ESG investing: The sharpening teeth of disclosure

By anticipating regulatory developments in ESG investing, financial firms have an opportunity to stay ahead of the curve, minimize future costs of compliance and feed the growing demand from investors for responsible products and services, write **Jonathan Rogers**, **Samantha Richardson** and **Paula Melendez**

Environmental, social and governance (ESG) investing is accelerating into the mainstream, as awareness among investors intensifies and they increasingly exert pressure on companies and their boards to consider the environmental and social impact of their businesses.

According to Bloomberg, global sustainable investments grew by 44 percent to US$30.7 trillion over the past two years. Consumers can choose from a growing array of sustainable financial products, from green bonds to sustainability-linked loans and green mortgages, as well as ESG funds.

At the same time, regulators are developing adequate frameworks to ensure that companies—including regulated firms—have guidance to work towards, and to prevent consumers from being misled over an issuer's or products' green credentials and thereby prevent or reduce "greenwashing"—the practice of marketing financial products as "green" or "sustainable", when in fact they do not meet basic environmental standards.

Sustainability is relevant for all financial market participants—from issuers to financial services firms to consumers—and EU financial services regulatory authorities, as well as a number of national regulators including the UK Financial Conduct Authority (FCA), are keen to ensure that these market participants work together effectively and ensure that markets can be trusted and operate without harm to the sector or consumers.

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The aim of regulators is to enhance the availability, reliability and consistency of issuers' information in relation to ESG risks and opportunities, so that regulated financial services firms can better integrate this information into the design and delivery of their products and services. In turn, consumers will have access to sustainable finance products and services and receive suitable information and advice to support their investment decisions.

US$ 30.7 tn

Value of global sustainable investment in 2019

Source: Bloomberg

EU regulatory initiatives

As part of their commitment to achieve the United Nation's 2030 Agenda and Sustainable Development Goals (UN SDGs) and to comply with various international agreements, such as the Paris Climate Agreement (COP 21), the European Commission has developed an Action Plan on Sustainable Finance (the EU Action Plan). The EU Action Plan, unveiled in March 2018, aims to provide a regulatory framework to support and promote sustainable investment in the EU in line with these global climate change commitments.

The EU Action Plan's aims include establishing an EU-wide classification system or "taxonomy" for sustainable finance and common labels for green financial products, clarifying sustainability-related duties for asset managers and institutional investors, and promoting transparent ESG policies and reporting. In order to implement the EU Action Plan, in May 2018 the Commission adopted several legislative proposals, which we examine in greater detail below.

Taxonomy Regulation

The proposed Taxonomy Regulation provides the framework for the establishment of an EU-wide scheme of classification to provide all stakeholders with a common language to help establish whether an economic activity is environmentally sustainable. In so doing, the stated aim of policy-makers is to reduce both greenwashing and fragmentation resulting from market-based initiatives and national practices.

The Regulation aims to embed the taxonomy in other EU laws in order to provide the basis for using a common classification system in different areas (e.g., standards, labels, sustainability benchmarks).

In practical terms, the taxonomy sets performance thresholds (referred to as "technical screening criteria") for economic activities which:

1. make a substantial contribution to at least one of the following environmental objectives (as set out in Article 5):
   - climate change mitigation
   - climate change adaptation
   - sustainable use and protection of water and marine resources
   - transition to a circular economy, waste prevention and recycling
   - pollution prevention and control
   - protection of healthy ecosystems
2. avoid significant harm to any of the other environmental objectives (further details of when this occurs are set out in Article 12) and

3. are carried out in compliance with a number of minimum social and governance safeguards (referenced in Article 13).

A report released by the Technical Expert Group (TEG), which was appointed by the Commission to develop the framework, sets out screening criteria for 67 activities across eight sectors that can make a substantial contribution to climate change mitigation, and provides guidance and case studies for investors preparing to use the taxonomy. Technical screening criteria for the other environmental objectives included in Article 3 are expected to be progressively established in delegated acts.

The Taxonomy Regulation continues to progress through the EU legislative process and came one step closer to being finalised on December 5, 2019 when EU negotiators reached a provisional agreement on the framework. The deal is subject to approval by the European Parliament and EU Council, which is expected before the end of 2019. Although the Taxonomy Regulation will come into force 20 days after it is published in the *Official Journal of the EU*, it will not apply until after the adoption of the delegated acts establishing the technical screening criteria for each environmental objective.

