International
Comparative
Legal Guides

Practical cross-border insights into ESG law

Environmental, Social & Governance Law 2022

Second Edition

Contributing Editors:

David M. Silk & Carmen X. W. Lu
Wachtell, Lipton, Rosen & Katz

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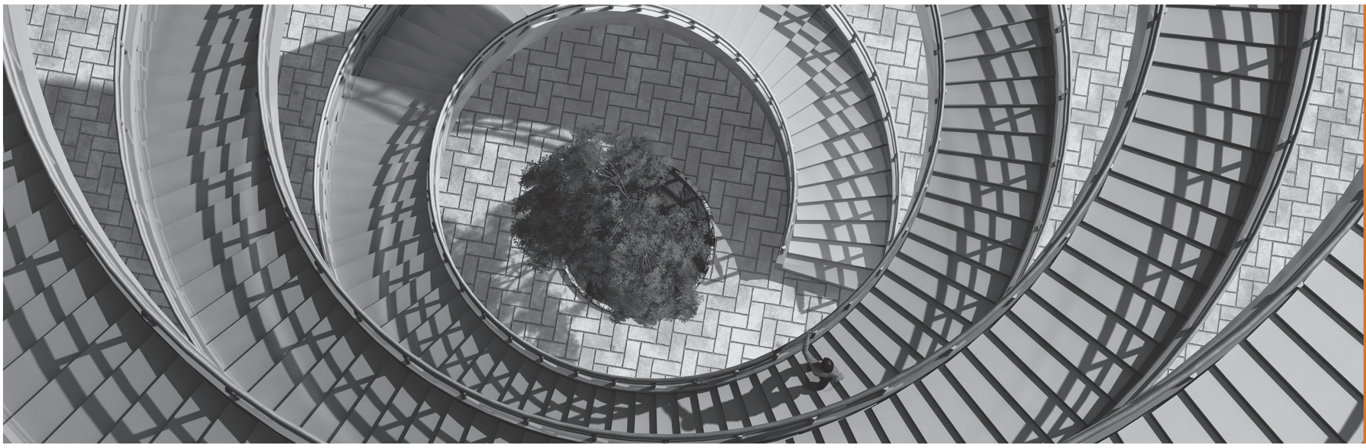

ISBN 978-1-83918-161-0
ISSN 2634-8977

Published by
glg global legal group
59 Tanner Street
London SE1 3PL
United Kingdom
+44 207 367 0720
info@glgroup.co.uk
www.iclg.com

Publisher
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Printed by
Ashford Colour Press Ltd.

Cover image
www.istockphoto.com

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Preface

Dear Reader,

Welcome to the second edition of *ICLG – Environmental, Social & Governance Law*, published by Global Legal Group.

This publication provides corporate counsel, international practitioners and other interested readers with comprehensive jurisdiction-by-jurisdiction guidance to the law and lore of Environmental, Social and Governance (ESG) issues around the world. The guide is also available at www.iclg.com.

The guide starts with seven expert analysis chapters covering ESG considerations for boards, ESG in connection with UK pension schemes, the role of shareholders in shaping ESG strategy, ESG for asset managers, legal and compliance issues for private fund advisers in the U.S., how to mitigate litigation risks from public ESG statements, and ESG considerations in project, energy and infrastructure finance.

The question and answer chapters cover 24 jurisdictions, providing detailed answers to common questions raised by professionals dealing with ESG issues.

This publication has been written by leading ESG experts, for whose invaluable contributions the editors and publishers are extremely grateful.

David M. Silk and Carmen X. W. Lu
Wachtell, Lipton, Rosen & Katz

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ESG Oversight and Integration: Considerations for Boards

David M. Silk

Carmen X. W. Lu

Wachtell, Lipton, Rosen & Katz

Over the past several years, environmental, social and governance (ESG) issues have drawn increasing attention from investors, asset managers, shareholders, corporate leaders and the public. Over the past 18 months, the COVID-19 pandemic has exposed how improperly managed ESG risks can leave lasting reputational and bottom-line impacts on businesses. Mounting concern over climate change risks – as reflected in this year's proxy season and the growing regulatory focus on climate-related disclosures – further underscores the growing need for companies to identify, monitor and manage ESG risks and opportunities and to integrate ESG considerations into their medium- and long-term business strategy.

This chapter lays out considerations for boards in light of heightened expectations from investors and regulators with respect to ESG. Following a brief review of recent developments, this chapter examines (1) the evolving ESG priorities of investors, (2) the core features of an ESG-capable board, and (3) the role of the board in ESG disclosures, goal-setting and shareholder and stakeholder engagement.

ESG Developments in 2021

ESG in the United States has continued to pick up momentum from last year. Two recent developments are particularly notable: the uptick in interest from U.S. regulators on ESG disclosures and enforcement; and the increasingly vocal concerns of investors, as reflected in the most recent proxy season. These developments continue to reflect growing investor and broader public focus on how companies are addressing their ESG risks and demand for greater transparency and clarity on ESG disclosures.

On the regulatory front, this year saw a flurry of new ESG initiatives driven by the Biden Administration. In February 2021, President Biden issued an executive order requiring the federal government to drive assessment, disclosure, and mitigation of climate pollution and climate-related risks in every sector of the U.S. economy. The following month, the U.S. Securities and Exchange Commission (SEC) announced an all-agency approach to tackling climate change and other ESG risks and opportunities, which included, among other things, the creation of a Climate and ESG Task Force in the Division of Enforcement and the ramping up of enforcement on climate-related risks. The SEC is also undertaking a review of climate-related disclosures in public company filings, with proposals expected before the end of this year. The Federal Reserve has also signalled its concern about climate change's potential risk to financial stability and earlier this year set up a Financial Stability Climate Committee and a Supervision Climate Committee to monitor and address climate change-driven macroprudential risks. In October, the Financial Stability Oversight Council (FSOC), which consists of the heads of several U.S. financial regulators, published a report calling for new climate change-related disclosures, endorsing the core principals of the Task Force on Climate-related Financial Disclosures (TCFD) and recommending a variety of climate-related actions across the FSOC's regulatory agencies.

This year's proxy season also saw record levels of support for ESG proposals, both in the number of proposals voted on and the number proposals that received majority support. Major investors including BlackRock, State Street and Vanguard demonstrated increasing willingness to support ESG proposals, which were further buttressed by the support from proxy advisors ISS and Glass Lewis. Among the shareholder proposals that received majority support this year included proposals calling for reductions of scope 3 greenhouse gas emissions and proposals pushing for greater racial and ethnic diversity on boards and more comprehensive reporting on companies' diversity, equity and inclusion (DEI) efforts. In a new milestone for ESG activism, Engine No. 1, then a six-month-old hedge fund holding only a 0.02% stake in ExxonMobil, managed to oust three members of the Exxon board in a climate change-based campaign after gaining the support of BlackRock, State Street and Vanguard. On the other hand, activists successfully managed to force executive change at Danone amid concerns that the company's ESG initiatives had contributed to lagging returns.

The major ESG disclosure frameworks have continued to consolidate with major investors lending their support to standards developed by the Sustainability Accounting Standards Board (SASB) and TCFD. In April 2021, the Global Reporting Initiative (GRI) and SASB issued guidance to companies on how the frameworks can form complementary facets of a comprehensive ESG reporting framework. In June 2021, the International Integrated Reporting Council (IIRC) and SASB merged to form the Value Reporting Foundation, which is now working to further streamline reporting standards as ESG disclosures become mainstream.

As we mark almost two years since the start of the COVID-19 pandemic, many of the ESG issues such as workplace safety, human capital management, and racial DEI have evolved to become mainstay concerns of investors. As the pandemic continues to wear on, concerns regarding the global supply chain and geopolitical risks have also become headline risks. Several high-profile security breaches this year have also underscored the growing threat of cybersecurity risks in our new digital economy. Meanwhile, government regulators and both parties have continued to scrutinise Big Tech on issues relating to anti-competitive behaviour, product safety and data privacy concerns.

Looking ahead to the rest of the year, the biggest potential developments in ESG may be yet to come as we await the SEC's updated guidance on climate-related disclosures and as global leaders gather in Glasgow for the 26th United Nations Climate

Change Conference (COP26). The past year has already seen climate change-driven natural disasters of unprecedented scale occurring worldwide, and global leaders are under political pressure to implement steps to curb global carbon emissions. As BlackRock's Chief Executive Officer, Larry Fink, noted earlier this year, climate change will "spark a fundamental reallocation of capital". The continued growth in ESG investment has signalled that market has already begun to price in ESG risks. Any global agreements that come out of COP26 or from the SEC later this year could further propel a fundamental shift in how businesses recognise risk and allocate value.

While ESG sceptics remain and as concerns regarding greenwashing continue to spark debate on the validity of ESG, the mainstream investor view on ESG has largely moved beyond questions of ESG's value to questions regarding its role in the operations and strategic direction of companies. With ESG starting to underpin strategy and operations, investors and other stakeholders have turned their sights on the board, which is now expected to have a key role in guiding the company through ESG-driven change.

Evolving Investor Priorities in 2021

Effective management of ESG ultimately requires boards and management to assess the risks and opportunities specifically relevant to their businesses. In doing so, it is important as a starting point to consider and engage with the priorities of institutional investors. Social issues, particularly racial inequity, diversity and human capital management, and climate change remain as critical concerns among investors. Some of the important issues that have attracted investor attention and garnered an uptick in support during the most recent proxy season are highlighted below.

Climate Change, Net Zero and Say on Climate. Climate change risks and opportunities are wide-ranging and cover both physical and "transitional" issues, including the impact of new regulations, the risk of stranded assets, shifts in capital allocation, supply chain disruptions, and the reputational costs arising from failures to recognise and adapt to climate change. In August, the United Nation's Intergovernmental Panel on Climate Change's most recent report declared that human behaviour had already unleashed irreversible changes to the planet's climate system that presented a "code red" threat to humanity. The unexpectedly severe floods and wildfires that have swept across the globe have further drawn political pressure for governments to act before the climate crisis spirals beyond the limits of human intervention.

In light of the growing challenges posed by climate change, investor calls for better disclosure and management of climate-related risks have continued to grow: BlackRock has called for companies to "disclose a plan for how their business model will be compatible with a net zero economy" and "disclose how this plan is incorporated into your long-term strategy and reviewed by [the] board of directors". State Street has also declared climate change a "key systemic threat, representing both a strategic and business challenge for all companies".

During the past proxy season, nearly half of the climate-related proposals voted on received a majority of shareholder approval, compared to none only two years ago. Three major energy companies saw majority support for shareholder proposals that sought to cut scope 3 emissions. Proposals requesting reports on the financial impacts of the International Energy Agency's Net Zero 2050 Scenario also saw substantial support. In addition, the Children's Investment Fund Management's Say on Climate initiative (whereby companies solicit non-binding shareholder approval for the company's climate action plan) was also voted on at four companies.

