



# The Legal 500 Country Comparative Guides Hot Topic

**ESG**

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# ESG

## 1. INTRODUCTION

1.1 One of the most challenging aspects of practising environmental law is the need to simultaneously keep pace with the rapid changes in laws and regulations as well as trends in the market. Over time, the market and governments have converged to move their focus beyond more traditional issues, such as soil and water pollution and asbestos, to products and product regulation, and now to an even broader view of the value chain. This is exemplified by the increasing importance of environmental, social, and governance (ESG) matters, which are now mainstream considerations across the global economy.

1.2 In this article, we consider why ESG has gained traction among various stakeholder groups, and look at some of the major ESG-related laws and standards that are impacting, and will continue to impact, companies and investors.

## 2. WHAT IS ESG?

2.1 ESG encompasses a range of environmental, social, and governance factors by which investors can evaluate themselves or companies they invest in to ascertain their performance. These factors are sometimes referred to by other names depending on context, such as sustainability, corporate social responsibility (CSR), and responsible investing. Investors can use these ESG performance indicators to look beyond the bottom line financial performance of a company and find out how it operates as a corporate citizen.

2.2 Whilst precisely defined ESG indicators have yet to be universally accepted, and will vary from company to company and sector to sector, the UN Principles for Responsible Investment (UN PRI) identify approximately 40 factors. These factors are broken down across each of the “E”, “S”, and “G” pillars, and the UN PRI’s list is regarded by many as an authoritative reflection of ESG. From an environmental perspective, examples may include issues relating to a business’ resilience to climate change or its waste disposal policies. Social factors may include gender pay gap reporting, employee living wage policies and modern slavery, and governance may be focused around board diversity and whistleblowing policies.

2.3 Given recent publicity, companies’ resilience to the possible impacts of climate change is increasingly becoming the ESG factor that generates the most attention. However, climate change is far from the only ESG issue that has hit the headlines in recent times. Blue Planet II placed plastic waste issues at the front of the agenda, #MeToo has ensured that attention has been given to gender equality and harassment at work, and the negative reputational impact of the public disclosure of various corporate tax strategies has kept tax fairness on the agenda. These examples highlight why investors and companies are appreciating the importance of achieving strong performance across each of the three pillars of ESG, and across all aspects of a business and its supply chain.

## 3. WHY IS ESG GROWING IN IMPORTANCE?

3.1 There are both legal and non-legal drivers for the recent surge in attention being given to ESG. There are two significant non-legal factors: investor pressure and the acknowledgment that consumer attitudes are changing. Investor pressure has come about as a result of individuals increasingly becoming concerned that their investments are not just financially sound, but are also supporting ethical investments that do not harm the environment and are socially beneficial. These preferences are then reflected by the funds (e.g., pension funds) that are making the investments. In addition, there is an increasing amount of evidence that suggests a correlation between a company's strong ESG credentials and a strong financial performance. Investors, particularly those who are interested in the long-term outlook of assets, such as pension funds and insurers, are taking note of this body of evidence and tailoring their portfolios accordingly.

3.2 Secondly, the consumer focus on ESG matters is resulting in markets changing, in some cases very rapidly. The reputational risks that have always been a part of poor ESG performance are now being magnified more than ever, and leading to whole markets changing, and companies struggling, as a result of ESG issues. Therefore, the risks involved in neglecting ESG performance, both for investors and businesses, have substantially increased, and the necessary response to that has been to place more focus on these areas.

3.3 The prevalence of these two factors shows that informal and non-binding standards and public opinion are driving the focus on ESG. However, there have also been instances when ESG-related legislation has led the way in making a significant impact. One such example is the UK Modern Slavery legislation, which has in many cases materially changed public awareness of modern slavery and the way in which companies consider modern slavery issues in their supply chains.

#### **4. RISKS AND OPPORTUNITIES**

4.1 The growing importance of ESG has led to greater consideration of the resulting risks that may affect investors and companies. These can broadly be broken down into three categories: (i) reputational risks, (ii) physical risks (especially related to climate change), and (iii) risks resulting from a changing economy.

4.2 Beginning with reputational risks, these have long been a relevant consideration for companies dealing with ESG matters. As highlighted above, however, the increasing availability of information, combined with the increase in public concern about ESG, has exacerbated these reputational risks. Internet-led "boycotts" of companies based on their fossil fuel emissions, employee relations, and tax behaviour have been just one type of adverse impact realised in recent years, and the increasing risk of such events is likely to continue.

4.3 Investors are also increasingly identifying physical risks from climate change as noteworthy, particularly with regard to long-term investments in locations and industries that are predicted to feel significant climate-related upheaval. For example, it was estimated that extreme weather events in 2018 (such as Hurricane Michael in the US and Typhoon Jebi in Japan) caused US\$215 billion in economic loss worldwide, and this number is predicted to rise in future years.

