The ESG journey in the United Arab Emirates

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With the UAE due to host the 28th session of the United Nations Conference of the Parties ("**COP**") in November this year (**COP 28**),[1] there has perhaps never been a greater spotlight on, or opportunity for, ESG momentum in the region. Following the publication of the Middle East proposals for the region's sustainability focus, we take a closer look into the position in the Middle East and UAE ahead of the UAE hosting COP 28. We will also draw some comparison with the UK's recently published and proposed investment labelling and disclosure regime ("**SDR**").

What is COP 28 all about?

COP 28 is an annual international climate summit comprising global climate leaders (a "**Party**" or together, "**Parties**") who convene to renew their commitment to the Paris Agreement ("**Agreement**"). The Agreement, which came into force at the 21st United Nations Climate Change Conference (COP 21) in Paris 2016, is the first legally binding international treaty to mark signatories' obligation to combat climate change and which has grown its signatory membership steadily – the UAE was the first Middle Eastern Party to sign, in 2016.

Setting out clear goals and ambitions on a five-year cycle, the Agreement has the ultimate goal of reducing greenhouse gas emissions by limiting the globe's temperature increase to 2 degrees Celsius (with a view to reduce this to 1.5 degrees Celsius), and each Party's climate action plan is scrutinised with this in mind.

Amongst other milestones, this year's COP 28 will mark the fifth meeting of the COP serving as the Meeting of the Parties to the Paris Agreement (CMA 5) and the first Global Stocktake, which the Parties agreed would take place at the end of 2023 (and every 5 years thereafter) to assess progress thus far. As a particularly noteworthy event in the global calendar, COP 28 places the spotlight firmly on the UAE's (and the wider Middle East region) efforts in the region so far towards the global effort for a low-carbon and zero-carbon economy.

1. ESG in the UAE so far

The story of ESG in the Middle East is not as new as the COP 28 hosting might suggest. The UAE has been proactive in engaging companies to invest efforts in the sustainability sector as early as 2020. For example, by making ESG reporting mandatory for listed companies.

In 2020, the UAE Securities and Commodities Authority ("**SCA**") issued the 'Corporate Governance Code for Public Joint Stock Companies' ("**Governance Code**")[2]. Article 76 of the Governance Code states that Public Joint Stock Companies on the Abu Dhabi Securities Exchange or the Dubai Financial Market ("**Listed PJSCs**") must publish an annual sustainability report. By way of a clarification note dated 10 January 2021, the SCA detailed the required content of these sustainability reports to clarify that it would accurately address how the company's operations contribute (or have the potential) to the environment; society; and governance (i.e., how its operations positively impact society as well as local economy). In tandem with this mandatory reporting, Listed PJSCs must comply with the Global Reporting Initiative standards, as well as sustainability standards issued by the Abu Dhabi Securities Exchange or the Dubai Financial Market, as appropriate. At this stage, this mandatory reporting only applies to Listed PJSCs and while private and state-owned companies are welcome to adopt sustainability reporting, they are not obliged to produce these reports.

In more recent times, the Abu Dhabi Global Market ("**ADGM**") has identified Sustainable Finance ("**SusFin**") as a strategic priority and was the first International Financial Centre globally to become carbon neutral. This, along with the 2021 issuance of sustainable bonds reaching USD $8 billion in the Middle East and North Africa, show the strides that the Middle East has made in the development of ESG so far.

By way of example, one of the oldest private banks in the UAE has voluntarily joined the United Nations Global Compact (UNGC) initiative for responsible business practices and has pledged to facilitate USD $30 billion of SusFin by 2030. Further, the bank has already enabled USD $15.5 billion of SusFin investments (including projects outside the Gulf) as well as supporting water-related projects worth USD 1.3 billion, which have seen a tangible increase in job generation.

Substantive commitments for future progress have also been made by governments in the Middle East - notably the UAE - which has committed to achieve a "Net Zero by 2050 Strategic Initiative", and provide USD $163 billion to invest in renewable energy until this date. Furthermore, the governments of Saudi Arabia and Bahrain have pledged to achieve net zero by 2060.

However, challenges remain. Globally, an estimated USD $2.5 trillion is needed to close the 'green financing gap' between public body funding and expenditure required to meet the 2015 Paris Agreement to limit global warming to 1.5 degrees Celsius. Private sector initiatives and financial services firms will have an important role to play here, and the ADGM in particular is aiming to use its position as a leading International Financial Centre to foster SusFin activity within the region.