Going forward, boards will be expected to work closely with management to assess, monitor, disclose and integrate climate-related considerations into the company's business model. Boards and management should be prepared to engage with investors on climate risks as part of the annual meeting cycle. As companies increasingly roll out net zero plans and other climate-related targets, expectations regarding board oversight of implementation and disclosure processes will also likely draw investor attention. As climate change reshapes the global economy, companies seeking to convert potential climate change risks into opportunities can be expected to look beyond the benchmarks of their peers towards first-mover challenges.

Diversity, Equity and Inclusion. The events of last year have elevated concerns regarding DEI and this focus has continued into 2021. A number of institutional investors, including Vanguard, State Street and AllianceBernstein, along with ISS, have announced their intent to vote, or recommend voting, against the chair of the nominating committee should the board fail to reflect racial diversity. But the focus has also shifted beyond the board into the ranks of senior management and the workforce more generally, with State Street, for example, announcing that beginning next year, it will vote against the chairs of compensation committees at S&P 500 companies that do not disclose their EEO-1 reports, which provide a standardised breakdown of workforce demographics across 10 employment categories.

During this past proxy season, proposals on board diversity saw some of the highest support in recent years, with three proposals receiving over 70% support. A large number of proposals calling for EEO-1 disclosures were also submitted, with the majority withdrawn after companies agreed to disclose EEO-1 data. Of the three proposals on EEO-1 disclosure that did go to a vote this year, two received over 80% support from shareholders. Six shareholder proposals calling for disclosure of the effectiveness of DEI programmes were also voted on and three received majority approval. In addition, approximately eight proposals calling for companies to undertake an independent racial equity audit to assess whether the company's policies, products and services contribute to discrimination were voted on, receiving on average approximately 31% approval.

Supply Chain Management. Prior to the pandemic, investor and public concerns regarding supply chains often focused on labour and compliance issues and environmental responsibility. The pandemic exposed the fragility of just-in-time supply chains, and the blockage of the Suez Canal earlier this year further underscored the vulnerability of global supply chains. While the concerns regarding supply chains during the height of the pandemic centred on the shortages of personal protective equipment, the current global supply chain woes combined with hikes in the price of oil have led to persistent shortages driving up the costs of consumer goods globally. While not all companies are equally affected by the current global supply chain crunch, investors will likely be keen to understand whether companies have made thorough assessments on their vulnerability to supply chain shocks and taken action to bolster resilience and adopt industry best practices.

Human Capital Management. As the pandemic continues to wear on, the past year has seen record levels of employee turnover and growing recognition among investors that a company's value is measured in part by the talent it is able to hire and retain. During the pandemic, companies were forced to immediately reassess their workplace safety protocols, develop strategies to facilitate remote work, and review their succession planning processes. In recent months, as the threat of the pandemic continues to subside, focus has shifted towards building corporate culture and purpose, addressing the growing epidemic of employee burnout and assessing the effectiveness of talent management and retention initiatives. With the SEC now requiring companies to provide a description of their human capital resources and as the knowledge and service sectors of the economy continue to grow and compete for talent, boards and management should be aware of growing demand from investors for information and disclosure on the subject.

Cybersecurity Risks. The past year has seen a record number of criminal ransomware attacks that have resulted in, among other things, the shutdown of one of the largest pipelines in the United States, the breach of the data security systems of thousands of companies including U.S. government agencies, and the temporary shutdown of one of the largest meat suppliers in the world. The risk of targeted attacks from criminal groups, foreign intelligence services, and other bad actors has only increased with the mass shift to remote work arrangements, embrace of cloud-based operations and increased reliance on virtual commerce spurred by the pandemic. Institutional investors and proxy advisor firms are increasingly considering a company's cybersecurity defences as part of their review of governance and ESG performance, with some shareholders having issued shareholder proposals in response to damaging cyber incidents. Shareholder activists may also increasingly scrutinise cybersecurity defences following the spate of incidents this past year. Boards and management are increasingly expected to coordinate closely on oversight, management and reporting of cybersecurity risks, as well as crisis responses to cybersecurity incidents. Corporate cybersecurity incidents will need to take into consideration a company's supply chain, vendor and business partner relationships and other operating structures and models that could provide entry points into a future cyber attack.

Facets of an ESG-Capable Board

While the legal duties of boards have remained unchanged, investors and other stakeholders increasingly expect boards to play a pivotal oversight role on ESG matters and lay the strategic groundwork for integrating ESG into a company's operations and strategy. Board responsibilities include shaping corporate culture and purpose, reviewing disclosures on ESG performance, monitoring the integration of ESG into the company's business operations, and overseeing the process for identifying ESG risks and opportunities. As with other governance issues, major institutional holders and proxy advisors will hold directors accountable for their companies' performance on ESG. BlackRock will vote its proxies against directors of companies in instances where it believes the company and its board are not "producing effective sustainability disclosures or implementing frameworks for managing these issues". State Street has stated that it will vote against directors of companies that lag behind on ESG performance and fail to articulate plans for improving their companies' ESG performance. Best practices for an ESG-capable board include the following:

Company-Specific ESG Competency. The effectiveness of board oversight on ESG hinges on building ESG competency as it specifically relates to the company. As investor expectations on ESG continue to grow, boards are expected to understand and oversee the material ESG risks and opportunities affecting their company as well as the ESG expectations of their investor base, including issues raised during private engagements and gathered through stakeholder surveys. Boards should also be acquainted with the major ESG disclosure frameworks and take an active role in reviewing the company's public ESG disclosures.

Management is critical to shedding insights into how ESG intersects with the company's operations and identifying the challenges and opportunities on the ground. Boards can also leverage management to track industry developments and peer initiatives, which may provide the board with additional insights into best practices and evolving expectations of their role on ESG oversight. Engagement with key institutional investors and consultations, where appropriate, with outside advisors can provide insights into broader market trends, expectations and best practices.

Boards should also periodically evaluate their ESG competencies. Depending on the circumstances, boards may wish to consider adding directors whose expertise and background can enliven the board's analysis and discussion on ESG issues. Should boards adopt this approach, it is important to remember that ESG remains a dynamic subject and ongoing director education remains key.

Established ESG Oversight Framework. Boards are increasingly expected to articulate and allocate ESG oversight responsibilities, which oversight may occur at the full board level or among board committees. There is no one correct approach of how boards choose to allocate ESG oversight, and the board has full discretion to determine how responsibilities are allocated. Among the oversight responsibilities that boards will need to consider include oversight on ESG reporting and disclosure, identification and assessment of risks and opportunities relating to various ESG issues, and oversight of management's implementation and processes with respect to the company's ESG targets.

When deciding whether to allocate oversight responsibility to a new or existing board committee, boards should consider how best to align ESG oversight responsibility with core board competencies, whether the committee and its members have sufficient time in light of other responsibilities of that committee, and how best to prevent overlaps or gaps in committee responsibilities as ESG issues expand and evolve over time. In addition, boards looking to delegate ESG oversight responsibilities among multiple committees should also consider how best to prevent lags in reporting issues to the full board, so as to minimise sacrificing speed and agility in exchange for greater oversight and expertise. Boards and management should also consider the relationship of ESG disclosure to the company's general financial disclosures.

Allocation of ESG oversight responsibilities on the board will also be an iterative process: as boards accrue new insights into the ESG issues affecting their company and as investor and stakeholder priorities evolve, board responsibilities should be reviewed to address any blind spots and, where necessary, to reallocate the board's resources towards appropriate expertise and priority issues. The board's oversight of ESG should also evolve with the company's operations, business strategy and business climate. For example, the adoption of carbon reduction commitments and expansion of ESG reporting may necessitate additional board oversight. Likewise, strategic pivots into new industries, or significant acquisitions of new businesses and assets, should prompt a reassessment of the scope of board oversight of the related ESG issues.

Periodic Management Engagement. In recent years, as part of efforts to fully integrate ESG into business operations, companies have created ESG working groups composed of internal specialists. Such working groups help funnel information to the board, identify emerging company-specific trends and risks, and help implement the board's strategic priorities. Regardless of the scale of ESG issues affecting the company, the board should seek to ensure that a continuous feedback loop is in place with management that keeps the board informed of material ESG issues and ensures board directives become actionable responses. For example, in addressing risks related to workplace safety, the board and management should work together to understand how key statistics are collected, verified and reported to the board, how vulnerabilities are identified and potential solutions found, how priorities and weaknesses identified by the board coalesce into action plans, and how to respond to stakeholder concerns.

The board also has responsibility for guiding management over the longer term and ensuring that management is allocating sufficient resources to realising longer-term ESG goals. Over the past few months, a number of companies have adopted net zero carbon reduction targets. With respect to these and other commitments, the board should monitor progress and the alignment of management's activities and incentives with the company's public commitments.

Aligning Compensation to ESG Performance. Currently, just over half of S&P 500 companies use ESG metrics in their executive compensation plans, most commonly in annual incentive plans, although the use of ESG metrics continues to grow. While the use of ESG metrics in incentive plans continues to evolve, the current most common approach is to use ESG metrics as part of a scorecard of non-financial or strategic objectives or as part of an individual performance assessment that is used to adjust incentive plan performance. Use of weighted metrics, as typically done for financial measures, is less common with ESG inputs, particularly when measuring performance on "E" and "S" issues. However, as the use and measurement of ESG metrics becomes more mainstream and as companies commit to longer-term ESG goals, we expect that ESG performance will play a growing role in incentive plans, including long-term incentive plans, and that boards will take a role in helping to establish appropriate metrics and targets.

Board Oversight of ESG Disclosures and Goal-Setting

ESG disclosures continue to be a focal point for regulators and investors, and boards should collaborate closely with management to ensure that public disclosures demonstrate that the company has conducted comprehensive assessments of its ESG risks and opportunities and has taken steps to integrate such considerations into the business goals and strategy. Disclosures should also be decision-useful to investors and data presented should be verifiable. As investors and other stakeholders use public disclosures on ESG performance to identify and engage with the company on their ESG priorities, companies will increasingly find their performance being compared against peers and industry leaders or against external benchmarks. Set forth below are key considerations for boards when evaluating their company's ESG disclosures.

Investor and Stakeholder Expectations. Perhaps one of the biggest challenges for boards and management will be addressing, responding to and managing investor and stakeholder expectations on ESG disclosures. Institutional investors have already made clear that they expect companies to disclose data – preferably raw quantitative data accompanied by contextual disclosure – to help them assess the ESG risks and performance of companies. As ESG disclosure frameworks continue to evolve, boards and management should stay attuned to the needs and demands of their investors and recognise that merely disclosing against one or more frameworks or meeting prescribed regulatory requirements, without illuminating decision-useful ESG data, could mean that the company's disclosures will fall short of investor and broader stakeholder expectations.

