors such as human

trafficking in certain countries or regions. This presupposes that firms have the means to properly assess ESG risk in the client acceptance context, and mechanisms to work with new customers and clients to ameliorate any issues that come up in the risk assessment process.

- ▶ **Prudential stress testing:** Climate-risk-induced environmental changes pose a significant threat to the long-term quality and value of assets held by the financial institutions. Banks are being pushed by prudential and market regulators to have robust processes in place to keep this in check. This includes detailed examination of how firms and their suppliers are adapting to climate change risks, including changing business models to prosper and serve their stakeholders in affected or risk-prone areas. Compliance leaders need to anticipate more regulations surrounding the same and work with risk leadership to make sure they establish and maintain frameworks to ensure compliance. The process includes building credible analytical models to identify and mitigate environmental exposures, and effectively communicate that to regulators and other stakeholders.

- ▶ **ESG in the context of director and management accountability:** In countries that have implemented strong accountability frameworks for the board and senior executives, ESG may increasingly be a focus of regulatory attention. Questions may be asked as the extent to which sustainable finance concepts are aligned with the firm’s purpose and strategy, the degree to which management time and resources are being dedicated to sustainable finance, how ESG imperatives are being embedded into compensation and performance systems and so on. Since policymakers are increasingly positioning ESG matters (especially climate change) as an existential threat to the industry, it’s hard for directors or executives to argue with it being a top priority.
- ▶ **Influence of culture on ESG:** Regulators have signaled they view internal corporate culture as an important factor on driving management decision-making. A lack of diversity and inclusiveness (D&I), of all kinds, may inhibit firms’ focus on financial inclusion (e.g., through product design, accessibility or pricing) and can create conduct risk.

⁶“The Future of Capital is Green” – Keynote Address by Mr Ravi Menon, Managing Director, Monetary Authority of Singapore, at IMAS-Bloomberg Investment Conference on 9 March 2021.

Are we managing the interactions across sustainable finance?

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[The SEC] will review the consistency and adequacy of the disclosures [registered investment advisers] and fund complexes provide to clients regarding these strategies, determine whether the firms' processes and practices match their disclosures, review fund advertising for false or misleading statements, and review proxy voting policies and procedures and votes to assess whether they align with the strategies.

US Securities and Exchange Commission, 2021 Examination Priorities⁸

In some ways, CCOs may be thinking about ESG in a compartmentalized way. Today, it is as much about the convergence of issues as it is standalone subject matter.

Take two examples:

- ▶ **Within the S (financial inclusion and equity):** Firms are starting to realize that there is a major intersection between financial inclusion (access to financial products and services) and racial equity. It is essential people of color have equitable access to finance, whether as consumers or business owners. But the interaction doesn't stop with racial equity – it includes cohorts, such as women, the elderly, veterans, religious minorities and immigrants. The same care and attention should be applied for all such underserved cohorts to make sure access to finance is even and equitable.
- ▶ **Across the E (climate change) and the S (financial inclusion):** In the US, for example, we are all expecting Federal Emergency Management Agency (FEMA) to update its flood maps. Projections on the effect range significantly,

but most seem to suggest that between 8 and 15 million homes may be rezoned as being in a flood plain, and naturally lenders will require flood insurance. The challenge is, some have suggested that upwards of 80% of those in those homes are from low-income families, which includes a high proportion of people of color. So, what should banks and insurers do? Banks will want the flood coverage. Insurers will want the premiums. But this may create an acute challenge for the homeowners, making their homes unaffordable. Will the banks and insurers leave them high and dry? It's not surprising the term "bluelining"⁷ is catching on, akin to redlining, when firms systematically exclude cohorts of customers. Remember, we all watched the disparate impact of Hurricane Katrina and Hurricane Sandy on disadvantaged minorities and protracted insurance payout negotiations that followed.

These examples are pointing to alignment across the organization as one of the biggest challenges for compliance. If anything, one of the most complex challenges for firms, and thus CCOs, is validating everyone is swimming in the same direction across the entire organization. As one CCO put it, "A challenge for us is making sure what we do with ESG in our funds aligns with what we are doing on ESG across the organization, more broadly." This may not be just compliance with regulations, but with corporate policy and position, which is even harder to assess and monitor. There are reputational issues to be considered, after all.

Take an easy example: there is a decision to not support fossil fuels across the organization. How does a firm – especially one with multiple businesses, including asset management – validate such a position is complied with? Where does one draw the lines? You may know you're not lending to firms

associated with fossil fuels. But, what if you are lending to, or investing in, private equity, which in turn invest in fossil fuels? You may also be lending to a fossil fuel company, but your funds may be supporting a transition toward renewables. Technically, you may be compliant, but would that stand up to public scrutiny from a reputational perspective? Do you need external support to inform decisions and assess compliance? In some ways, this issue is akin to challenges the industry had a decade ago on implementing business practices controls to make sure they weren't taking different positions on the same trade. It's really hard, in practice.

Naturally, these kinds of complexities go well beyond the scope of compliance to risk, underwriting, pricing, etc. But compliance should have an active and visible role in what is taking place and how to address these challenges.

⁷Where a financial institution reduces or stops the provision of products and services to specific customers or communities experiencing the consequences of climate change. It is akin to redlining (now outlawed), where organizations systematically deny provision of products and services to certain customer cohorts (often those in underserved and low-income communities).

