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Professional Perspective

Green Bond Second Party Opinions: Legal and Practice Considerations

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Annual issuance of "green bonds," financing instruments connected to business activities with positive environmental effects, have gone from non-existent in 2007 to greater than $250 billion (equivalent) in 2019, using the most conservative estimates.

The rapid growth in this market has been driven by investor interest rather than by regulatory incentives, and governments have stayed on the sidelines for the most part. Without a central, government-mandated regime for certifying a bond as green, market participants have developed alternative means to validate issuers' labeling of bonds as green.

The most widely followed of such initiatives is the "Green Bond Principles," which were developed by the International Capital Market Association (ICMA), a committee of investors, issuers and underwriters, and have been periodically updated since their initial publication in 2014. The Green Bond Principles are voluntary guidelines that establish the elements an issuer must disclose to the market to support the green label on a green bond. They do not, however, state exhaustively which business activities are considered green.

The Green Bond Principles recommend, but do not require, that issuers obtain external review of their Green Bond Framework (discussed below) prior to issuing a green bond. This external review can take the form of verification or certification under external standards (such as the Climate Bond Standards) or quantitative ratings (such as from a ratings agency), but the most popular form of external review is a second party opinion that addresses factors relating to the issuer's labeling of the bond as green. SPOs are provided by consultants with environmental expertise, and were obtained in greater than 85% of green, social or sustainability bonds by number of issuances in 2019, according to *Environmental Finance*.

Despite their popularity in the green bond market, SPOs are not a customary part of the broader fixed-income finance market with well-defined market practice and broadly accepted legal status under U.S. or European securities law. This article describes SPO practice in more detail, discusses how an SPO fits within the existing U.S. legal framework for securities offerings, and outlines some best practices. The analysis in this article applies equally to registered and unregistered securities offerings, with distinctions made as needed.

SPOs Defined

SPOs are generally five to 10-page documents that review the issuer's Green Bond Framework and policies related to environmental issues. The purpose of the SPO is for the reviewer to provide its assessment of whether a Green Bond Framework, as promulgated by that issuer, meets the standards of the Green Bond Principles and market expectations of "greenness," such that the Green Bond Framework can credibly be used for an issuance of green bonds. Since SPOs focus on the Green Bond Framework instead of a particular bond, they need not be obtained for each individual bond issuance under a given Green Bond Framework.

An issuer's Green Bond Framework represents the internal policies and governance that support that issuer's assessment of what makes their bond green. This generally includes four elements, which track the four core components of a green bond as set forth in the Green Bond Principles:

> **Use of Proceeds.** A statement to the effect that an amount equal to the net proceeds of the offering will be allocated to eligible green projects and a definition of eligible green projects. These projects can include any number of business activities with purported environmental benefits. Lists of eligible green projects with five to 10 categories are not uncommon.
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> **Project Selection.** A description of how the issuer will determine which eligible green projects should receive allocations. Typically, this determination is handled by one or both of the issuer's sustainability team and treasury team.

Management of Proceeds. A description of how the issuer will manage the proceeds. This typically states that the issuer will deposit the funds in its general liquidity accounts, as green bonds generally do not segregate funds or use escrow structures.

Reporting. Expected reporting to the market. This typically requires the issuer to report annually which projects the proceeds were allocated to, until full allocation.

The conclusion or opinion provided in the SPO varies depending on the provider. The SPO will often state that the Green Bond Framework complies with the Green Bond Principles. SPOs might also opine generally on the alignment of the issuer's Green Bond Framework with the issuer's sustainability strategy or related policies.

Some SPOs will provide their assessment on the relative merits of the Green Bond Framework, such as by stating that it is "light green" or "dark green." This distinction is made by SPO provider Cicero, for example, which applies the dark green label if the framework permits allocating funds to projects that are consistent with the long-term goal of a climate resilient, low carbon future, such as well-designed and well-governed wind energy projects.