Boards and companies should also prepare themselves for the growing number of third-party ratings on their ESG performance, and tailor their company's public disclosures accordingly. Smaller investors, and other stakeholders who do not have the resources to formulate their own assessments of ESG performance among companies, rely on ESG service providers to inform their investment and engagement priorities. While it is not possible for boards and management to closely engage with all of the ESG participants, they should monitor how their company is rated by the most commonly used third-party service providers such as MSCI, Sustainalytics and ISS. In instances where the company's performance has been inaccurately reported, the company should take prompt action to identify and address the underlying causes (bearing in mind that certain check-the-box ratings systems proffered by ratings agencies may fail to contextualise performance or will over-penalise companies in the process of implementing changes, and it will be up to the company to provide reassurance to concerned stakeholders).

Materiality, Scenario Analyses and Assurance. Aside from the ongoing debates over what types of ESG metrics should be reported, questions regarding materiality, scenario planning and assurance also continue to pique investor interest. Among the major ESG disclosure frameworks, companies are required to disclose ESG metrics to the extent they are material to the company. However, what constitutes "material" information continues to vary from framework to framework and companies should be particularly careful in articulating such differences to their audience. Among the ESG disclosure frameworks, materiality can range from financial materiality (SASB) to stakeholder materiality (GRI). In addition, the SEC, which now requires companies to make disclosures on human capital metrics and permits the disclosure of other key performance indicators, asks companies to disclose information that would be important to a reasonable investor. Given the range of materiality standards, boards should be mindful of the potential legal implications of disclosures that may be viewed as potentially misleading or incomplete by investors. Appropriate disclaimer language can provide safeguards against potential litigation. Clear explanations illustrating the company's internal processes for arriving at materiality determinations is another way to help audiences parse through ESG disclosures.

Certain forms of ESG disclosures relating to long-term projections and scenario analyses also require additional attention from the board. Companies should take time to educate their audience about the assumptions and other limitations that underlie long-term projections. Boards should pay particular attention to such projections and analyses to not only help inform their strategic decision-making but also to ensure that information is presented in a manner that mitigates potential litigation concerns.

Finally, companies should consider the scope of third-party assurance that may be provided in connection with the public release of ESG data. It is increasingly expected that companies will provide either internal or independent verification and/or assurance for key portions of quantitative data (e.g., greenhouse gas emissions) disclosed in their public ESG reports.

Goal-Setting. When reviewing ESG disclosures (and taking stock of feedback from investors and other stakeholders), boards and management should consider how these public communications can be used to level set the company's ESG priorities and contextualise its progress on ESG. ESG disclosures in and of themselves can also help identify priorities, create opportunities to demonstrate leadership on ESG matters, and expose areas where the company may be lagging behind its peers.

The Board and Shareholder and Stakeholder Engagement

The ongoing shift towards stakeholder capitalism has drawn attention to stakeholder engagement. Stakeholder engagement asks companies to consider the interests of their stakeholders such as employees, suppliers, customers and local communities, and some ESG disclosure regimes contemplate that reporting entities will engage directly with stakeholders to help identify material ESG topics. Unlike traditional shareholder engagement, which typically involves periodic in-depth meetings between investors and members of the board and management with a schedule determined by the annual meeting cycle, stakeholder engagement will also require companies to harness their investor relations platforms, marketing platforms, social media handles, public policy strategies, consumer research, focus groups and internal reporting processes. In some cases, the company's stakeholders may not seek to engage with companies through traditional, typically private, channels. Rather, concerns may be voiced through a wider range of channels, including mainstream and social media, public forums, and whistleblower hotlines. As a result, companies should implement processes for identifying emerging ESG concerns before they draw negative publicity and develop action plans for responding publicly to stakeholders.

When engaging with stakeholders, companies should also recognise that many are likely to focus on a narrower subset of ESG issues that directly affect their well-being and priorities. For employees, focus areas will be human capital management issues such as diversity and inclusion, workplace safety, pay equity and job satisfaction. For customers and suppliers, issues of concern will revolve around labour practices, regulatory compliance and supply chain resilience. It is also possible that certain stakeholders will also seek to use their influence to draw attention to issues that do not directly implicate their immediate interests but align with their broader values: stakeholders who wield greater influence over a corporate reputation, shape media coverage and impact market share, such as employees and customers, have already demonstrated their willingness to draw attention to climate change and poor labour practices. Unlike institutional investors, the priorities of stakeholders may not be directly or cohesively articulated – it is incumbent upon the company to proactively identify stakeholder concerns and build a culture and infrastructure that encourages dialogue between the board and management and internal and external stakeholders.

As stakeholders continue to gain stature and influence over corporate purpose and decision-making, conflict of priorities among stakeholders will inevitably arise. In such cases, the board – in the exercise of its business judgment – will be the arbiter of competing interests and, in doing so, will seek to identify which pathways best align with its corporate purpose and long-term value creation. Boards and management should acknowledge the concerns of stakeholders but also be transparent with stakeholders that their priorities may not necessarily mirror the priorities of the company.

* * *

The growth of ESG has transformed investor expectations of companies, their boards and their management on oversight, disclosure and goal-setting around ESG risks and opportunities. Today, there is growing recognition that companies that ignore ESG will face significant reputational and economic damage, as demonstrated by the impact of the current pandemic and the economic and social repercussions that have followed, and may miss valuable opportunities.

In the face of this new business environment, companies should prepare to integrate ESG into their operations and strategy. In the immediate term, steps towards integration include engaging with the priorities of investors and other stakeholders, building a strong governance framework that incorporates board oversight over key ESG issues, demonstrating ESG competence and leadership through public disclosures, and identifying new pathways to engage with the growing number of participants who will have sway over the company's perceived ESG performance and reputation. Investors will look to the board to help guide their company's transition into the new economy and as more capital flows to ESG, expectations of boards will continue to grow.

David M. Silk is a partner of Wachtell, Lipton, Rosen & Katz where he focuses on merger and acquisition transactions, takeover defence, private equity, corporate governance, ESG and sustainability issues, proxy contests, joint ventures and securities laws. He represents public and private companies and private equity funds worldwide and in a wide variety of industries.

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ESG and UK Pension Schemes: A Matter of Governance?

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1 Introduction

UK occupational pension schemes are now subject to extensive ESG requirements. The law is being driven by a rapidly evolving combination of policymaking, scientific guidance and commercial commentary alongside wider societal expectations that, as institutional investors responsible for providing private individuals' retirement benefits, pension schemes ought to be deploying their capital to promote ESG objectives (or, at least, protecting that capital from adverse impacts caused by ESG risks).

In that context, much of the commentary on ESG for pension schemes naturally focuses on the substantive investment aspects of the topic, such as the risks and opportunities that exist, the financial products available, and how these can be aligned with scheme investment strategies.

This chapter suggests a slightly different perspective. It outlines the key aspects of ESG law for occupational pension schemes in England and Wales and argues that although the commercial investment perspectives are entirely legitimate, the way the law is structured means that ESG in pensions should also be approached as a governance matter.

2 The Starting Point: Fiduciary Duties and ESG

Case law in the 1980s and 1990s[1] highlighted an apparently fundamental tension between the duties of occupational pension scheme trustees to invest assets in order to fund pensions and other retirement benefits, and their ability to take ESG considerations into account when investing.

These debates are now largely settled. Following two landmark Law Commission reports,[2] in very broad terms the orthodox legal view is that:

- ESG considerations can and probably should feature in pension scheme investment decision-making where they are "financially material" (i.e., relevant) to investment performance or risk; and
- ESG issues that are not "financially material", or criteria based on wider non-financial considerations (such as political, ethical or philosophical beliefs), are known as "non-financial factors". These must meet additional legal tests before they may influence pension scheme investment decisions.[3]

Although a full discussion of the economics is beyond the scope of this chapter, economic evidence confirms that ESG considerations are capable of being financially material. There is also evidence that ESG investments can be compatible with achieving desired risk-adjusted financial returns. An increasingly diverse range of ESG-themed investment products are coming to the market and we have seen a number of pension schemes exploring these. Naturally, this means that the commercial and financial aspects of ESG are an important and legitimate area of focus for pension trustees.

From a legal perspective, though, the key requirement is for trustees to discharge their fiduciary duties to invest in the best interests of the pension scheme's beneficiaries, and in a prudent manner.

In effect, these duties mean the law requires trustees to seek to identify the "financially material" ESG factors that exist for their scheme, and then integrate those factors into their investment decision-making. In practice, this involves:

- obtaining information and advice to identify the ESG factors the trustees consider to be financially material;
- considering the information, advice and financially material ESG factors and raising questions where necessary;
- balancing the relevant ESG considerations with other relevant factors (including other financially material factors) in order to reach an overall decision – probably through debate on the board or investment committee; and
- having sufficient expertise and understanding to be able to do all of the above.

As lawyers, we would argue that these steps amount to a *governance* duty. Of course, the end results will be strategic and commercial investment decisions about where and how to deploy the pension scheme's assets in practice – but they flow from the way the trustees carry out their fiduciary duties in preparing for, and taking, those decisions. The substantive investment decisions are the output of a governance process.

3 ESG in Pensions Legislation

Investment policies, disclosures and implementation statements

Pensions investment regulations now require ESG-related investment policies to be set out in a scheme's Statement of Investment Principles (SIP), covering:

- financially material considerations (including, but not limited to, ESG and climate change) and how these are integrated into the investment strategy;
- how, if at all, non-financial factors are taken into account;
- stewardship and engagement with investees, co-investors and other stakeholders in relation to a non-exhaustive list of matters such as strategy, performance, capital structure and conflicts of interest; and
- arrangements with the scheme's asset managers (on areas such as incentivisation and alignment with SIP policies), or an explanation of why there are no such policies.

Many schemes are also being required to publish their SIP on a publicly available website and to prepare an "implementation statement", over a period starting from 1 October 2020. Broadly, the implementation statement is an annual report tracking progress against the SIP policies and explaining how far these have been applied during the year.[4] Like the SIP, implementation statements must be disclosed online.

Although the substance of trustee investment policies is certainly an investment question, the requirements to develop the policies, write them down, disclose them and then monitor and report on how far they have been implemented, show how trustee investment policy choices are, in fact, underpinned by a series of ongoing governance obligations.[5]

Climate change

Over a phasing-in period starting from 1 October 2021, new legal obligations apply to many pension schemes[6] based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

The new regulations require that on an ongoing basis, climate risks and opportunities must be integrated into scheme governance, strategy and risk management processes (including investment and scheme funding strategies). There are also specific duties to undertake climate scenario analysis and calculate climate metrics and targets for the scheme, and for trustees to have sufficient knowledge and understanding of climate issues. All of this is backed up by extensive additional public reporting requirements.