⁸SEC.gov | SEC Division of Examinations Announces 2021 Examination Priorities

Managing ESG compliance risk in investment funds

Not all funds are alike, so the assessment of ESG and potential compliance risk have to be addressed in different ways depending on the source of risk:

- ▶ **Alignment with a benchmark:** The easy use case is a fund that says it aligns with a specific external benchmark, say one aligned with an ESG index. Making sure the portfolio aligns should be relatively straight forward, so long as the index provider does their job well. But what if the fund is your own proprietary index? How do you validate your internal processes for data capture, analysis and reporting are effective? How do you provide any visibility for the market on the index? After all, your portfolio manager depends on that information for stock selection. Funds may have to evaluate how ESG influences portfolio managers' stock selection, where they are compensated to beat a benchmark index.
- ▶ **Alignment with guidelines:** Often, in passive and active funds, asset managers have their proxy voting guidelines, many of which claim to include ESG considerations. So, asked one CCO, "How do we validate a defined amount of the assets align with our guidelines?" Also, how does the firm validate that of

portfolio manager's ESG-related actions are consistent with investment guidelines in trading and compliance systems? The issue becomes thornier if you are an investor that has taken a prominent position on ESG matters and is active in the proxy season. To the extent you have announced key themes you'll press companies on – think climate change, gender or racial equity – how do you validate those themes influence proxy voting or company engagement?

- ▶ **Embedding ESG into active investment:** Perhaps the toughest use case is an active fund that claims to take ESG into account or an active fund whose overall fund complex claims to be active on ESG. How do you validate that, all things being equal, ESG has affected stockpicking? "We let our active portfolio managers take ESG into consideration in a way they feel is relevant. But how do we show ESG influences their investment decisions?" asked one COO. "Where are funds getting their ESG data or inputs from to determine what should be in their portfolio?" remarked another.

Of course, this all becomes even more complex for asset managers that have a global position on ESG. To the extent you are claiming to be a leader in embedding ESG into stock selection, proxy voting and company engagement, so as to attract more assets and stand out from the crowd, how do you validate those claims across all your funds, passive and active?



A role for compliance in reporting?

In the context of ESG, reporting inevitably comes up. Notwithstanding signs that we may be tracking toward global convergence on reporting standards (which may take years to unfold), there will remain myriad reporting frameworks, each with its own purpose and stakeholder orientation.

The challenge on ESG reporting is as much about consistency in messaging as the alignment and conformance with specific standards. Many firms start by asking, "Which reporting framework should I adopt?" This is putting the cart before the horse. The starting point should be your strategy and alignment with purpose, and thereafter how you will execute and resource the strategy, assure adherence to commitments and policy. Only then will you get to "how will you report on progress to your stakeholders?" Forgetting this can mean firms getting sidetracked on disclosures versus designing, executing and reporting on sustainable, long-term growth.

In that context, the reporting challenge is much broader than specific frameworks. In practice, ESG-related reporting falls into three broad categories:

- ▶ **Corporate communications:** These include press releases, websites and reports, such as those focused on sustainability or corporate social responsibility (CSR). Here, few standards exist.
- ▶ **Quasi-official frameworks:** This group refers to frameworks such as Task Force on Climate-related Financial Disclosures (TCFD⁹), Sustainability Accounting Standards Board (SASB), Global Reporting Initiative (GRI), Climate Disclosure Standards Board (CSDB) and so on. Such standards are typically fairly principles-based, leaving much room for maneuver.
- ▶ **Official reporting:** Reporting, in this regard, refers to 10-K risk factors and related prospectuses. Here the rules are rigid, as they should be, and are very likely to expand in the near future.

The inherent challenge, then, is two-fold. How do firms implement sufficient rigor across each of these disclosures to validate accuracy? And, how do they deliver consistency across the many reporting channels so the overall narrative is aligned? Said simply, "Are we doing what we said we would do?" Increasingly, firms may need to rely on third-party validation or assurance in helping assuage external stakeholder concerns about ESG-related disclosures and matters, such as greenwashing, to help build trust.

Interestingly, for privately owned or mutual financial institutions, there is a third challenge. They may not be subject to the same baseline reporting requirements that their publicly traded peers are, which is often viewed as a positive. But in the realm of ESG, where various entities rate a firm's ESG based on public disclosures, the lack of disclosures from privately held or mutually owned firms may hurt their ESG scores (or even mean they don't have one assigned).

Clearly, the bulk of this work is not in compliance. Executives in the controller's group, investor relations, corporate communications and those leading ESG reporting are squarely accountable. But, as some of the reporting standards become mandatory, can compliance really watch from the sidelines? That's likely not tenable in the long run.

⁹Task force on Climate-related Financial Disclosures report playbook.

A time to stand up and lean in

The pace at which sustainable finance and ESG has shot up financial services' agenda has been, in some ways, startling. What felt like a niche issue 12 to 18 months ago, now seems deeply entwined with a firm's purpose, strategy, growth, and risk management. When the issue was, at best, low on the top 10 list of issues, it was easier to deprioritize. Now it's a top-three concern, requiring significant cross-functional leadership and activity.

CCOs have an important role to play. That's their intuition and they are not mistaken. Some CCOs, especially in Europe, have taken on a more substantive role. But generally, it's time CCOs get off the bench, roll up their sleeves and lean in. In so doing, they will bring a lot to the discussion, especially in terms of influencing the direction of strategy and execution by bringing insight on regulatory trends. They'll need resources and specialist experience, however; this should not be a hobby.

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