The vast majority of large companies in the region are calling for strengthened ESG regulation, whilst it is thought that less than 20% of companies have teams and systems in place to comprehensively cover ESG functionality. The ADGM's proposal for a SusFin regulatory framework represents a valuable opportunity to accelerate implementations of ESG strategies across such companies.

2. ADGM Consultation Paper: Proposals for a sustainable finance regulatory framework

On 10 November 2022, the Financial Services Regulatory Authority ("**FSRA**") and the Registration Authority of the ADGM issued a joint consultation paper: 'Proposals for a Sustainable Finance Regulatory Framework for ADGM' (Consultation Paper No. 6 of 2022), which sought views from a range of stakeholders for this first-iteration of the SusFin regime.

This consultation paper builds on the ADGM's Sustainable Finance Agenda, as published in January 2019, and Sustainable Finance Platform, as well as the work of the Abu Dhabi Sustainable Finance Forum and the UAE Sustainable Finance Working Group.

The ADGM hopes that its proposals in this consultation paper will cultivate a SusFin hub in which financial returns and positive environmental impact can go hand in hand and ADGM-incorporated entities are incentivised to become greener. In addition, the consultation paper presents ESG disclosure regulatory framework, which, differently to the proposed UK's regime under SDR, works on a 'comply or explain' basis.

As the consultation process closed on 23 January 2023 and its publication is awaited, it will be interesting to review stakeholders' response. It could be argued that the approach suggested by the ADGM is more favourable to corporations trying to grapple with rigorous and divergent disclosure requirements globally, giving them the choice to make disclosures if they so wish. However, it will be difficult to achieve greater investor transparency in relation to 'green' products without the related disclosures to back them up.

3. ADGM's SusFin regulatory framework proposals

ADGM Green Funds

In recognition of the fact that investment funds are great facilitators of investment towards green assets, the ADGM's first proposal in its SusFin regulatory framework is that of an ADGM Green Fund.

The ADGM proposes to tackle greenwashing (the misrepresentation of sustainability-related practices and/or investment products) and general questions over the environmental credibility of assets held by supposedly green funds, by combining the green fund with an 'ADGM Green Fund Designation'. This ADGM Green Fund Designation is currently proposed as an opt-in framework which, for funds that meet the eligibility criteria, means they will be given official recognition and appear on the FSRA Register as a Green Fund. They can also opt to use the ADGM Green Fund logo on marketing and communications materials as an outward facing symbol informing investors that they abide by this SusFin framework.

The ADGM proposes a robust and objective assessment process that pays particular attention to the verification process for green assets. To receive the ADGM Green Fund Designation, the fund must either invest in assets aligned with a green taxonomy, or those included in, or which track a Paris-Aligned Benchmark. In addition, a level of attestation is required which varies (i.e., self or third-party) depending on the eligibility criteria used and the fund type.

The ADGM is trying to strike a balance between building up investor trust and encouraging investment into these funds, whilst not disproportionately presenting barriers to entry.

ADGM Climate Transition Funds

The ADGM also tables the establishment of a 'Climate Transition Fund' that invests in greening assets (instead of green assets). With decarbonising still in early stages, the capacity for investment in green assets is limited. As such, the ADGM recognises the necessity for a second sustainable fund so as to not limit the framework. Greening assets are those which have the potential to become green over time and investment in these assets contributes directly to financing their decarbonization.

Whilst it is sometimes difficult in practice to accurately categorise and distinguish between the two asset groups, transparency in choice between Green Funds and Climate Transition Funds is designed to build investor confidence, attract investment in such sustainable-positive funds, as well as prevent greenwashing.

To maintain credibility and objectivity, greening assets will be defined according to a minimum criteria and can fall into one of the following categories:

- assets aligned with a climate transition taxonomy;
- shares and debt issued by entities that have a published net zero target and a credible strategy of achieving it;
- green and sustainability-linked bonds and sukuks;
- greening real estate assets and infrastructure; and
- assets featured in or that track a Climate Transition Benchmark.

The ADGM seeks particular feedback on the asset types that Climate Transition Funds should be permitted to invest in; greening criteria those assets must fulfil; and additional controls of fund managers to mitigate greenwashing risks.