Where the climate regulations apply, they will therefore directly and immediately affect the shape of the scheme's governance systems and processes. In turn, those systems will support the trustee's ultimate strategic actions in relation to climate issues, including on investment.

Pensions Regulator single Code of Practice

In 2021, the Pensions Regulator consulted on a draft single Code of Practice, which will act as a quasi-legal statement of the actions required of trustees in line with the statutory duty to operate effective scheme governance and internal controls.

Although the finalised Code of Practice is not due until mid-2022, it is likely to set out further and more specific expectations around trustee approaches to ESG matters in investment (as part of the own-risk assessment schemes will have to carry out on their governance), including how trustees or managers assess new or emerging ESG risks.[7] Climate risk is flagged as requiring specific consideration, even for schemes that are not directly subject to the TCFD regulations described above. The draft code also encourages adherence to the UK Stewardship Code, effectively on a comply-or-explain basis.

These, too, amount to regulatory requirements to integrate ESG into scheme governance.

4 Beyond Investment

Other current and emerging themes continue the governance trend. They also, in our view, demonstrate that ESG in pensions is increasingly moving into new areas beyond investment. To give two examples:

- **Employer covenant**. Where the TCFD regulations apply to a defined benefit pension scheme (see above), there is now a clear legal obligation for trustees to consider how climate risks and opportunities may affect the ongoing financial support available from the scheme's sponsoring employers – the "employer covenant". Even for schemes where the TCFD regulations do not apply, we consider that there are arguments based on existing regulatory materials that climate and ESG factors should be considered in relation to the employer covenant where relevant.
- **Diversity and inclusion**. An organisation's diversity and inclusion is a recognised ESG factor and is sometimes used as an indicator of financial performance or risk in pensions investment and funding. But, diversity and inclusion considerations apply within a pension scheme, too, most obviously in the composition of its trustee board. Looking ahead, we expect increasing regulatory focus on how diversity and inclusion might better contribute to the effective management of pension schemes.[8]

5 Rationale

Why is pensions ESG law structured around governance in this way?

One possible legal reason is that this reflects both the core fiduciary duty outlined above and a deeper-rooted legal tradition of respect for the autonomy of trustees. In essence, both the law and policymakers have tended to be reluctant to impose mandatory solutions in place of trustee decisions based on legally valid decision-making processes.[9]

A more practical reason is that the risks and economics of ESG are complex and developing fast. There are no one-size-fits-all solutions. In that context, it seems sensible to give trustees wider margins of discretion, allowing them to respond to ESG challenges in the way that is appropriately tailored to the circumstances of their particular scheme.

6 Conclusions

The commercial and financial aspects of ESG investing are a significant area of focus in the pensions industry. This is legitimate and highly relevant in the context of trustee fiduciary duties and existing legislation.

However, we would suggest that the structure of the current law means the governance aspects of ESG deserve at least as much attention.

This is because, as this chapter has sought to demonstrate, almost all the relevant law in this area is couched in terms of governance. If ESG is the desired public policy outcome, then governance obligations are the legal delivery mechanism. Consequently, in our view, the foundation of effective ESG legal compliance for UK occupational pension scheme trustees is to have good governance systems in place. Good governance provides a clear legal framework within which trustees' substantive decisions will be made, acted upon and monitored.

Endnotes

1. Notably *Cowan v Scargill* [1984] 2 All ER 750 and *Harries v Church Commissioners* [1992] 1 WLR 1241.
2. *The Fiduciary Duties of Investment Intermediaries* (2014) and *Pension Funds and Social Investment* (2017).
3. Aspects of this test were considered by the Supreme Court in *R (Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16. Nevertheless, there remain a number of areas of legal uncertainty. In addition, one of the legal thresholds for integrating non-financial factors into investment decisions is so high that it is difficult to see how many occupational pension schemes would be able to do so in practice.
4. The prescribed contents vary depending on the type of pension scheme.

5. The SIP and related requirements are not the only example. A separate piece of Competition and Markets Authority legislation requires trustees to set "strategic objectives" for their investment consultants. Although this is a governance requirement deriving from competition law and policy, there is no reason in principle why strategic objectives should not include ESG matters – a point that was recently picked up in the Society of Pension Professionals' *Environmental Social and Governance (ESG) Guide* (September 2021). The implication of the legislation is that once strategic objectives have been set, trustees should evaluate their consultants periodically against those objectives.
6. Broadly, the regulations apply from 1 October 2021 to all authorised master trusts, collective money purchase schemes and occupational pension schemes with relevant assets exceeding £5 billion. Occupational pension schemes with relevant assets exceeding £1 billion will be in scope from 1 October 2022. Other schemes may come into scope from *c.*2023, subject to further consultation.
7. The consultation has now closed and the final Code of Practice is awaited.
8. The first industry statement of best practice for diversity and inclusion in UK pensions is the Pension and Lifetime Savings Association's *Diversity & Inclusion: Made Simple Guide* (2020), co-authored with Travers Smith LLP. https://www.plsa.co.uk/Policy-and-Research/Document-library/Diversity-Inclusion-Made-Simple. In due course, further areas of scheme operations beyond investment strategy may come into scope of ESG legislation: for example, there could be new requirements around resource consumption by a pension scheme, its investees and/or its suppliers ("negative externalities"); or treatment of workers by third-party suppliers. The Mansion House speech by the Chancellor of the Exchequer on 1 July 2021 and the Government's subsequent Greening Finance Roadmap (October 2021, https://www.gov.uk/government/publications/greening-finance-a-roadmap-to-sustainable-investing) indicate that there will be further sustainability disclosure regulations affecting UK pensions, but the detailed proposals had not been published at the time of writing.
9. For example, there was debate in Parliament about whether the TCFD regulations introduced under the Pension Schemes Act 2021 interfered with trustees' autonomy and discretion to choose investments in line with the core fiduciary duty.

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Activism Rising – The Role of Shareholders in Shaping ESG Strategy

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While environmental, social and governance (ESG) activism has long been a feature of many markets globally, 2021 has signalled the increased willingness of large institutional investors to take or support activist action against corporate boards where they perceive companies' progress on ESG issues to be slow or halting. While ESG-related shareholder activist campaigns may have been driven by non-governmental organisations (NGOs), community groups and worker groups in the past, it seems that institutional investors are increasingly willing to draw from the activist 'toolkit' to improve ESG performance within their portfolios.

Particularly relevant during the year was the election of three external candidates to the board of ExxonMobil in May 2021 on the back of a climate action campaign by 0.02% hedge fund investor Engine No. 1 (see case study below). This type of activism is not new. In this instance, however, it was notable for both the size and prominence of the target, as well as the institutional investors that supported the campaign. While institutional investors have for some time indicated their intentions to vote against board members if they feel that progress is not being made on ESG issues that are important to them (most typically, climate and gender diversity), the amount of capital that was mobilised in support of Engine No. 1's climate campaign at ExxonMobil may represent 'the beginning of the end of the road' for investors' patience on ESG progress.

Activist pressure for companies to adopt and deliver a corporate strategy aligned (or at least not perceived to be inconsistent) with improved ESG outcomes has not been confined to proxy fights and shareholder proposals either. Importantly, the past 12–24 months have also seen the increased use of regulatory complaints and litigation as part of the activist toolkit. Alleged duties of care and claims of greenwashing will mean that even boards that are market-leading in respect of climate response and other ESG issues will still need to ensure that their commitments and disclosure are underpinned by robust systems of governance and diligence.

ESG as an Influence on Corporate Strategy

Businesses are increasingly cognisant of their duties to the communities within which they operate. This shift in focus has not only been driven by regulation but also by the growing recognition (by long-term institutional investors, in particular) that value can be enhanced with reference to a company's broader stakeholder groups, as well as its shareholders. As a result, a number of businesses have voluntarily made ambitious commitments on ESG issues, including climate, human rights, gender and ethnic diversity and governance practices more generally.

In 2019, 181 of America's top business and financial leaders signed the Business Roundtable's Statement on the Purpose of a Corporation,[1] publicly committing to lead their companies for the benefit of all stakeholders, including customers, employees, suppliers, communities and shareholders. The following year, the World Economic Forum (WEF) released the new Davos Manifesto – The Universal Purpose of a Company in the Fourth Industrial Revolution[2] – stating that companies should pay their fair share of taxes, show zero tolerance for corruption, uphold human rights throughout their global supply chains, and advocate for a competitive level playing field.

Companies are facing significant and growing pressure from investors, consumers, employees, activists, regulators and society to take strong positions on ESG issues and to be transparent on their progress. As noted in the WEF's 2020 white paper, 'Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG', the majority of Millennials (67% according to the Boston Consulting Group (BCG)) expect employers to have purpose and want their jobs to have societal impact. Given that Millennials and Generation Z employees made up 59% of the workforce in 2020, this is a call that businesses are unlikely to ignore. The same white paper stated that, according to BCG, 72% of European consumers prefer to buy products with environmentally friendly packaging and that, globally, 46% of consumers are willing to forgo preferred brand names in favour of eco-friendly products. Some 38% of global consumers also indicate the willingness to pay a premium for eco-friendly and sustainable materials.

It is therefore unsurprising that many institutional investors are encouraging of the move away from near-term profit maximisation and supportive of ESG shaping corporate strategy and activity in the longer term. In response to a 2019 survey conducted by IHS Markit and Mergermarket,[3] 53% of respondents noted that they had walked away from a deal due to a negative assessment of ESG considerations relating to a target company. A significant number of the risks that fall within ESG have in fact affected M&A for some time; however, what has changed is the stage of the process at which potential bidders are looking into these issues and the rigour with which they are doing so. Would-be acquirers now regularly consider ESG issues from the outset of the target identification stage. As part of this, they are looking further forward than ever before, to where the market and the law appear to be heading and how that might affect financing costs, reputation and their ability to sell the asset in due course.

Respondents to the aforementioned IHS Markit and Mergermarket survey unanimously chose business risks as a major driver for taking ESG considerations into account in the M&A process; 83% also cited investor pressure. The incorporation of ESG factors into investment decisions suggests that ESG performance will play a growing role in the cost of, and access to, capital. This can also be seen amongst lenders, with demonstrably 'green' borrowers facing lower financing costs than 'brown' borrowers, and with a growing number of lenders incorporating ESG metrics in their credit analysis and borrower evaluation.

The Shareholder Activist 'Toolkit'

Globally, many jurisdictions are conducive to shareholder activism. A significant number of companies in the UK, US and Australia have been subject to activist pressures on ESG in recent years; however, by no means are they the only regions where this is the case. Within Europe, the volume of share capital controlled by activist shareholders has grown substantially and the European legal environment (which promotes long-term investment, transparency and ESG criteria for investment) has helped to make shareholder activists increasingly active.

