Cases on Ethics in Sustainable Investments

BUY-SIDE ANALYST ROLES
Many buy-side analysts need to collect, handle and process ESG data at scale or rely on colleagues or external service providers to do this for them. This presents a new challenge, as ESG data is often unaudited, qualitative, and comes from a wide range of sources of varying reliability rather than from audited financial accounts or official trade figures. This means ESG data can be more easily misconstrued and is often a matter of interpretation rather than fact. Also, the growing influence that ESG data has on market prices means that analysts handling ESG data need to carefully consider whether it is MNPI.

1) Sustainability Context:

ESG data may often be disputed, partial or capable of different interpretations. In such situations, buy-side analysts should make clear whether the data that informs and influences their investment decision is opinion, based on possibilities or probabilities, or can legitimately be described as fact.

Personal and commercial bias can also easily enter investment decisions if adequate steps are not taken to retain analytical independence and objectivity. The qualitative nature of ESG data can lead analysts to ‘fit the data to the story’ and produce the commercially or personally preferred outcome. Firms should embrace good governance and peer and committee review procedures to minimise this risk.

Current ESG ratings and data methodologies vary significantly in the ESG topics they cover, how the topics are weighted, and the metrics used to measure ESG performance. Although regulators in the UK, EU and Asia are rapidly developing regulatory proposals for ESG ratings providers, the proposals mandate transparency rather than stipulating any particular approach. Buy-side analysts must interrogate ESG ratings and data just as with all other data inputs into investment decisions. This means not taking them at face value, identifying the source, taking a view on their reliability, checking whether they have been independently assured, and considering data and opinions that might lead to an opposing view.

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1 IOSCO published a set of principles for ESG ratings and data providers in November 2021. Voluntary codes of conduct modelled on it have been (or are being) developed in some countries. The European Union has published a draft text on the regulation of ESG rating activities and the UK has confirmed that ESG ratings providers will be brought within the regulatory perimeter.
2) Key CFA Institute standards relevant to buy-side analyst roles:

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<th>CFA INSTITUTE STANDARD</th>
<th>RELEVANT ISSUE</th>
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<td>I (B) INDEPENDENCE &amp; OBJECTIVITY</td>
<td>Analysts need to retain their independence and objectivity. This applies as equally to sustainability considerations as to other investment considerations. Analysts should not allow commercial considerations or their personal sustainability views to bias their investment recommendations or independence.</td>
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<td>II (A) MATERIAL NON-PUBLIC INFORMATION</td>
<td>As sustainability related information is becoming increasingly relevant and material for capital markets participants and is also often private and qualitative in nature, analysts have to exercise care when coming into possession of it. Whilst a change in a company’s credit rating is recognised as material non-public information (MNPI), whether and when a change in an ESG rating is MNPI is not that clear. ESG ratings as MNPI fit within the UK’s Market Abuse Regulation (MAR) definition of inside information, but there have been no notable FCA enforcement actions or court cases to date. Best practice suggests treating non-public knowledge of ESG rating changes as MNPI and staying up to date with legislation and regulation in relevant jurisdictions.</td>
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<td>V (A) DILIGENCE &amp; REASONABLE BASIS</td>
<td>Sustainability related information may be vague, incomplete, disputed, or wrong. Analysts need to be careful to establish the veracity of the sources and the quality of any sustainability related data before they use it in their recommendations.</td>
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APPLICATION OF THE CFA INSTITUTE STANDARDS (10 cases)

Issue 1: Local law record retention requirements may be more onerous than the requirements of CFA Institute’s Code and Standards

Example
Dr. Bart, CFA is an analyst at an asset manager, Eurnoe Group. She wrote her PhD thesis on the benefits of diversity, the conclusion of which was that, on average, companies with diverse senior management outperformed and had higher EPS numbers than firms with lower diversity. In her new role as an investment analyst, Dr. Bart is keen to put her theory into practice and decides to speak to the lead fund managers of the Eurnoe’s Duvnee fund. They like her idea of using a gender and race screen and agree that if she could produce robust data to support it, they would allow her to run a small fund in their part of the Eurnoe group. Encouraged, Dr. Bart attends the AGMs of all the companies that the Duvnee fund invests in. She records the name, assumed race and gender of each senior management company representative she meets on her work computer. After three years, the correlation analysis shows a strong fit: the stock prices of the most diverse firms clearly outperformed. Impressed, the Duvnee fund managers start to use the diversity screen for their fund going forward. Dr Bart is then contacted by Eurnoe’s compliance officer questioning Dr Bart’s retention of the personal information of company representatives; they ask her to delete the information to avoid a violation of GDPR. Dr Bart refuses, arguing they form the basis for the fund’s investment decisions and that under Standard V(C) she needs to maintain these records for 7 years.

