INTUITION®

Learning Insights

ISSUE 10 NOVEMBER 2021

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European Funds Warn of Greenwashing Epidemic Amid Confusion Over Sustainability Disclosure Rules

As European asset managers scramble to implement the Sustainable Finance Disclosure Regulation (SFDR), they are warning of a significant risk of greenwashing. With little clarity on what makes a fund "sustainable," it is possible that asset managers may mislabel instruments, leading to investor confusion and errors. The muddle over the new rules highlights a key issue that has long bedeviled the ESG industry: A lack of universal definitions and terminology. It's a problem that has the power to undermine good faith efforts to make investing more sustainable and destroy investor confidence in the industry, and solving it will not be easy.

Most asset managers agree that the goals of the SFDR are both laudable and important. As world leaders gathered at the COP26 summit in Scotland, investors worldwide were giving serious thought to the role their investment money can play in building a more sustainable economy and staving off the ravages of climate change. Better disclosure on sustainability matters should help these investors make wiser choices and drive faster systemic change.

However, while financial professionals support the objectives of the SFDR, they are increasingly worried about its implementation.

What is the SFDR?

The SFDR is a European regulation aimed at promoting disclosures related to sustainability issues.

Part of the broader EU action plan for sustainable finance, the goal of the SFDR is to enable investors to compare the sustainability characteristics of different financial products.

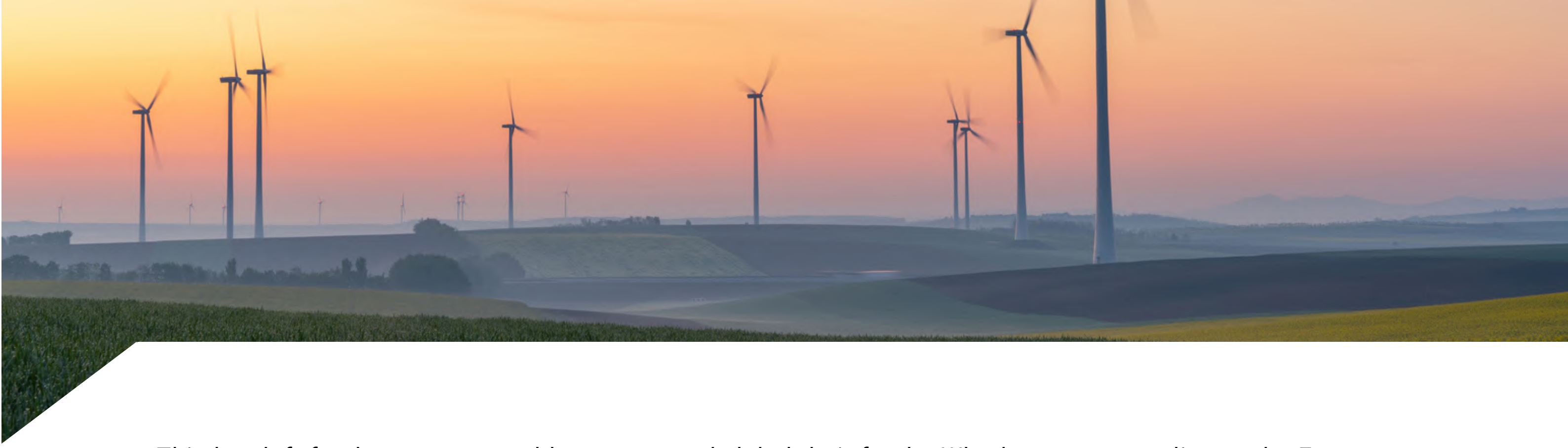
Under the SFDR, financial market participants must ensure they integrate sustainability risks into their investment processes and inform customers of the sustainability-related details of their products. The regulation has two related objectives:

- To provide rules for financial market participants and financial advisors on transparency around the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes
- To provide rules on the provision of sustainability-related information about financial products

With no guidance, errors are inevitable

Among the requirements of the SFDR is that all investment funds must explicitly disclose their sustainability status to investors. The idea is that this will empower those investors to choose funds that align with their personal sustainability goals.

But fund managers are finding it almost impossible to label their funds accurately because the rules for doing so are unclear and unfinished. Even though the deadline for disclosing funds' sustainability status is January 1, 2022, the guidelines for evaluating funds have not yet been finalized. The Regulatory Technical Standards (RTS), which are supposed to help fund managers interpret the green taxonomy that underpins all of Europe's new sustainable finance rules and apply it to fund classification, have been delayed as lawmakers struggle with the complexity of their task.