In Spain, shareholder activism has been on the rise in recent years, although it is still, by all accounts, less prevalent than in other jurisdictions such as the UK or the US. Notably in Spain, most listed companies tend to have the majority of their share capital controlled by a relatively small number of shareholders, which can reduce the margin for activist minority shareholders to build support for ESG action. In France, some of the traditional general barriers to activism seem to have been lifted recently, leading some commentators to believe there is a 'democratisation of activism' now being observed in that market.

While the 'toolkit' used by activists varies considerably based on jurisdiction, it will in most cases involve an approach to the target seeking to engage on the ESG topic in the first instance. Such approaches may be either private or public:

- **Private approaches** may include requests for closed meetings, calling or meeting with executive team or board members, private letters to executives or directors, threats of litigation or regulatory complaints or, in some cases, private demands for directors to step down.
- **Public approaches** may include open/public letters to the board, contacting other investors and stakeholders, joining analyst calls and other company events, websites, editorials and advertising, and (actually) commencing litigation or making regulatory complaints.

The broader set of 'tools' open to activist investors will typically include:

- exercising an ability to call general meeting and propose resolutions;
- requisitioning specific resolutions at an annual general meeting (AGM) or general meeting (including to remove/appoint directors);
- voting against directors or exercising blocking rights at various thresholds;
- inspection of the register of members to identify and contact other investors to build support;
- circulating statements, proposals and white papers for reform; and
- threatening or commencing shareholder derivative claims and litigation.

Institutional activists may also engage in stake building to enhance their influence and the activist 'tools' available to them. This may include private stake building (i.e. without disclosure, subject to relevant regional limits under law) or public stake building (as part of their formal communications strategy). Contracts for difference and leverage may also be used to accelerate stake building and increase influence.

The Rising Tide of Institutional Investor Expectations

The endorsement of ESG as a key area of focus for asset managers globally has significantly influenced the attitudes of companies to ESG issues as they strive to meet increasing informational demands and demonstrate their resilience to ESG risks. The emergence of private sector-led ESG initiatives, such as Climate Action 100+ (CA 100+), highlights the extent to which large institutional investors are engaging with ESG issues and placing pressure on large companies to embed ESG in their strategy and operational footprint.

Shareholder activism associated with ESG issues, most notably climate change, has for some time featured on the AGM agendas of a broad cross-section of listed companies due to activism driven by special interest groups, non-profits and retail investors. Whilst these groups continue to mobilise social media channels to initiate the majority of requisitioned resolutions at listed companies, the reality is that there has been a noticeable increase in the level of institutional shareholder support for ESG activism more generally.

The increasing willingness of institutional investors to take activist action on ESG issues has been particularly notable in 2021 with reference to three market trends: (1) demands for accelerated action; (2) expanded use of benchmarking frameworks; and (3) calls for a greater 'say' on core ESG issues (notably, climate).

Demands for accelerated action

For some time, major global institutional investors such as BlackRock and Vanguard have signalled their clear expectations on progress in relation to portfolio companies' ESG strategies and performance across climate change, human rights and diversity and inclusion, amongst other ESG issues. During 2021, however, there were a number of prominent examples of institutional investors actively using their capital to influence the pace of change at major listed companies.

Activists in the boardroom: Case study – climate campaign at ExxonMobil

On 26 May 2021, ExxonMobil faced a contentious vote at its shareholder meeting, which resulted in three activist nominees appointed to its board. Engine No. 1, a hedge fund that held approximately 0.02% of the votes in the company, mounted a climate action campaign against ExxonMobil on the basis that the company's commitments on carbon emissions reduction were allegedly inadequate.

The external candidates that Engine No. 1 put forward had strong credentials, and the campaign was supported by a number of major institutional investors. While individual voting decisions were not clear, a number of major global institutions supported some or all of the successful Engine No. 1 candidates. Based on commentary at the time, it appears that institutional investors were frustrated with the quality (and outcomes) of engagement with ExxonMobil on climate and were trying to catalyse a more rapid transition to lower emissions.

The result of the campaign not only clearly illustrates the importance that institutional investors now attach (and have attached, in fact, for a number of years) to environmental issues, but also shows that they are increasingly willing to exercise their influence over board elections to catalyse action at companies that they perceive are not sufficiently engaged.

On track but still under pressure? Case study – proxy voting policy by BlackRock

BlackRock has, for a number of years, actively signalled its intention to use its influence as a major global institutional investor to catalyse improved ESG outcomes at its portfolio companies. As well as engaging directly and indirectly with companies through company meetings and CEO Larry Fink's widely publicised annual letters, BlackRock also sets expectations through its global and regional proxy voting guidelines.

In this context, commentary in BlackRock's global *2021 Stewardship Expectations*[4] has been notable for signalling a shift in its proxy voting policy to clarify that it will in future vote in favour of appropriate ESG-related shareholder proposals, even where it considers that the relevant company's management is already 'on track' in managing the issues.

In line with prior years, the *Stewardship Expectations* acknowledge BlackRock's view that voting on shareholder proposals plays an increasingly important role in its stewardship efforts around ESG. Accordingly, where it agrees with the intent of a shareholder proposal addressing a material business risk and considers that management could do better in managing and disclosing that risk, it will support the proposal.

However, BlackRock now also expressly acknowledges that it may support a proposal if management is on track, but it believes that voting in favour of the proposal might accelerate the company's progress. BlackRock explains that as a long-term investor, it has historically engaged to explain its views on an issue and given management ample time to address it; however, given the need for urgent action on ESG, it has signalled that it will now be more likely to support a shareholder proposal without waiting to assess the effectiveness of engagement.

Increased use of benchmarking by investor groups

As well as demands for faster progress on ESG issues, institutional investors are also increasingly making granular requests of companies to apply and report against ESG benchmarks and detailed policies. This is not an entirely new trend, with many companies' climate governance and risk disclosure having been shaped by strong institutional investor support for the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). There has, however, been a tendency for more granular requirements from investor groups in the past 12–24 months.

Climate has been the primary focus of this activity thus far, with CA 100+ being particularly prominent in this regard having gained significant traction with its Net-Zero Company Benchmark for climate action (see below). Responsible Investor has reported[5] that the Principles for Responsible Investment is working on establishing a similar collective engagement effort on human rights, which may see enhanced efforts on benchmarking companies' progress on social issues in future periods.

Over the past 12–24 months, the influence of CA 100+ has been strengthened by the inclusion of several key long-term institutional investors amongst its now 617 global investors (responsible for more than $55 trillion in assets under management across 33 markets). This has resulted in its Net-Zero Company Benchmark gaining considerable influence across various markets.

CA 100+'s Benchmark assesses the performance of its 159 heavy emissions 'target' companies against three high-level goals: emissions reduction; governance; and disclosure. It is intended to help CA 100+'s investor signatories to evaluate company ambition and action in tackling climate change and covers 10 indicators spanning net zero commitments by 2050 through to capital allocation alignment.

The CA 100+ framework is just one example of enhanced benchmarking. In April 2021, the Australian Council of Superannuation Investors (ACSI) also released a new detailed policy outlining its expectations for ASX-listed companies exposed to climate-related risks. ACSI represents a significant proportion of superannuation investors in Australia and its members own; in aggregate, an average of 10% of each ASX200 company.

Key aspects of ACSI's expectations on climate include:

- **Adoption of TCFD**: Disclosure of climate-related risks by adopting the recommendations of the TCFD risk assessment and reporting framework.
- **Net zero alignment**: Alignment of corporate strategy to the Paris Agreement and the objective of net zero emissions by 2050. ACSI notes that Paris-aligned metrics should inform company strategy and be integrated into capital allocation decisions, financial reporting and audit, and, where appropriate, remuneration practices.
- **Undertake scenario analysis**: Stress-testing the resilience of companies' portfolios and strategy against a range of plausible but divergent climate futures, including a Paris-aligned 1.5°C scenario and physical-risk scenarios based on current warming trajectories.
- **Set Paris-aligned emissions targets**: Setting short-, medium- and long-term emissions-reduction targets that align with the Paris Agreement.

Other expectations relate to analysing and managing physical climate-related risks, aligning policy and advocacy activity with climate commitments and the Paris Agreement, and supporting just and equitable transitions that incorporate impacts on employees, communities and other stakeholders into strategy and planning.

In the policy, ACSI notes that where companies consistently fall short of its expectations (as outlined above), it may recommend that its members vote against directors of ASX200 companies on a case-by-case basis. In doing so, it plans to focus on the individual directors most accountable for oversight of climate-change related risks; for example, company Chairs, and the Chairs of the risk and sustainability committees or similar.

Demands for a greater 'say' on ESG issues

One of the most prominent trends over the past 12 months has been the growing support for voluntary 'Say on…' votes at large listed companies. As with the trend for granular benchmarks (see above), the initial focus has been on 'Say on Climate' votes. However, there has been some discussion that broader votes on other ESG issues may be pursued in the future, either by institutional investor groups or special interest groups and NGOs.

What is 'Say on Climate'?

'Say on Climate' was proposed by Sir Christopher Hohn's The Children's Investment Fund (TCI) and has subsequently been promoted by CA 100+ and a range of investor groups, NGOs and activists. Under the CA 100+ approach, boards are encouraged to voluntarily propose 'Say on Climate' resolutions along the following lines:

- an initial (and periodic) resolution to approve the company's climate strategy (as set out in an appropriate report published by the company); and
- subsequent annual votes on an implementation report published annually by the company, covering matters such as:
  - the integration of climate risks in the company's capital expenditure decisions;

- the company's Scope 1 and Scope 2 long-term reduction targets, and Scope 3 goals; and
- 'just transition' measures to mitigate the possible impacts of the company's climate strategy on its employees and local communities.

The vote, like a remuneration report or 'Say on Pay' vote, would be an 'advisory resolution'. While shareholders cannot typically requisition an advisory resolution in some markets (such as Australia where a constitutional amendment is needed or the UK where a 'direction' is needed by special resolution), the board can itself choose to include such a resolution on the AGM agenda and 'Say on Climate' is requested on that basis.

What is the impact of 'Say on Climate'?

'Say on Climate' has been adopted (or committed to) by a number of companies globally over the past year, including LSE-listed companies (such as Moody's, Unilever, Shell and Glencore), ASX-listed companies (such as Rio Tinto, Woodside Petroleum, Santos and AGL Energy) and IBEX-listed companies (such as Aena, Ferrovial and Iberdrola).

For the most part, companies' boards have decided to voluntarily submit 'Say on Climate' to recognise and respond to investor expectations and requests. However, Spanish airport manager and IBEX35 company, Aena, was subject to more overt activist pressure from TCI with respect to its proposal.