CFA UK Comment
Dr Bart is right that she is required to keep the records for a minimum of seven years under CFA Institute’s Standard V(C) Records Retention or longer if local regulations require her to do so. However, the compliance officer is also correct. Under GDPR personal data concerning racial or ethnic origin is special category data. Processing special category data is allowed only if certain conditions are met, of which one that applies in this situation is the explicit consent of the data subject. Dr Bart requires the permission of the “data subjects” to collect and retain their personal data. Under CFA guidance for Standard I(A) Knowledge of the Law, EU jurisdictional law takes precedence over the CFA Institute’s Codes and Standards. To continue incorporating diversity analysis in the investment process for her fund while maintaining compliance with applicable law, Dr Bart must seek the permissions required by GDPR and ensure that the permissions sought are consistent with the firm’s desired retention period.
**Issue 2:** Objectivity in providing recommendations influenced by ESG issues

**Example**

Albert, CFA is an equity research analyst for a portfolio management company and is currently performing an ESG analysis on the stocks his firm is holding for its clients. After doing his own detailed research, he finds out from an environmental activist’s blog that a small oil exploration company in which his portfolio is currently invested is very likely to be sanctioned by local authorities for environmental damage. Albert decides to talk to his manager as he is due to issue an update in the coming weeks on his recommendation of this stock to clients; he believes this event could lead to significant fines and reputational issues for the company and impact its stock heavily. Albert’s manager, however, recommends against notifying this concern when publishing the report given that, although likely, this is not yet certain and because this stock is held by most of their company’s clients.

**CFA UK Comment**

Notwithstanding the pressure from his manager, Albert should not be influenced by the fact that most clients hold the stock. Provided Albert has carefully and independently assessed the validity and reliability of the information, and also confirmed it is not MNPI, we think that he should act with independence and objectivity when issuing the revised report and updated recommendation to his clients. Failure to do that would probably mean violating CFA Institute’s Standard I(B) Independence & Objectivity.

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**Issue 3:** Using external experts to support research and analysis

**Example**

Evans, CFA is a research analyst working for an insurance company. Her firm relies on the opinions of external sustainability experts to stay informed about the impact of climate change on the companies they insure. At a recent meeting, some experts indicated that a particular company
that they had recently interviewed is significantly exposed to climate change transition risks and that they are working with the management of that company to mitigate these risks with appropriate strategies and action plans. Following the meeting, Evans immediately informs her risk colleagues about this. The insurance company then plans to implement an increase in the company’s insurance premiums at the next renewal period.

**CFA UK Comment**

The opinion of external experts is often valuable to the work of many firms. However, these should be covered by a formal contract / NDA and an agreed protocol on information sharing. Experts who are working with a specific company to mitigate sustainability risk exposure of that company should not be disclosing material that would be MNPI based on the experts’ access to confidential internal information from that company. The experts should have either not disclosed such information or confirmed that it is MNPI in the meeting with Evans. Similarly, Evans should have first checked whether this information was already publicly disclosed by the experts or the company before suggesting her colleagues act on it. Evans has likely violated CFA Institute’s Standard II(A) Non-Public Information and passed MNPI received from experts’ assessments to her colleagues.

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**Issue 4: Mishandling material ESG NPI**

**Example**

Jolie, CFA, equity analyst at ZZZ Asset Management, is analysing Global Oil, a publicly traded oil major, which is expected to publish its first Sustainability Report soon, following its recent announcement of Net Zero commitments on Scope 1 and 2 emissions. Jolie is talking to Global Oil’s chief climate officer (CCO), who is responsible for the report being issued and whom she has known for years. She learns from these private conversations with the CCO that the report will show that the amount of the company’s Scope 1 and 2 GHG emissions will be much less than the industry analysts are currently predicting] due to very low energy intensity of Global Oil’s operations. The CCO also advises Jolie that this disclosure is validated in the report by a second party opinion provider. Jolie issues a “BUY” recommendation for the Global Oil stock, ahead of its Sustainability Report being issued.