Similar to the process of ADGM Green Fund Designation, there are certain attestation requirements which Climate Transition Funds must meet and an opt-in ADGM Climate Transition Designation for compliant funds. The benefits of which include being listed on the FSRA Register and permitted use of an ADGM Climate Transition Fund logo in client communications.

Discretionary Managed Portfolios

In light of the significant expansion in the number of investment managers operating in the jurisdiction, the ADGM proposes setting minimum standards that Discretionary Managed Portfolios must meet in order to be considered green or greening.

With a goal of attracting investor capital and increasing investor confidence, the regime will operate in much the same way as Green Funds and Climate Transition Funds, except that it will only be applicable to:

- Discretionary Managed Portfolios offered to retail clients, as professional clients are expected to have a more sophisticated investment knowledge and greater control over asset management; and
- Model portfolios, as these are often subject to a high concentration of “green-labelled” Discretionary Managed Portfolios and a low level of client control over the investment strategy.

The ADGM proposes that, in addition to ESG-labelled benchmarks as a reference point for appropriate assets, investment in a Paris-Aligned Benchmark or Climate Transition Benchmark is also permitted.

Currently the ADGM’s position is that whilst the designation will allow managers to use the logo, because Discretionary Managed Portfolios are not “standalone legal entities” and differing to the approach taken with respect to Green Funds and Climate Transition Funds, they will not be listed on the FSRA register.

Green bonds and sukuks, and sustainability-linked bonds and sukuks

There is already a recognised green bonds market in the region, which through a new opt-in framework that is designed to encourage confidence, enhance the reputation of the existing market and catalyse investment, the ADGM hopes to transition into a “thriving centre” for green debt. It proposes to issue ADGM Green Bond Designation to debentures funding specific green projects and ADGM Sustainability-Linked Bond Designation to debt funding general improvements in organisational sustainability.

Identified as a strong priority throughout the proposals, the ADGM recognises the importance of raising investor awareness of anti-greenwashing standards and intends to further strengthen these controls post-implementation (e.g., setting minimum standards for second party opinions).

The ADGM acknowledges that as the SusFin regulatory framework matures and expands over time, it hopes to incorporate transition bonds, transition sukuks and other types of green debt.

ESG disclosures

The ADGM proposes a ‘comply or explain’ framework which requires entities that choose not to make ESG disclosures, to communicate their reasons for failing to do so to the Regulation Authority of ADGM. This obligation only applies to ADGM-incorporated entities with USD$6 billion or more, and for other companies governed by the Companies Regulations 2020 with a turnover of USD $68 million or more (there is an opt-in arrangement operating for entities below these thresholds).

The ADGM, whilst it supports the International Sustainability Standards Board ("**ISSB**"), remains flexible with regards to which global standard the ESG disclosures adhere to. Furthermore, to encourage new business, there is an exemption of disclosure for newly incorporated entities until the third anniversary of their establishment in the ADGM. Post-implementation, the AGDM proposes to consolidate this proposed ESG disclosure framework with that already existing in respect of listed, mining and petroleum companies.

This represents what the ADGM considers as the most comprehensive ESG disclosures regulatory framework in the Middle East, Africa and South Asia region. It will hopefully be a "significant" first step for ADGM-based companies in observing ESG disclosure standards.

4. A Consultation Paper: Principles for the effective management of climate-related financial risks

More recently, on 28 March 2023, the Dubai Sustainable Finance Working Group (which is co-ordinated by the FSRA) opened a consultation in relation to their proposed Principles for the Effective Management of Climate-related Financial Risk (the "**Principles**").

These 7 Principles represent the UAE Sustainable Finance Working Group's minimum expectations of 'financial firms', and in particular their board and senior management, in overseeing the physical, transition and liability related financial risks arising from climate change. For example, Principle 5 comprehensively addresses the monitoring and reporting of climate-related financial risks. It requires financial firms to operate monitoring reporting systems that are "*capable of producing relevant, accurate and timely information*"; identify any reporting gaps; and report this information to the board, senior management and other stakeholders as appropriate.

While the drafting of these Principles takes into account relevant and similar standards published by international bodies, including the Basel Committee on Banking Supervision and the Network for Greening the Financial System, it also allows appropriately wide discretion and flexibility in application for financial services regulators on account of the continually evolving global landscape.