4.4 Finally, investors and companies are increasingly taking a view that the growing importance of ESG is likely to lead to wholesale changes in global markets, whether this be through the evolution of consumer preferences, or the prospect of increasing regulation as issues such as climate change reach the top of legislative agendas worldwide. What constitutes a sound investment or business strategy is changing, and many view neglecting ESG issues as evidence of companies failing to come to terms with that systemic change.

4.5 Perhaps the best evidence of these changes is the proliferation of voluntary standards that investors and companies alike are signing up to in order to demonstrate their commitment to ESG. The signatories of the UN PRI commit to incorporate ESG factors into their investments, and in doing so seek to better manage the associated risks. In addition, the Climate Action 100+, a body that seeks to combine the strength of investors to engage with companies that are seen to be “significant emitters” of greenhouse gases (GHGs), has recently added BlackRock, the world’s largest asset owner, to its roster of members. These commitments made by large, global investors will make securing funding increasingly challenging for those companies without coherent ESG strategies.

4.6 Conversely, this likely change in market dynamics is seen by many market participants as a significant opportunity for growth, as funding for new business strategies and investment opportunities becomes available to those willing to embrace the change.

## **5. THE APPLICATION OF “SOFT” AND “HARD” LAW IN RELATION TO ESG**

5.1 As discussed above, the ESG space has long been defined by a significant number of voluntary standards that have been relevant to investors and companies alike. Responding to the challenge of reaching agreement on binding laws related to ESG on an international scale has long been the rationale for these “soft law” regimes, and voluntary measures that entities can sign up to have proved more popular and workable than legally binding requirements. In recent times though, whilst voluntary standards remain the predominant method of regulating ESG performance, a number of “hard” laws, have begun to evolve, particularly with regard to companies’ ESG disclosures. These include the regulations associated with the European Green Deal and the Non-Financial Reporting Directive (NFRD) (discussed below). This shift has been made possible partly due to the increasing acceptance among market participants of the importance of such standards, and if continued, could represent a material change in the approach to ESG regulation.

5.2 On the other hand, in the US, the SEC has warned of the dangers of implementing blanket rules on ESG disclosures, on the basis that the market has not yet worked out which ESG disclosures are actually relevant to investors. It will be interesting to see how the approaches in these two jurisdictions (and the rest of the world) play out moving forward, particularly bearing in mind the desire held by investors (frequently demonstrated through market surveys) to achieve internationally applicable ESG standards and disclosures.

5.3 A further trend is the significant increase in the demand for “sustainable finance”, the concept of financial flows to environmentally beneficial and sustainable investments (such as green bonds). The sustainable finance market has ballooned, from virtually non-existent as

recently as 2012, to over US\$300 billion in 2019. To date, this market has largely relied on voluntary standards to police it, but there are signs that “hard law” may have an increasing impact on green finance in the future.

## **6. NOTABLE ESG ISSUES**

6.1 We thought it would be helpful to consider specific “soft” and “hard” law examples that we expect to see come to the fore over the next few years:

### 6.2 Task Force on Climate-related Financial Disclosures (TCFD)

(a) The TCFD is a body set up under the Financial Stability Board that seeks to develop and monitor voluntary and consistent climate-related financial risk disclosures for use by companies in providing information to a wide range of stakeholders. A first set of recommendations (the Recommendations) were promulgated by the TCFD in June 2017, and have received significant uptake among market participants and regulators alike. The Recommendations contain guidance to companies relating to specific areas of climate-related disclosure, such as board oversight of climate risk and climate-related opportunities that the business has identified, and are focused on those risks that have the potential to substantively impact financial performance.

(b) Most importantly, the TCFD has found a great deal of traction among regulators and politicians. This is demonstrated by the fact that the UK government, in its Green Finance Strategy, has said it expects all UK listed companies and large asset owners to disclose in line with the Recommendations by the end of 2022, and by Canada’s recent report from its Expert Panel on Sustainable Finance suggesting the incorporation of the Recommendations on a “comply or explain” basis in the near future. In addition, June 2019 saw the EU offer Guidelines on Reporting Climate-Related Information in line with the NFRD, which included mapping the Recommendations to the NFRD, signalling the bloc’s interest in using the Recommendations moving forward.

### 6.3 EU Green Deal

(a) The EU Green Deal was formally adopted in December 2019, and sets out a roadmap for the EU’s environmental program over the coming years. As part of this, the Green Deal pledges to enshrine in law the EU’s commitment to net zero GHG emissions by 2050.

(b) A key aspect of the Green Deal is the Sustainable Finance Action Plan (the Action Plan), which intends to help channel private funds into environmentally friendly and sustainable areas. Perhaps the most notable aspect of the Action Plan is the creation of a new EU Taxonomy for sustainable investment.