Cicero also applies the light green label if the framework permits allocating funds to projects that are environmentally friendly, but do not directly contribute to that goal, including projects that increase fossil fuel infrastructure efficiency, thereby decreasing cumulative emissions.

SPO Providers

SPOs are provided by organizations that specialize in environmental, social and governance research and analysis and have the expertise and reputation to provide assurance regarding the "greenness" of a Green Bond Framework. Two of the most prominent SPO providers in 2019 were Sustainalytics and Cicero.

SPO providers should generally be independent from the issuer and its advisers, although the Guidelines for External Reviews (published in June 2018 by ICMA) suggest affiliates of the issuer or advisers may provide this review with appropriate information firewalls. Unlike accounting firms that audit financial statements, many SPO providers are not subject to stand-alone independence requirements. In some cases, SPO providers or their affiliates provide advisory services to potential green bond issuers, which may raise independence issues analogous to those raised in respect of proxy advisory firms that provide both proxy voting recommendations to institutional investors and consulting services to corporations seeking assistance with improving their corporate governance rating.

Use of SPOs

SPOs are generally made publicly available concurrently with the issuer's public announcement that it is marketing a green bond. The key audience for an SPO is the investor universe, which looks to the SPO primarily to understand the Green Bond Framework and to review the analysis of the issuer's sustainability policies, if included. Some investors simply need to confirm the existence of an SPO by a recognized provider to meet a portfolio criterion.

SPOs are also, in some cases, required for a green bond to be included on a green-specific list of securities. For example, listing on the NASDAQ sustainable debt network requires that the issuer obtain an external review. Although the existence of an SPO may be useful for the underwriters of a bond offering as supporting their due diligence, SPOs generally are not addressed to the underwriters.

SPO Legal Issues

Most documents involved in a securities offering raise potential risks under generally applicable securities laws, and SPOs are no different. The still-developing nature of market practice for SPOs makes identifying and managing those risks more challenging, especially given the rapidly evolving nature of the green bond market. The below discussion addresses certain of those legal risks and presents best practices for protecting offering participants.

SPOs May Constitute 'Offers'

Under U.S. securities laws, all "offers" of securities must be registered or subject to an exemption from the registration requirement. Section 2(a)(3) of the U.S. Securities Act of 1933, as amended, defines "offer" expansively to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."

Courts have interpreted this broad definition to include any activity that may have the effect of soliciting or creating a buying interest in a security. To the extent the issuer has the SPO published concurrently with announcement of a green bond offering, there may be a risk that the SPO will be interpreted as soliciting an offer to buy the bonds. Securities purchased pursuant to impermissibly unregistered offers can be subject to rescission by the buyer.

In a typical offering, issuers and underwriters rely on a variety of safe harbors and exceptions to ensure no inadvertent offers occur. But with no safe harbor or exception specifically contemplating an SPO, issuers conclude, in effect, that the SPO is not an offer of securities. This conclusion has some merit: the stated purpose of an SPO is to confirm the appropriateness of a green label, not to solicit offers to buy a security, and the SPO provider does not directly benefit from or control any aspect of the sale of the securities. Still, there is room for debate given the expansive definition of offer and the publication of the SPO concurrently with the marketing effort. To minimize the risk that an SPO is treated as an offer, issuers should:

- Ensure that the SPO includes "not an offer" disclaimers—although not dispositive, it is prudent to include statements that the SPO does not constitute an offer to sell or a solicitation of offers to buy any security. Such statements are required for certain safe harbors and, by analogy, may be helpful in this context;
- Limit the discussion of a particular transaction in the SPO—the purpose of the SPO can often be accomplished without referring specifically to the live transaction. SPOs often discuss the Green Bond Framework in general without reference to the terms of a particular issuance, such as quantum, interest rate or maturity. This level of generality suggests that no "security" is being discussed—only a Green Bond Framework and related policies; and/or
- Consider publicizing the Green Bond Framework and SPO prior to a live transaction – more commonly seen in Europe and with medium-term notes programs, some issuers have posted information relevant to the green aspects of a potential bond issuance on their websites weeks or months prior to marketing a particular issuance. An SPO published outside of the context of an on-going securities sale is less likely to be plausibly considered an offer.