There will be staggered application dates for the different environmental objectives ensuring that market participants have sufficient time to prepare.

Disclosure Regulation and Low Carbon Benchmarks Regulation

On November 27, 2019, the European Parliament and the European Council adopted the following regulation as part of the EU Action Plan to facilitate investments in sustainable projects and assets across the EU:

- Regulation on disclosures relating to sustainable investments and sustainability risks in the financial services sector, or so-called Disclosure Regulation; and
- Regulation amending the Benchmarks Regulation as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks—the so-called Low Carbon Benchmarks Regulation.

67

activities across eight sectors that can make a substantial contribution to climate change mitigation already have corresponding technical screening criteria

The Disclosure Regulation details how financial market participants and financial advisors should incorporate ESG risks and opportunities in their processes, procedures and policies. The regulation sets out new responsibilities, which include:

- *Information on websites (Articles 3, 6 and 8):* In-scope entities will be required to publish policies on their website that describe the extent to which the organization integrates sustainability risks into the investment decision-making process. Additionally, for financial products that have sustainable investments as their target, prescribed information, such as a description and the sustainability assessment and monitoring methodologies, must be published on the website.
- *Pre-contractual information (Articles 4 and 5):* For all financial products, pre-contractual information should be provided that discloses how sustainability risks are integrated into the investment decision-making process and how those risks are expected to have an impact on the return of the product.
- *Reporting (Article 7):* On a periodic basis, reports will be required to be produced for financial products with sustainable investment objectives. These reports should evaluate the extent to which the sustainable investment objectives of the product have been attained and should detail the product's sustainability-related impact.

The Low Carbon Benchmarks Regulation amends Regulation (EU) 2016/1011 by introducing new categories of "low carbon" or "positive carbon impact" benchmarks.

To help investors compare the carbon footprint of investments, benchmark administrators will be required to disclose how their methodology takes into account ESG factors for each benchmark or family of benchmarks that is promoted as pursuing ESG objectives. That information should also be disclosed in their benchmark statement, along with the methodology used for the calculation, taking into account how the underlying assets were selected and weighted and which assets were excluded and for what reason. The index provider MSCI has announced that it has created provisional indices meeting the minimum standards of the Regulation and that these are being evaluated and tested by clients in anticipation of the final text being released.

The texts of both regulations were published in the *Official Journal of the EU* on December, 9 2019 and the Disclosure Regulation will take effect from early 2021, whilst the Low Carbon Benchmarks Regulation will take effect from early 2020.

Other anticipated EU legislative initiatives include amendments to Level 2 rules, including the Markets in Financial Instruments Directive (MiFID) and the Insurance Distribution Directive (IDD). These changes will be relevant to institutional investors, asset managers, investment advisors and other intermediaries, requiring them to consider sustainability risks in their activities.

UK and national regulatory initiatives

A number of national supervisory authorities have also pushed through initiatives aimed at improving ESG disclosure and preventing "greenwashing". France's Autorité des Marchés Financiers (AMF) recently announced the creation of a new Climate and Sustainable Finance Commission to tighten the supervision regime of ESG practices

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under its 2016 energy transition law, which requires asset owners to report their management of climate-related risks and the integration of ESG into investment policies.

In the UK, both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) are ramping up the development of supervisory guidance and requirements consistent with the UK government's commitment to transition to a net zero emissions economy by 2050.

FCA FS19/6 – Climate change and green finance

On October 16, 2019, the FCA published "Feedback Statement 19/6: Climate change and green finance", which summarizes responses received by the FCA to its October 2018 Discussion Paper (18/8). In FS19/6, the FCA identifies a number of priority actions, including:

- publishing a consultation paper in early 2020, in which the FCA will propose new mandatory disclosure rules for certain listed issuers and clarify existing obligations.
- finalizing rule changes requiring independent governance committees to oversee and report on regulated financial services firms' ESG and stewardship policies.
- challenging regulated firms where potential greenwashing is identified and taking appropriate action to prevent consumers from being misled, and
- contributing to several important collaborative initiatives, including the Climate Financial Risk Forum, the Fair and Effective Markets Review working group, the government-led Cross-Regulator Taskforce on Disclosures and the European Commission's Sustainable Finance Action Plan.