In 2020, TCI wrote to 17 Spanish companies asking them to report their carbon emissions, with the threat of voting against the election of their board members. After acquiring a 3.9% stake in Aena and a seat on the board, TCI pursued the introduction of new proposals at its 2020 meeting, including the approval of a Climate Transition Plan (as a 'Say on Climate' vote).

Aena initially refused the request, but TCI progressed the matter by making a call for more transparency to both the company and Spanish government. Amongst TCI's demands were more transparency in the breakdown of emissions and measures to reduce greenhouse gases contributing to the climate crisis. Finally, seven days before the meeting, Aena declared that shareholders would be able to vote on the new Climate Transition Plan.

Will 'Say on Climate' become commonplace?

While there is growing support for 'Say on Climate', it is not yet clear whether it will become a common feature of company governance. Importantly, support for 'Say on Climate' is not universal amongst investor groups, with certain American investors having made comments in the media over the past six months that it may prove an ineffective distraction. CalPERS in particular has been quoted as being ambivalent about 'Say on Climate' on the basis that its experiences with 'Say on Pay' were largely negative. Anne Simpson (director for governance) has been cited as saying that she considered voting against directors on the compensation committee to be a more effective approach than 'Say on Pay'.[6]

Leaving aside the weight of institutional shareholder expectations, pursuing a 'Say on Climate' vote does offer some advantages to companies and their boards:

- **Showing leadership** – adopting a leadership approach to climate-related business strategy will be well received by nearly all stakeholders – it has become a mainstream core business issue in the eyes of most shareholders, the community and regulators.
- **Securing institutional investor support** – it is now clear that institutional shareholders want to vote in favour of (and be seen to vote in favour of) resolutions promoting an effective climate change strategy. A board is likely to prefer to have those votes in favour of a board-proposed 'Say on Climate' resolution than cast, as a protest vote, in favour of a shareholder-requisitioned resolution.
- **Framing the resolution** – leaving the framing of a resolution to requisitioners risks a resolution being passed that is entirely impractical for the business and against the best interests of the company. While not binding, such a resolution would inevitably fetter the board's ability to set a climate change strategy that is 'fit for purpose' for the company. If the board takes the initiative in proposing the resolution, it can frame both the resolution and the disclosure itself.

There are some important disadvantages as well. By shifting towards annual 'Say on Climate' resolutions, a board risks losing the ability, in practice, for the company to chart the most appropriate climate change course given its own circumstances. The 'Say on Climate' concept is clearly modelled on the annual remuneration report vote ('Say on Pay'). What that precedent has demonstrated is the inevitable move towards a relatively standardised executive remuneration framework that is objectively acceptable (and tolerated by proxy advisers) irrespective of whether it best serves the needs of the particular company.

Boards that do move to put forward 'Say on Climate' resolutions will almost certainly benefit from a honeymoon period of strong institutional shareholder support. However, with respect to an annual or periodic advisory vote on 'implementation', it may prove to demonstrate progress against medium- and longer-term targets, given the timeframes involved and interdependencies with the development of new technologies. If a board-proposed resolution failed to pass (or even had a significant 'against' vote), the board would be under considerable pressure to change the strategy. That will not sit well with relevant duties to act in the best interests of the company where the board believes that its original strategy was right.

While practice on 'Say on Climate' is still evolving, one thing is clear: if a board decides to seek an advisory vote on climate-related matters, it will need to recognise that there is really no going back. It will not be easy to step away from the annual 'Say on Climate' vote in future years. It may also set a precedent for other important ESG issues in the future and could be viewed by governments as a case of 'best practice' that should become mandatory (and potentially binding) for all companies.

Activist Litigation and Regulatory Complaints

Recent developments on ESG activism have by no means been confined to the boardroom or AGM. In the past 12 months, there have been a number of activist proceedings instituted with a view to catalyse changes of corporate policy or progress on ESG commitments, particularly with respect to climate change.

While a number of these proceedings turn on facts particular to the case or features of domestic laws, they do provide growing evidence of activists using litigation to hold companies to account for climate impacts, seeking accelerated action on carbon transition and/or testing the boundaries of climate commitments and disclosure.

The case of *Milieudefensie et al. v Royal Dutch Shell* centred around the Shell Group's CO_2 emissions reduction goal by the end of 2030, which a group of NGOs considered inadequate and not aligned with the Paris Agreement. In the proceeding, the Hague District Court found that Shell owed an unwritten duty of care under the Dutch Civil Code to Dutch residents to take adequate action to mitigate its contributions to climate change. The Court determined that Shell must reduce its CO_2 emissions by 45% by 2030 compared to 2019 levels through its group corporate policy, which would require an acceleration to its existing climate actions.

Significantly, this was the first time that a national court has compelled a private company to reduce its emissions in line with the Paris Agreement. The judgment is currently subject to appeal. If upheld, it is possible that courts in other jurisdictions may have regard to the reasoning and outcome of the case, which may have wider implications for high CO_2-emitting companies and industries and their climate change programmes.

A duty of care was also found in the recent Australian case of *Sharma by her litigation representative Sister Marie Brigid Arthur v Minister for the Environment*. The case involved a challenge of the Minister's decision to approve the extension of a coal mine in New South Wales. The Court found that the Minister owed a duty of care to Australian children who may suffer potential 'catastrophic harm' from the climate change implications of the decision. Significantly, the Court found that:

- as a matter of statutory construction, potential harm to children was a mandatory relevant consideration that the Minister must take into account in making the decision; and
- the Minister also owed a separate private law duty of care to Australian children, having regard to the reasonable foreseeability of the harm, the Minister's control over that potential harm, and the vulnerability of children to the alleged risks.

Although the Court was not satisfied that a breach of the duty of care had arisen on the facts, the novel private law duty of care could (assuming that the decision stands) provide an avenue for plaintiffs to seek to restrain regulatory approval processes, embolden activists and plaintiff law firms, and impact project approval processes in the energy and resources sectors. The Australian government is appealing the finding.

Outside of tortious and 'duty of care'-type claims, there have also been increased allegations of 'greenwashing' and misleading disclosure. The risk of 'greenwashing' can arise if there is inconsistency between a company's stated position and ambition on climate risk management and its internal strategy, plans and actions, or where companies overstate their climate achievements or understate/misstate the environmental impacts of their products.

Climate position statements and other climate commitments in particular can pose risks for companies, as they are typically forward-looking statements about the company's future course of activities, investment and (environmental) performance. When making these public commitments, companies may be exposed to allegations of breaching disclosure laws if the statements are not being made on reasonable grounds with evidence to support their achievability at the time they are made.

Proceedings were filed in the US Federal Trade Commission on 16 March 2021 by Greenpeace and other environmental groups alleging that Chevron has misled consumers by overstating its investment in renewable energy and its actions to reduce its greenhouse gas emissions in its advertising. The complaint follows a number of proceedings previously commenced by US states (and the District of Columbia) alleging 'greenwashing' by oil companies, including claims against ExxonMobil, BP, Royal Dutch Shell and Chevron. Proceedings have also been commenced against Australian oil and gas company, Santos, on the basis of its net zero commitments and disclosure in relation to gas-powered energy.

Breach of disclosure law-type claims are also being made against a broadening range of market participants, with recent examples in Australia including:

- **superannuation funds** – regarding consideration of, and disclosure in relation to, climate risks in its portfolios (*McVeigh v REST*, settled in December 2020); and
- **government** – regarding the level of climate risk disclosure in relation to Australia's sovereign bond programme (*O'Donnell v Commonwealth*).

Conclusion

While the trends for greater regulation and disclosure of ESG risks are apparent, the increased (and increasing) incidence of activist action on climate over the past 12–24 months suggests that companies are also entering into a period of enhanced accountability to stakeholders. While shareholders are by no means the only group seeking for greater corporate commitments to ESG and enhanced ESG performance, their activist 'toolkit' means that they are well positioned to catalyse change in the businesses they own.

Endnotes

1. Available at https://opportunity.businessroundtable.org/ourcommitment/.
2. Available at https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/.
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ESG for Asset Managers

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The role of environmental, social and governance (**ESG**) matters in the operations and investment management activities of asset managers has been a subject of discussion for many years. In recent years, however, the conversation has become more urgent and focused, driven by the growing evidence of the global impact of climate change. These concerns underly the United Nations 2030 Agenda for Sustainable Development and 2015 Paris Agreement on Climate Change (**Paris Agreement**), the latter of which seeks to combat climate change and to direct finance flows towards low greenhouse gas emissions and climate-resilient development. The Paris Agreement has been the impetus for a growing body of law and regulation focused on ESG concerns and, in particular, sustainable investment.

The EU

The European Union (**EU**) has been leading the way in adopting rules and regulations focused on sustainable investment, the EU Commission taking the decision in 2016 to make sustainable development a political priority, and ESG has remained front and centre of legal and regulatory developments ever since.

For the EU, sustainable finance is about reorienting investment towards sustainable technologies and businesses, recognising that major public and private investment is needed to make the EU's financial system sustainable and ensure Europe is climate-neutral by 2050. To achieve this, in 2018 the EU launched its Action Plan on Sustainable Growth (**Action Plan**),[1] which set out 10 action points[2] with the key objectives of: (i) reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth; (ii) managing financial risks stemming from climate change, environmental degradation and social issues; and (iii) fostering transparency and long-termism in financial and economic activity.

Based on the Action Plan, the EU Commission set out three building blocks as the foundation for building a sustainable financial framework in the EU: (1) a classification system, or "taxonomy", of sustainable activities; (2) a disclosure framework for non-financial and financial companies; and (3) investment tools, including benchmarks, standards and labels, which are discussed below in detail.

Since 2018, the EU Commission's position with regard to what is needed to meet the sustainability goals has evolved, and the global context has changed. In July 2021, the EU Commission launched a new phase of the EU's sustainable finance strategy,[3] which identified four main areas where additional actions are needed for the financial system to support the transition of the economy towards sustainability. These are: (1) financing the transition of the real economy towards sustainability; (2) developing a more inclusive sustainable finance framework; (3) improving the financial sector's resilience and contribution to sustainability: the double materiality perspective; and (4) fostering global ambition as global efforts are key to tackling the financial stability implications of climate and environmental risks.

Other notable developments include the EU Commission's launch in December 2020 of the Green Deal,[4] described as a "*new growth strategy. It will help us cut emissions while creating jobs*".

In April 2021, the EU Commission reached provisional agreement on the European Climate Law, which "*enshrines the EU's commitment to reaching climate neutrality by 2050 and the intermediate target of reducing net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels*".

But What Does This Mean in Practice?