This has left fund managers unable to accurately label their funds. What's more, according to the European Fund and Asset Management Association (EFAMA), this is creating a troubling risk: Asset managers may mislabel their funds as Article 8 or 9 (the highest category of sustainability), thereby either inadvertently or intentionally greenwashing their products based on the incomplete rules. This could mislead investors and undermine trust in the classifications and the asset management industry.

A complex problem

The SFDR is part of the EU's broader action plan for sustainable finance, which consists of a series of legislative actions designed to boost the proportion of funding directed at sustainable activities (see graphic). The foundation of the plan is the EU Taxonomy for Sustainable Activities, which defines a wide range of activities that can be considered truly sustainable. The SFDR is meant to use the taxonomy as the basis for its classification of funds.

Irish Funds. European Union Action Plan on Sustainable Finance: Disclosures Regulation. November 2019.

This approach is intended to overcome one of the biggest issues facing the transition to sustainable finance: Identifying what funds or activities or companies truly count as sustainable.

It's a complex problem that has long dogged would-be ESG investors. A company may, for example, be an industry leader in workers' rights and governance, but may engage in activities like fossil fuel burning. Alternatively, a company may be developing green technologies but have a reputation for human rights violations and financial chicanery. Should these companies be part of a sustainable portfolio or not?

The taxonomy is designed to answer questions like those by assigning activities scores and creating thresholds for what should be considered "sustainable." However, the delays in creating the RTS highlight the complexity and difficulty of the task.

As fund managers await greater clarity, ESG investors around the world should take note of these unfolding events. If the EU succeeds in building a workable framework for defining, categorizing, and measuring sustainability, it will represent an enormous step forward for sustainable finance.

Intuition Know-How has a number of tutorials that are relevant to ESG-related investing and sustainable finance:

- ESG – An Introduction
- ESG Factors
- ESG Investing – An Introduction
- ESG Investing – Strategies
- Impact Investing
- ESG Reporting
- Sustainable Finance – An Introduction
- Sustainable Finance – Principles & Frameworks
- Sustainable Development Goals (SDGs) - An Introduction
- Sustainable Finance Disclosure Regulation (SFDR)

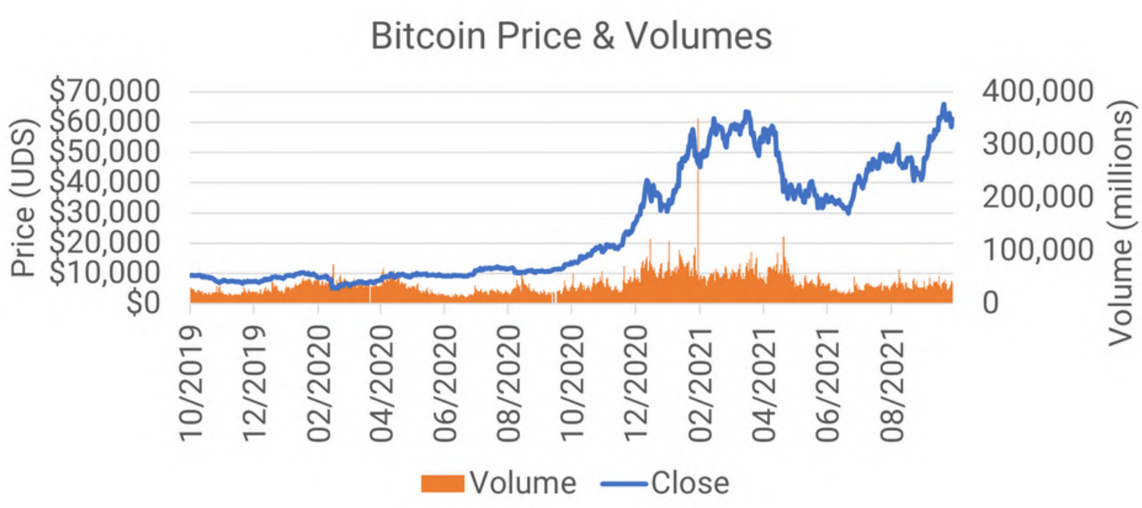
As Bitcoin-Related ETFs Launch, Traditional Financial Firms Are Poised to Dominate the New Market

With the launch of the first US-based Bitcoin futures exchange-traded funds (ETFs) in October, crypto assets took another important step toward mainstream acceptance. Many questions remain, including the timeline for ETFs that invest directly in coins (rather than futures) and the role of regulators in the market. Nevertheless, the early success of the new funds is a marker of the growing popularity of the asset class and Wall Street's rising interest in it. While crypto enthusiasts see blockchain-based currencies as an alternative to the mainstream financial system, traditional financial firms may be the main beneficiaries of investor appetite for these new assets.