Separation Between SPO and Offering Disclosure

Issuers and underwriters may be subject to liability in the event that the offering disclosure used for the sale of the security is misleading, either due to a false statement or due to omissions of material facts. To manage this liability, in underwriting agreements, offering participants seek to limit carefully the perimeter of what constitutes "offering disclosure" to the particular offering document or prospectus and those further documents specifically incorporated by reference.

The contents of the offering disclosure are subject to careful diligence by the various offering participants. Issuers generally provide representations and indemnities in favor of the underwriters supporting the completeness and correctness of the offering disclosure. To the extent the SPO is considered part of the offering disclosure, issuers and underwriters may face liability for any misleading statements in the SPO and underwriters would be without contractual protection from the issuer.

To minimize the risk that the SPO is considered part of the offering disclosure, issuers should:

- Ensure that both the offering document and SPO include "not offering disclosure" disclaimers – similar to the "not an offer" disclaimer – which are not dispositive, but would be helpful in the event of future disputes; and
- Include customary purchaser representations confirming that the investment decision was made without reference to any materials other than the specified offering disclosure.

Inconsistency Between SPO and Offering Disclosure

Issuers and underwriters may face claims that the offering disclosure was materially misleading, based on inconsistencies between the SPO and offering disclosure. This could occur if the SPO contradicts statements in the offering disclosure or if the SPO includes information not otherwise included in the offering disclosure. In general, issuers and underwriters look to include all material information and risks in the offering disclosure.

Materiality in securities offering disclosure has traditionally focused on facts related to financial performance. The focus is different for an SPO, in which environmental policies and risks are more directly addressed. The difference in focus means that the SPO will often include information not included in the offering disclosure. These inconsistencies can be categorized in three ways, with a corresponding best practice. In each case, it may be prudent for issuers and underwriters to review the SPO in advance of its use and in advance of finalizing the offering disclosure:

- Contradictory statements—if the offering disclosure and the SPO make factually inconsistent statements, these statements should be harmonized.
- Omissions at least arguably material—if the SPO includes statements about the issuer that appear arguably material, it may be advisable to include such statements in the offering disclosure out of an abundance of caution.
- Non-material omissions—similar to the manner in which non-material information included on an issuer's website is not included in the offering disclosure, in cases where the issuer and underwriters are comfortable that information in the SPO is not material, it can remain outside of the offering disclosure.

Naming SPO Provider in Offering Disclosure

For registered offerings in the U.S., the issuer must file the written consent of any person "whose profession gives authority" to his or her statements if the offering disclosure names such person (the "expert") as having prepared any report used with the offering disclosure. Examples of such experts are the accounting firms that audit an issuer's financial statements, and engineering firms that report on disclosures of natural resources reserves.

Any such expert can in turn be held liable under U.S. securities law to the extent the applicable disclosure is materially misleading. Such liability may be passed on to the issuer to the extent required under the terms of any indemnities included in the issuer's engagement with the SPO provider. This written consent requirement arguably sweeps in SPOs and SPO providers to the extent they are named in the offering disclosure, although we are not aware of any registered offerings that took such an approach. To avoid any possibility of unexpected liability or the need for a consent, it is advisable to avoid naming the SPO provider in a registered offering.

Conclusion

Just as with auditor comfort letters, reserve engineer reports and industry research, in due course, market practice around SPOs is likely to coalesce such that market participants can be reasonably confident that they are on the right side of the securities laws. The above-described best practices hopefully will help issuers, underwriters, and SPO providers navigate these issues in the meantime, in a way that works for all market participants.