The focus of recent years has been to integrate (i) ESG considerations into the investment processes of EU-based investment managers and investors, and (ii) ESG factors into the non-financial data that is tracked and reported on by European businesses. The most significant measures adopted to date being the building blocks of:

- The Taxonomy Regulation,[5] which entered into force on 12 July 2020. It essentially created a classification system for sustainable economic activities, although the majority of its operative provisions will not take effect until 1 January 2022. This regulation establishes the concept of a "Taxonomy-aligned investment", which in essence is an investment that contributes substantially to certain specified environmental objectives, does not significantly harm those objectives and complies with certain minimum safeguards and technical criteria.
- The Sustainable Finance Disclosure Regulation (**SFDR**),[6] which came into effect on 10 March 2021. It seeks to provide for (i) a harmonised understanding of what constitutes "sustainable investment",[7] and (ii) a uniform, mandatory set of disclosure and reporting obligations relating to sustainability issues in connection with investment activity, including in the offering documentation and annual accounts for investment products. The EU views it as a tool that will trigger changes in behavioural patterns in the financial sector, discouraging greenwashing, and promoting responsible and sustainable investments. At a more granular level, it requires in-scope entities to radically change the way they act and how they assess and document their approach to sustainability.[8] It also provides for the designation of green investment products, including dark green or "Article 9" products, which pursue a sustainable investment objective, and light green or "Article 8" products, which promote, amongst others, environmental and social characteristics, provided those companies in which they invest follow good governance.

- A proposal for a new Corporate Sustainability Reporting Directive (**CSRD**), which was adopted by the EU Commission in April 2021. This aims to ensure that companies report reliable, comparable and consistent sustainability information that investors and other stakeholders need in order to, for example, comply with the SFDR and Taxonomy Regulation. The CSRD revises and strengthens rules introduced by the Non-Financial Reporting Directive,[9] significantly expanding the scope of EU listed and established entities that are in scope of the reporting obligations. The intention is that the CSRD will increase transparency and the disclosure of sustainability information, making the comparison of different financial products easier.

The Taxonomy Regulation, SFRD and CSRD complement each other and cannot be viewed in isolation. While the obligations imposed by the Taxonomy Regulation are limited, the implications of its text are broad, establishing, as it does, the vocabulary underlying the EU's sustainable development agenda and, in this context, informing the content of the disclosure obligations under the SFDR. The CSRD is an important mechanism for ensuring that the data needed to report on the degree of sustainability is available.

Some other important measures introduced to make the financial sector even more sustainable include:

- The Climate Benchmarks Regulation,[10] in force since 23 December 2020, and which introduced two new types of benchmarks:
  - an EU Climate Transition Benchmark, being a benchmark with a "decarbonisation trajectory" as evidenced by a measurable, science-based and time-bound movement towards alignment with the objectives of the Paris Agreement (e.g. the 2C limit on global warming); and
  - an EU Paris-Aligned Benchmark, being a benchmark where the resulting reference portfolio's carbon emissions are aligned with the objectives of the Paris Agreement (e.g. in essence, the carbon emissions savings of each underlying asset exceeds its carbon footprint).
- The EU Taxonomy Climate Delegated Act, which classifies which activities best contribute to mitigating and adapting to the effects of climate change. Subsequent delegated acts will cover other environmental objectives set out in the Taxonomy Regulation, namely: the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystem.
- Amendments to existing legislation (AIFMD,[11] UCITS Directive[12] and MiFID[13]) to:
  - Ensure that sustainability factors and sustainability-related objectives are considered in the product oversight and governance process for products/instruments.
  - Require the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.
  - Ensure sustainability risks and sustainability factors to be taken into account by alternative investment fund managers and for UCITS.

While the entities in scope of the various Regulations and Directives are essentially financial firms active in the EU or the EU entities in which they invest, the impact is already being felt much more broadly, not only because financial firms are frequently global or operate cross-border into the EU, but because the EU has moved first to define regulatory parameters in a space that is of growing global importance and relates to issues such as global warming, which does not obey national boundaries.

The UK

The UK effectively exited the EU at 11 p.m. GMT on 31 January 2020 and although a great deal of existing EU legislation has been "on-shored" into the UK statute book, this has not been the case for legislation taking effect after this time. In the context of ESG, this includes the Taxonomy Regulation, SFDR and CSRD, as well as the amendments to existing legislation (i.e. AIFMD, UCITS Directive and MiFID). In fact, regulating sustainable finance is an area where the UK and EU are following divergent paths.

Although it is not taking the same direction of travel as the EU, the UK government has repeatedly stated its commitment to fighting climate change. The UK Chancellor stated that the UK government's economic policy objective "*remains to achieve strong, sustainable and balanced growth*"[14] and the government aims to deliver a "*financial system which supports and enables a net zero economy by mobilising private finance towards sustainable and resilient growth and is resilient to the physical and transition risks that climate change presents*".[15] To date, this has meant a focus on climate change.

More specifically, the UK government endorsed the recommendations of the Task Force on Climate-related Financial Disclosures (**TCFD**)[16] in 2017 and made implementation of the TCFD proposals a central part of its 2019 Green Finance Strategy.[17] The principal objective of the strategy being to "*align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by Government action*". In promoting the TCFD's recommendations, the UK Taskforce (described below) aims not only to improve the flow of information, but also to foster a step change in how organisations think about climate-related risks and opportunities.

In November 2020, a UK government and regulator-led taskforce (including the two principal financial regulators, the Financial Conduct Authority (**FCA**) and the Prudential Regulatory Authority) (**UK Taskforce**) published an Interim Report[18] and Roadmap,[19] setting out a strategy towards mandatory TCFD-aligned disclosures across the UK by 2025 and an indicative path for the introduction of regulatory rules and legislative requirements over the next five years, with most to be implemented in the first three years. The UK Taskforce recognises the global nature of the asset management industry and its interactions with related international initiatives, including those that derive from the EU's Sustainable Finance Action Plan. Most encouragingly, the Interim Report states that the proposed TCFD-aligned requirements would, as far as possible, be consistent with and complementary to these initiatives.

New disclosure rules for companies with a UK premium listing were finalised in December 2020 and the FCA is currently consulting on proposals to (i) extend the application of the TCFD-aligned Listing Rule for premium-listed commercial companies to issuers of standard-listed equity shares (**CP 21/18**), and (ii) introduce climate-related disclosure requirements, aligned with the TCFD's recommendations, for asset managers, life insurers, and FCA-regulated pension providers (**CP 21/17**).[20]

CP 21/17 explains that the FCA plans to introduce (i) "entity-level disclosures", meaning that firms would be required to publish annually an entity-level TCFD report on how they take climate-related risks and opportunities into account in managing or administering investments on behalf of clients and consumers, with these disclosures being made in a prominent place on the main website for the firm's business, and would cover the entity-level approach to all assets managed by the UK firm, and (ii) "product or portfolio-level disclosures", meaning that firms would be required to produce annually a baseline set of consistent, comparable disclosures in respect of their products and portfolios, including a core set of metrics. Further clarity for asset managers is expected when the FCA publishes its policy statement anticipated in Q4 2021. Whether the final proposals for asset managers will translate into broad consistency with the EU's initiatives in the longer term remains to be seen. The UK is predominately focusing on climate change, rather than the broader ESG concerns that are the focus of the EU regulators and legislators. This divergence will be a concern for asset managers with operations in both the EU and UK who may find they are subject to multiple and inconsistent disclosure and reporting regimes.

In summary, both the EU and UK legislative and regulatory bodies continue to focus on ESG. The divergent approaches do mean that it will become increasingly complex to navigate the overlapping but distinct legal and regulatory requirements as they evolve.

Hong Kong

Hong Kong's regulatory framework with regard to climate change and sustainable investment has gradually taken shape in recent years. Although the Climate Action Plan 2030+ published by the Hong Kong Environmental Bureau in January 2017 originally centred on green finance, the Hong Kong Securities and Futures Commission (**SFC**) and Hong Kong Exchanges and Clearing Limited (**HKEX**) have taken cues from international bodies and Mainland China to develop a regulatory agenda that goes beyond this initial focus.

There are three key drivers underlying Hong Kong's regulatory agenda with respect to sustainable investment: (i) Mainland China's status as a signatory to the Paris Agreement, the provisions of which apply to Hong Kong; (ii) the conviction of key regulators (including the SFC and HKEX) that climate change is a real threat and a source of financial risk to investors; and (iii) Hong Kong's position as an international financial centre, which necessitates proactive engagement with financial participants on climate risk-related issues. In light of these drivers, the SFC's and HKEX's efforts have been directed at: (1) disclosure of listed companies' environmental information and climate-related risks; (2) integration by asset managers of climate change factors into their investment and risk management process; and (3) ensuring accurate product disclosure of green investments that is consistent with international standards and to avoid greenwashing.

So far, similar to the regulations in the EU, the rules are far from being in their final form. At the time of writing, the following are the key measures that have been taken:

- the Hong Kong Stock Exchange published guidelines on mandatory reporting on ESG,[21] which came into effect on 1 July 2020 and replaced the voluntary ESG reporting regime that was first introduced in 2012. The guidelines largely emphasise climate-related disclosure, aligning with recommendations of the TCFD;
- the SFC released a circular to management companies of SFC-authorised unit trusts and mutual funds on "Green" or "ESG" funds on 11 April 2019,[22] which was subsequently amended on 29 June 2021.[23] The circular sets out the SFC's expectations on the "product-level" disclosure obligations of SFC-authorised funds that incorporate ESG factors as their key investment focus with the goal of improving their comparability, transparency and visibility. To accompany the circular, the SFC also set up a dedicated website to list all SFC-authorised funds that categorised themselves as ESG funds; and
- on 20 August 2021, the SFC published its consultation conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers,[24] which proposes amendments to the existing SFC Fund Manager Code of Conduct. The document follows a month-long consultation in which the SFC proposed high-level principles setting out the governance, investment management, risk management and disclosure obligations of fund managers with respect to climate risks. The proposals largely reference the recommendations of the TCFD – and notably allow for a two-tier approach (i.e. with baseline requirements for all fund managers and enhanced standards for fund managers with assets under management exceeding a threshold of HK$8 billion). It is expected that the earliest effective date will be 20 November 2022 (although large fund managers may have a deadline of 20 August 2022 with respect to their baseline requirements).

Singapore

While initially lagging behind the EU and Hong Kong, Singapore's development of a sustainable investment regulatory framework has accelerated. Earlier in 2021, the Singapore government set out its five-pillar climate ambitions for Singapore to achieve by 2030 in its "Singapore Green Plan 2030" (**Green Plan**).[25] The Green Plan makes reference to the Monetary Authority of Singapore's (**MAS**) own initiatives, as set out in their 2019 annual report, to "green" the financial system by: (i) developing Singapore's green finance markets and solutions; (ii) building a financial system that is resilient to environmental risks; and (iii) building the requisite capabilities and encouraging green Fintech innovation.