**CFA UK Comment**

Jolie has probably acted on material non-public information and encouraged others to deal in securities when in possession of material non-public information. As such, it is highly probable that she will have violated CFA Institute’s Standard II(A) Material Non-public Information. She
should have delayed the issuance of this recommendation until the Sustainability Report had been issued by Global Oil. Global Oil’s stock performance is likely to be sensitive to the company’s Scope 1 and 2 emissions data as it will indicate both the extent of its own exposure to climate change risk and also the future investment that Global Oil will be required to make to mitigate its carbon footprint.

Issue 5: Putting one’s own interests ahead of client interests

Example
Short, CFA is an investment analyst at Greenland Pension Fund which exclusively focuses on sustainable investment opportunities. He has been assigned to review an investment in a renewable energy company, Runever Ltd. Through his research, he discovers that Runever uses the same green technology as another company in his coverage, Newenergy Ltd. Newenergy’s most recent ESG rating was downgraded heavily earlier this year due to the discharge of toxic chemicals from its facilities directly into a river running through a nearby residential area. Studying Runever’s investment memorandum, Short realises that Runever owns a factory built near his own house, which he is now in the process of selling. Short worries that the river around his house may also have been polluted with similar toxic chemicals. After conducting extensive due diligence, Short can find no evidence to suggest that Runever is disposing of its waste responsibly or is using different practices than Newenergy. Once public, this information would very likely have a negative impact on his house sale both in terms of price and speed. Given that he can find no clear evidence of responsible disposal of environmental waste by Runever, he includes the serious risk of a copycat environmental problem in his report for Runever Ltd. However, he decides to delay issuing the report by a few weeks until he succeeds in selling his house.

CFA UK Comment
Short has probably breached CFA Institute’s Standard III(A) Loyalty, Prudence, and Care as he delayed the issuance of his report disclosing the Runever factory’s environmental risk. Short has placed his own interests before his clients’, which is not loyal and lacks the necessary care of making his client’s interests a priority. We think that Short also has a conflict of interest, and under CFA Institute’s Standard VI(A) Disclosure of conflicts, he should recognise he has a financial interest in the timing of public release of his report, declare this to his line manager or compliance officer and discuss the most appropriate way forward.
Issue 6: Ownership of completed prior work

Example
Colin, CFA, is an analyst at a global asset manager, working in the sustainable investing team. Colin is developing a proprietary ESG scoring model for companies in the firm’s investment universe. He believes his work is different to anything else in the market, provides a new insight into the ESG factors affecting company performance and should give the firm an edge when making investment decisions. Despite his good work, Colin has been looking for a new role, and was recently approached by a head-hunter recruiting for a position at a rival firm. After an extensive interview process, in which he referenced his current work in detail, he accepts an offer to join the new firm. Before leaving his current role and without asking permission, he copies the logic and mapping tables that underpin the model and the most updated scores for all of the companies. Upon arriving at his new firm, he immediately uses this material to aid the investment process, which is very well received.

CFA UK Comment
By copying and using the work, Colin has probably violated CFA Institute’s Standard IV(A): Loyalty (to employers) as he has misappropriated property without his employer’s permission. Research and tools developed in the employ of the firm are usually contractually the property of that firm. Colin may have also violated his employment contract, which would typically have included provisions on intellectual property.

Issue 7: Insufficient thoroughness in due diligence

Example
Dainty, CFA is a junior research analyst on the credit investment team at ABC Asset Management. Dainty has been assigned to undertake credit analysis on XYZ Cement PLC to determine whether or not the team should invest in their bonds. XYZ operates in Greenlandia where the introduction of carbon taxes is widely anticipated. Dainty thinks it would be prudent to undertake some scenario analysis highlighting what the cash flow of XYZ Cement PLC would look like with the introduction of carbon taxes. In his research, Dainty comes across a podcast featuring an experienced and highly regarded fund manager talking about their investment in XYZ Cement and why the potential upcoming carbon taxes won’t be a problem. Upon listening to this podcast,
Dainty decides that carbon taxes are not a material issue for XYZ Cement PLC and decides to publish their internal investment recommendation without having undertaken any scenario analysis.

CFA UK Comment
Dainty, CFA is likely in breach of CFA Institute’s Standard V(A) Diligence and Reasonable Basis which dictates that Dainty must exercise diligence, independence, and thoroughness in analysing investments, making investment recommendations, and taking investment actions. Dainty is likely in breach of this by not undertaking their own investment research, and instead relying entirely on and not evaluating the quality of a third party opinion in coming to their conclusion.