(c) The Taxonomy is a system to determine whether an economic activity is “sustainable”, meaning that it contributes to at least one of six identified sustainability objectives, and “does no harm” to the other objectives. Together with the Disclosure Regulation (a separate aspect of the Action Plan that was adopted in October 2019), the Taxonomy will require investors to disclose whether their investment products meet the criteria for a sustainable economic

activity, and the hope among regulators is that this will lead to companies themselves disclosing in line with the Taxonomy in order to attract “green” investment.

(d) The Taxonomy will also modify the NFRD, by requiring those companies currently subject to the NFRD (broadly those with offices in the EU with over 500 members of staff) to disclose the proportion of their turnover and of their total investments and/or expenditure that derives from sustainable economic activities. This is an additional requirement to those already in existence under the NFRD, which include a variety of environmental, social, human rights, and diversity matters.

#### 6.4 UN Principles for Responsible Investment (UN PRI)

(a) The UN PRI is a list of six principles that investors can sign up to in order to demonstrate their incorporation of ESG factors into their investment analysis and decision-making processes. From its launch in 2006, the UN PRI has now gained almost 2,500 signatories representing a majority of the world’s professionally managed investments, and is arguably the pre-eminent set of international voluntary standards with regard to ESG.

(b) In 2020, signatories to the UN PRI are for the first time required to report in line with the Recommendations. The purpose of this reporting is to allow signatories to receive feedback and learn from best practice in reporting, and individual companies’ results will not be publicly disclosed.

#### 6.5 OECD Guidelines for Multinational Enterprises

(a) The Organisation for Economic Co-operation and Development (OECD) is an international organisation that seeks to develop international norms to facilitate economic prosperity. The OECD Guidelines for Multinational Enterprises (the Guidelines) are intended to be an international standard for responsible business conduct, and incorporate a number of ESG considerations for multinationals to abide by. The most recent version of the Guidelines was published in 2011, and contains recommendations for multinationals in a number of areas, including human rights, the environment, science and technology, and tax behaviour.

(b) The Guidelines are an example of soft law, and are not legally enforceable, with a dispute resolution process centred around an adjudicator known as a National Contact Point (NCP) providing good offices for both parties to settle their dispute. If no agreement is made between parties, the NCP can issue an unenforceable opinion on whether the multinational involved has, or has not, complied with its obligations under the Guidelines. The Guidelines are signed up to by states, not by the multinationals themselves, and multinationals are not obliged to engage with the dispute resolution process (although the NCPs have the ability to issue opinions even without the multinational’s engagement).

(c) Whilst being found in violation of the Guidelines has no legal effect, the reputational damage to a multinational may be significant. In addition, under the EU’s Taxonomy, investments that are not compliant with the Guidelines will be excluded from being deemed sustainable, and they also cannot be included as part of the EU’s Climate-Related Benchmarks (a further aspect of the Action Plan).

## **7. CONVERGENCE OF STANDARDS**

7.1 As investors have increased the amount that they incorporate ESG into their investment decisions and strategies, they have become aware of the limits of currently available ESG data. Part of this issue stems from the wide variety of ESG standards that currently exist, leading to reporting from companies being inconsistent and unhelpful. In a 2019 survey by McKinsey & Co., 89% of investors backed the notion that there should be fewer reporting standards than currently exist, and 75% wanted to see one consolidated standard.

7.2 As a result, we have seen action already to consolidate the multitude of standards that currently exist, including the aforementioned example of the work of the TCFD in producing the Recommendations (although the Recommendations only apply to climate-related disclosures, and not the full spectrum of ESG issues), which have been adopted and encouraged by a number of regulators worldwide. In addition, the World Economic Forum International Business Council in early 2020 announced that it was working on addressing the issue, by sponsoring a program to create common metrics and consistent reporting regarding ESG matters. Whether this program will be successful in its aims, or whether it will just add another standard to those that are currently in the market, is unclear. However, it does signal that world business leaders are engaging with investor concerns about ESG metrics, and that further efforts to create converging and consolidated standards are likely.

## **8. CONCLUSION**

8.1 Those areas listed above form a snapshot of the numerous and rapidly evolving ESG standards, requirements, and programs that exist worldwide. Given the increasing importance that investors and companies are placing on ESG, and the interest in the promulgation of more uniform ESG standards, these will likely be supplemented or consolidated moving forward, and we are already seeing interplay between these standards (such as entities in breach of OECD Guidelines being excluded from the Taxonomy), demonstrating regulators are seeing the benefits of this approach.

8.2 This potential standardisation would be a welcome development, as investors have increasingly called for a system whereby they can acquire standardised and reliable ESG data in order to factor into their decision making, and it would also allow companies to accurately identify the areas that most require improvement.

8.3 However, as has been noted by a number of market participants (including the SEC), it is extremely challenging to identify a set of ESG criteria that is useful and relevant for all companies, and attempting to do so runs the risk of distorting investment decisions. Therefore, the key for regulators and standards setters will be to carefully balance this standardisation with a framework that proves adequately responsive to the uniqueness of ESG issues.