The transition to a low-carbon and zero-carbon economy presents both risks and opportunities to the financial sector, and as such these Principles have an important role to play in equipping financial firms with the tools to best identify and effectively manage risk in the eyes of clients and regulators.

In advance of hosting COP 28, the Dubai Sustainable Finance Working Group has produced guidance literature:

1. Unlocking the Potential of ESG Innovation in the UAE and Across the Globe (considering the perspectives of companies of all sizes, whether start-up or large corporates, providing a step-by-step guide on how to integrate sustainable practices via data- and industry-driven frameworks).
2. The Net Zero Guide (providing high-level, sector-specific guidance to companies across the emirates on how to develop decarbonisation strategies).

It has also published a report, the Sustainability-Linked Loans Guide, aimed at companies wishing to meet financing requirements and sustainability goals, suggesting an approach on how to raise Sustainability-Linked Loans (the terms of which rely on the performance of sustainability targets).

The consultation closed for comments on 1 May 2023.

5. The UK's SDR by way of comparison

In October 2022, the Financial Conduct Authority ("**FCA**") in the UK published a Consultation Paper (CP22/20) on 'Sustainability Disclosure Requirements ("**SDR**") and investment labels'. Whilst the contents of both consultation papers differ; their overarching aims - to tackle greenwashing and increase investor transparency - are comparable. The fact that these themes are drawn out in both papers, and globally, illustrate the importance that governments across the world are placing on developing effective regulation in this space to overcome the existing challenges.

By way of background, a very high level overview of the key areas covered by the FCA's consultation paper are set out below (for more detailed information in relation to the UK regime please see our Law-Now article here) – although these remain subject to change as we await the publication of the final rules from the FCA:

1. **Sustainable investment labels** - similarly to the 'green fund' and 'climate transition fund' designations presented by the ADGM, the UK's labelling proposals present an opt-in regime permitting certain products to use the proposed labels where they meet the associated criteria to do so. The labels proposed by the FCA are currently: **sustainable focus, sustainable improvers and sustainable impact** and the article linked above sets out further information in relation to these labels and their associated criteria. The UK's regime also restricts the use of certain sustainability-related terms in product names and marketing materials unless the product uses a sustainable investment label.
2. **Disclosures** – under SDR, firms must make certain product and entity level disclosures available to investors. This is a very different approach to the comply or explain disclosure framework proposed by the ADGM. Despite the UK regime presenting an additional hurdle for firms to comply with, it does mean that investors will be given clear and accessible information about the sustainability features of a specific product, which may not always be the case under the ADGM's proposals. It will be interesting to see how two diverging proposals play out in reality.
3. **General 'anti-greenwashing' rule** will also be applied to all regulated firms which reiterates existing rules to clarify that sustainability-related claims must be clear, fair and not misleading.

Both the UK's and UAE's consultation periods have now ended - it will be very interesting to see how both the UK and ADGM respond to industry feedback in this area and how the final rules will evolve as a result. Already, the UK's implementation of its proposed rules has been delayed as a result of the volume of industry feedback received on the consultation paper. Furthermore, as the ISSB develop sustainability requirements, it will be interesting to see whether either jurisdiction opt to use global disclosure standards to promote the greater standardisation of sustainability-related information flowing through global investment chains.

6. The future of ESG

ESG is an evolving and growing framework that is gaining prominence in investor circles worldwide. We expect to see significant developments over the coming years, both in the UAE and globally. Clearly regulators and public bodies have an important role to play, however, companies must also take responsibility of ensuring that their ESG strategies are up to scratch, and in some cases it is likely that business innovation which offers new services and products in the green finance market will actually take the lead in further development of the regulatory framework.

CMS has leading specialists working within the ESG and sustainable finance sectors on all aspects of law and regulation. Please get in touch if you have any questions or require further guidance on any of these proposals.

[1] COP 28 will be held from 30 November to 12 December 2023.

[2] Chairman of SCA Board Decision No. 3/2000 – Adopting the Corporate Governance Code for Public Joint Stock Companies.

KEY CONTACTS

Gabriella Savastano

Director, Dubai

Head of Financial Services - UAE

T +9714 374 2859

Laura Houët

Partner, London

Co-Head of ESG

T +44 20 7367 3582

Avita Rajoo

Associate, London

T +44 20 7067 3446