If the proposed disclosure rules noted above are adopted, the FCA will go further and faster than the UK government's plan to require securities issuers and large asset owners to start disclosing their climate-related risks by 2022. The FCA disclosure requirements would be in line with the recommendations made by the Task-Force on Climate-related Financial Disclosure (TCFD), a global organization formed by the Financial Stability Board to coordinate disclosures among companies impacted by climate change. Although mandatory, the proposed rules are currently expected to be on a "comply or explain" basis. In time, the FCA may consider disclosure requirements on other sustainability factors, beyond climate change, as appropriate frameworks emerge.

PRA SS3/19 – Supervisory statement on enhancing banks' and insurers' approaches to managing the financial risks from climate change

In April 2019, The PRA issued a supervisory statement addressing all UK insurance and re-insurance firms, as well as banks, building societies and PRA-designated investment firms. Building on its reviews of current practices in the banking and insurance sectors, the PRA highlights that while firms are enhancing their approaches to managing the financial risks from climate change, few are taking a strategic approach that considers how actions today affect future financial risks. In particular, the PRA has identified that financial risks from climate change arise through two primary risk factors—physical and transition—and additionally, liability risk, which applies to the insurance sector.

On the basis of these financial risks, the PRA sets out clear guidelines for banks and insurers to follow in governance, risk management, scenario analysis and disclosure.

Regarding governance, and building on the Senior Managers Regime, banks and insurers must have in place updated senior management function forms addressing financial risks from climate change.

On the disclosure front, banks and insurers are being asked to consider disclosing how climate-related financial risks are integrated into governance and risk management processes, including the process by which a firm has assessed whether these risks are considered material or principal risks. These are in addition to their disclosure obligations arising from the Capital Requirements Regulation, Solvency II and the UK Companies Act.

The PRA also expects firms to improve their disclosures to reflect their evolving understanding of climate risks, to recognize that disclosure is likely to be mandated in more jurisdictions and to prepare accordingly.

Finally, and in line with the FCA's expectations outlined above, the PRA wants firms to engage with wider initiatives on climate-related financial disclosures, including the TCFD's policy recommendations and framework.

Other initiatives being heralded in the UK include the Financial Reporting Council's (FRC) recently revised Stewardship Code, which will take effect from January 1, 2020. This so-called 2020 Code includes a set of

The Stewardship Code 2020 will take effect

"Enhanced disclosure protects consumers against "greenwashing" and ensures that risk management remains transparent

"apply and explain" principles for asset managers, asset owners and service providers who will be expected to report certain information in order to remain signatories.

In particular, signatories will be expected to take account of material ESG factors when fulfilling their stewardship responsibilities. The 2020 Code therefore presents an opportunity for listed companies to review their approach to ESG reporting and ensure that it is fit for the purpose. Although adherence to the 2020 Code is voluntary, the FRC can make annual assessments as to whether an existing signatory can maintain its status and take action where a signatory is not complying.

Risks and opportunities ahead

As ESG and climate risk remain high on the agenda of both the public and private sectors, there is an obvious need for the development of policies to guide and regulate the growth of ESG investing. Enhanced disclosure not only protects consumers against "greenwashing" but also ensures that risk management remains as transparent as possible, and that future performance data is valid. In fact, disclosure is likely to form the basis of future ESG regulation mandating specified levels of, for example, green holdings, and limiting the amount of non-green holdings.

Further, while ESG as a framework is already being applied by a large number of financial actors, substantive regulation appears to have mainly covered environmental factors thus far. This may be largely explained by the quantitative nature of environmental considerations, which makes it easier, in contrast to social and governance factors, to distill common metrics and generate comparable information. Initiatives on standards for social and governance factors do exist and may see further developments in the near future.

Jonathan Rogers
Partner, London

T +44 20 7532 2163
E jonathan.rogers@whitecase.com

Samantha Richardson
Professional Support Lawyer, London

T +44 20 7532 1287
E srichardson@whitecase.com

Paula Melendez
Trainee Solicitor, London

T +44 20 7532 2116
E paula.melendez@whitecase.com