Issue 8: Manager research and selection of sustainable funds

Example
Tomas, CFA works as an analyst at a UK based wealth manager in its manager research team. His primary responsibility is the research and selection of mutual funds to be used in the firm’s sustainable investment portfolios. One of the funds he has been analysing scores very well on third party ESG metrics, with top quartile ESG scores based on its holdings. Some members of the portfolio management team are keen to add this fund to the firm’s portfolios: it is run by a very well-known asset manager, has the desired risk-return profile, and would improve the overall scores of the portfolios based on the third party ESG metrics. However, after further analysis, Tomas discovers that there are no mechanisms in the investment process for this fund to arrive at a sustainable portfolio, i.e. any positive scores of the portfolio’s current holdings are purely coincidental and not an intentional outcome of the investment process. Additionally, he does not believe that the third party ESG scores being used are a good measure of sustainability, and as a consequence, on both counts, the fund does not actually meet his firm’s policy for selecting sustainable investments. Accordingly, Tomas decides not to recommend the fund for inclusion in the firm’s sustainable portfolios, much to the frustration of some of the portfolio managers.

CFA UK Comment
Tomas seems to have met his diligence responsibilities under CFA Institute’s Standard V(A) Diligence & reasonable Basis. Tomas conducts thorough due diligence on the fund, and despite pressure from other internal stakeholders, does not think it meets the minimum acceptable standard for a sustainable fund. As such, he has no reasonable basis to recommend the fund. In addition, in many jurisdictions the lack of process would violate disclosure regulations. UK SDR requires that at least 70% of the product’s assets must be selected with reference to a robust,
evidence-based standard that is an absolute (as opposed to a ‘relative’) measure of environmental and/or social sustainability. EU SFDR requires that Article 8 and Article 9 products disclose the investment strategy that guides their investment decisions, such as objectives and risk tolerance.

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**Issue 9: Verifying accuracy of third-party data and opinions**

**Example**

Turner, CFA is an equity analyst responsible for analysing the sustainability data of his firm’s stock universe. Given the large number of enterprises in the stock universe, and the lack of internal resources and processes, Turner relies on external advisers for compiling the companies’ climate change targets and strategies (e.g. their TCFD reports and SBTi targets) and for their analysis and opinion on the data. Turner then aggregates and uses these external opinions outside his firm with a generic assessment in terms of the portfolio’s alignment to net-zero by 2050.

**CFA UK Comment**

To meet his responsibilities under CFA Institute’s Standard V(A) Diligence & Reasonable Basis, Turner should check and evaluate the information and assessment as he shares a responsibility for the accuracy and reliability of the data and opinions. We think that Turner should also encourage his employer to develop a proper set of procedures and compliance checks to verify the information that is collected via third-party firms. When using internal and external advisers to provide an opinion, his firm should independently validate their assessments before marketing these externally.

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**Issue 10: Managing funds in accordance with stated sustainability objectives**

**Example**

Kemi CFA works as an analyst at a leading hedge fund, ABC, which has enjoyed a top-quartile performance over the last five years amongst peer European equities funds. ABC explains the integration of ESG into the fund’s investment process in its fund documents and state it is implemented in line with the “UNPRI / CFA Institute definition of ESG Integration” i.e. the “the
explicit and systematic inclusion of ESG issues in investment analysis and investment decisions”. The fund follows a prescribed decision process for all new investments, which includes a stage to consider ESG factors. Kemi was enthused by ABC’s investment in one company, GreenHyo, which is at the cutting edge of green hydrogen development. Shortly after Kemi joins, the fund begins to underperform, and the CIO asks for a review of all the fund’s holdings. GreenHyo had announced a significant new investment in a new technology and the analyst’s in-house view was that it would take 5-10 years before the firm could generate material profits from this investment. GreenHyo had also just announced the loss of a large client contract. The fund managers sell down the GreenHyo investment and then short the stock. Kemi, CFA is affronted by the decision, stating that she did not want to work for a fund that placed short-term trading performance ahead of supporting sustainable companies and failed to follow the declared strategies of its funds.

CFA UK Comment
ABC’s fund managers have likely not violated CFA Institute’s Standard V(B) Communication with Clients and Prospective Clients as the UNPRI / CFA Institute definition of ESG integration does not require ESG factors to be dominant or primary at all times. ESG factors do have to be considered for every individual investment decision, but they can be overridden by other factors that may be determined to be more significant. Provided the disposal and shorting of GreenHyo stock was an exceptional case rather than a common occurrence, we believe ABC’s fund managers’ actions are in compliance with the fund documents.