On October 19, the ProShares Bitcoin Strategy ETF launched on the New York Stock Exchange amid great fanfare. The fund saw almost $1 billion in trade on its first day as US investors flocked to gain exposure to the world's biggest cryptocurrency, and it was quickly followed by the similarly structured Valkyrie Bitcoin Strategy ETF on October 22.

These new ETFs – and others like them elsewhere – hold futures contracts that track the price of Bitcoin, rather than holding the coins directly. Regulators prefer this model because futures trade on regulated markets, in contrast to bitcoins, which trade primarily on unregulated exchanges.

That means that futures ETFs offer investors a way to gain exposure to Bitcoin without the risks associated with using unregistered coin exchanges, many of which have been the target of fraud, AML, and other financial misconduct investigations – as well as hacks in which millions of dollars of coins were stolen.



Source: Yahoo! Finance. Bitcoin Price and Volume. October 2021.

Wall Street comes knocking

The success of these new ETFs underscores Wall Street's growing interest in crypto assets – and the fees generated by crypto products.

Already, US investors can access Bitcoin and other cryptocurrencies through private trusts. With the launch of Bitcoin futures ETFs, however, the market is now open to a greater range of investors, including retirement accounts such as 401(k)s and IRAs. As more investors dip their toes into crypto through derivative instruments, products with the reassuring stamp of traditional financial firms stand to grab significant market share.

That could make traditional financial firms among the biggest beneficiaries of the emergence of crypto assets – an irony, given the stated desire of many cryptocurrency enthusiasts to build an alternative financial system uncorrupted by traditional firms.

Regulatory tussles

As mainstream investors move assets into crypto markets and Wall Street firms launch crypto-linked products, regulators are taking these assets more seriously. Efforts are underway in many jurisdictions to expand oversight of digital assets, although the results have been patchy.

In the US, for example, there has been some confusion over the regulation of crypto assets. The US system divides responsibility for financial oversight among multiple agencies. The Commodity Futures Trading Commission (CFTC), for example, has responsibility for regulating derivatives, while the Securities and Exchange Commission (SEC) regulates securities.

This has meant that different crypto instruments fall under different agencies. The CFTC defines cryptocurrencies as a commodity, meaning that the agency has authority over crypto derivatives, including swaps and futures. However, some digital tokens have been defined as securities – the SEC, for example, has charged Ripple with conducting an unregistered digital securities offering by selling its coin XRP.

As a result of these wrangles, it is unclear which agency should take primary responsibility for the regulation of crypto assets, and both the SEC and the CFTC have sought to expand their authority in this area.

Recently, for example, the CFTC has been increasingly aggressive in its oversight of crypto markets – in October it fined Tether, an issuer of a US dollar-linked stablecoin that has a close relationship with Bitcoin, $41 million for making false and misleading statements about its reserves. The CFTC also fined the cryptocurrency trading platform Bitfinex $1.5 million for illegal transactions. Rostin Behnam, the Biden administration's pick to head the CFTC, has said that Congress should expand the CFTC's power over cryptos given the explosive growth in digital assets.

But at the same time, SEC head Gary Gensler has pushed for more power to oversee digital coins and the SEC has flexed its regulatory muscles with action against Ripple, online crypto lending platform BitConnect, and others.

Heading to the moon

While it's yet unclear how the regulatory environment will evolve, Wall Street obviously sees enormous potential for the crypto market.

Even though regulators don't yet allow traded funds to directly hold coins, derivatives products that track cryptocurrencies and other digital assets offer a regulator-approved – and, for Wall Street firms, highly lucrative – avenue for crypto investment. With the success of the Bitcoin futures ETFs, we will doubtless see many new instruments emerging over the next few years.

Once the regulatory dust settles and effective oversight over crypto is established, it is likely that big Wall Street firms – much derided by crypto enthusiasts – will be among the most important players in the market.

Intuition Know-How has a number of tutorials that are relevant to crypto assets, ETFs, and futures contracts:

- Cryptography
- Blockchain – Primer
- Crypto Assets
- Exchange-Traded Funds (ETFs) – An Introduction
- Exchange-Traded Funds (ETFs) – Types
- Forwards & Futures – An Introduction
- Forwards & Futures – An Introduction
- Financial Regulation (US) – SEC
- Financial Regulation (US) – CFTC