In a short timeframe, the MAS has consulted the industry and taken measures to facilitate its green initiatives. At the time of writing, the following are the key measures that have been taken:

- the Singapore Exchange (**SGX**) published its guidelines for sustainability reporting,[26] which listed companies are required to adhere to on a "comply or explain" basis from the financial year ending on or after 31 December 2017. There are five primary components in the guidelines, which comprise: (i) selection of a sustainability reporting framework; (ii) identification of material ESG factors; (iii) policies, practices and performance of the company against material ESG factors; (iv) ESG targets; and (v) board statement on its oversight of material ESG factors; and
- on 8 December 2020, the MAS released the final Guidelines on Environmental Risk Management for asset managers (**Guidelines**).[27] The Guidelines aim to address environmental risks, which are broader than climate risks alone, and are defined as risks that arise from potential adverse impact of change in the environment on economic activities and human well-being. The Guidelines are largely aligned with the recommendations of the TCFD and cover the areas of: (i) governance and strategy; (ii) research and portfolio construction; (iii) risk management; and (iv) stewardship and disclosure.

The expectation is that both measures will be further developed. The SGX has released a consultation paper to the industry, inviting comments on enhancing sustainability disclosure requirements in line with the TCFD recommendations for listed companies, with the plan being that certain sectors will be subject to mandatory climate reporting starting from the financial year commencing in 2023 onwards. With respect to the Guidelines, once the MAS has had the opportunity to review their implementation, it is expected that it will publish a paper on best practices and areas for improvement.

It is worth noting that the MAS is itself taking climate change seriously as an institution. In the words of Ravi Menon, the managing director of the MAS, the MAS aims to lead by example, hoping that financial institutions in Singapore and

Asia will follow suit. The MAS, as the guardian of Singapore's official foreign reserves, will also integrate climate risks and opportunities into its investment framework by implementing climate risk mitigation strategies for its equity portfolios and allocating more investments to actively managed strategies that seek out climate change-related opportunities. At the level of infrastructure, the MAS is monitoring its own carbon footprint, tracking usage of electricity, water and paper.

The US

Although ESG factors are not new considerations for reporting companies, asset managers and regulators, there have been only limited regulatory developments related to ESG in the US to date. Indeed, as of the summer of 2021, neither reporting companies nor asset managers in the US are subject to ESG-specific regulatory requirements. However, as reporting company shareholders increasingly demand ESG information on company operations and asset managers increasingly incorporate the use of ESG factors and data into their investment process, the US Securities and Exchange Commission (**SEC**) under Chair Gary Gensler is evaluating potential rulemaking that would impose uniform ESG climate risk disclosure standards for reporting companies and is directing more attention towards how investment managers and investment funds disclose their ESG investment processes. As discussed in further detail below under "Other Considerations", the Department of Labor (**DOL**) has also become more receptive to the use of ESG factors and data in the management of plan assets.

The Inputs: Reporting Company Disclosures

In the absence of regulatory disclosure standards, non-governmental organisations emerged to create uniform ESG disclosure practices. For example, reporting companies in the US have been paying attention to the Global Reporting Initiative and Sustainability Accounting Standards Board (**SASB**) sustainability reporting standards. These standards are voluntary and not universally adopted; consequently, the ESG data, if it is available to investors, can be difficult to compare across industries and issuers. In December 2020, the Investment Company Institute's Board of Governors issued a statement supporting US reporting companies providing ESG disclosure in the manner recommended by SASB and the TCFD.

Recognising the patchwork nature of ESG-related disclosures available to financial market participants, Chair Gensler signalled in a July 2021 speech[28] that the SEC could mandate reporting company climate risk disclosures. Eschewing the current principles-based materiality standard for reporting company disclosures, Chair Gensler suggested that any such rulemaking could include prescriptive disclosure standards. Importantly, Chair Gensler signalled that the SEC could develop its own standards in this regard rather than rely on existing standards under SASB or the TCFD. These developments, if adopted, could significantly expand both the nature and comparability of climate risk disclosure available to financial market participants.

The Process: ESG Developments Affecting US Asset Managers and Funds

Notwithstanding the absence of a uniform definition of what constitutes ESG investing or requiring disclosure of ESG metrics, the SEC and its staff have demonstrated an interest over time in asset managers' ESG investment processes, including the nature and source of supporting data. For example, of the approximately 488 ESG-related SEC disclosure review staff comments provided to registered funds between 1 January 2017 and 6 January 2021 that were captured in a proprietary Dechert LLP survey, 42% of the comments focus on the ESG criteria used by the fund's investment adviser, 21% relate to the incorporation of ESG criteria into the investment process, and 5% relate to the proxy voting.

Similar to the reporting company context, the SEC's and its staff's focus on ESG investing has increased under the Biden Presidential Administration. Specifically:

- The SEC's website was updated to include a landing page titled *SEC Response to Climate and ESG Risks and Opportunities*,[29] which highlights the SEC's recent initiatives related to ESG.
- The SEC's Division of Examinations' (**Division**, formerly known as the Office of Compliance Inspections and Examinations) 2021 Examination Priorities underscore an enhanced focus on climate and ESG-related risks.[30]
- On 4 March 2021, the SEC announced the creation of a Climate and ESG Task Force within the Division of Enforcement. The task force will, in the context of asset managers, be monitoring to ensure that ESG investment practices are consistent with disclosures, fund advertising is not false or misleading, and proxy voting practices are consistent with professed strategies.
- On 9 April 2021, the Division released a Risk Alert that discusses the staff's findings during recent examinations related to ESG investing including, among other things, (i) potentially misleading statements about investment processes and adherence to global ESG frameworks, (ii) proxy voting practices inconsistent with proxy voting policies, and (iii) policies and procedures inadequate to ensure the accuracy of client disclosures.[31]
- On 7 July 2021, Chair Gensler indicated that he had asked the SEC staff to consider whether the Names Rule (Rule 35d-1 under the Investment Company Act of 1940)[32] should be updated given the growth of ESG-related investment funds. This follows a 3 March 2021 request for comments on the Names Rule, in which the SEC staff observed that "*funds appear to treat terms such as "ESG" as an investment strategy (to which the Names Rule does not apply) and accordingly do not impose an 80 percent investment policy, while others appear to treat "ESG" as a type of investment (which is subject to the Names Rule)*".[33]
- Also on 7 July 2021, the SEC Asset Management Advisory Committee adopted non-binding recommendations, prepared by the SEC's ESG subcommittee, regarding both issuer disclosure of material ESG matters and ESG investment product disclosure. The investment product disclosure recommendations suggest that the SEC should adopt a taxonomy consistent with the one developed by the Investment Company Institute's ESG Working Group that would harmonise the terminology used to articulate non-financial objectives (e.g. non-financial objectives and religious requirements) and establish best practices for describing shareholder engagement activities in the Statement of Additional Information.[34]
- On 28 July 2021, through the July Speech, Chair Gensler signalled the SEC's expected future rulemaking with respect to asset managers' use of ESG investment processes. With respect to asset managers, Chair Gensler reiterated his intention for the SEC to revisit the application of the Names Rule to the ESG context and mandate asset manager disclosure related to ESG investing processes, including by defining terminology and specifying ESG criteria used.

On 11 June 2021, the SEC released its annual regulatory agenda (**Agenda**) under the Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions. Of the 49 items in the Agenda, a number of proposed rule-stage items relate to ESG. The Division is considering recommending that the SEC:

- "propose requirements for investment companies and investment advisers related to environmental, social and governance (ESG) factors, including ESG claims and related disclosures" by April 2022;
- "propose rule amendments to enhance registrant disclosures regarding issuers' climate-related risks and opportunities" by October 2021; and
- "propose rule amendments to enhance registrant disclosures regarding human capital management" by October 2021.

Other Considerations

The DOL, under the Biden Presidential Administration, has signalled an increased willingness to permit, and has taken preliminary steps to facilitate, the inclusion of ESG investments on retirement plan menus. For example, the Biden DOL indicated on 10 March 2021 that it would enforce neither the "Financial Factors in Selecting Plan Investments" nor the "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" rules enacted under the prior Presidential Administration. Those decisions, however, remain subject to the prudent person standard of care that exists under the Employee Retirement Income Security Act of 1974. In addition, on 13 October 2021, the DOL issued a Notice of Proposed Rulemaking[35] (**NPR**) that, among other things, recognises that ESG factors can be "financially material" to the process of selecting investments and that a fiduciary's duty of prudence may require an evaluation of the economic effects of various ESG factors on the particular investment or investment course of action. Although the NPR does not define "ESG" for purposes of the proposed rule, it does provide examples of ESG factors that may be material to the risk-return analysis.

Endnotes

1. Action Plan: Financing Sustainable Growth is available here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN.
2. In summary, the 10 action points are: (1) establishing an EU classification system for sustainable activities; (2) creating standards and labels for green financial products; (3) fostering investment in sustainable projects; (4) incorporating sustainability when providing financial advice; (5) developing sustainability benchmarks; (6) better integrating sustainability in ratings and market research; (7) clarifying institutional investors' and asset managers' duties; (8) incorporating sustainability in prudential requirements; (9) strengthening sustainability disclosure and accounting rule-making; and (10) fostering sustainable corporate governance and reducing short-termism in capital markets.
3. The Strategy for Financing the Transition to a Sustainable Economy is available here: https://eur-lex.europa.eu/resource.html?uri=cellar:9f5e7e95-df06-11eb-895a-01aa75ed71a1.0001.02/DOC_1&format=PDF.
4. "What is the Green Deal?" is available here: https://ec.europa.eu/commission/presscorner/detail/en/fs_19_6714, and a factsheet describing the architecture of the Green Deal is available here: https://ec.europa.eu/commission/presscorner/detail/en/fs_21_3671.
5. Regulation (EU) 2020/852.
6. Regulation (EU) 2019/2088.
7. "'*[S]ustainable investment*' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance."
8. April 2021 EU Sustainable Finance package.
9. Directive 2014/95/EU.
10. Regulation (EU) 2019/2089.
11. Directive 2011/61/EU.
12. Directive 2009/65/EC.
13. Directive 2014/65/EU.
14. Letter from the Chancellor to the FCA "Recommendations for the Financial Conduct Authority" dated 23 March 2021 is available here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/972445/CX_Letter_-_FCA_Remit_230321.pdf.
15. *Ibid.*
16. The TCFD has over 1,000 supporters, which are headquartered in 55 countries, span the public and private sectors and include organisations such as corporations, national governments (Belgium, Canada, Chile, France, Japan, Sweden and the United Kingdom), government ministries, central banks, regulators, stock exchanges and credit rating agencies.
17. The Green Finance Strategy is available here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf.
18. The Interim Report is available here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933782/FINAL_TCFD_REPORT.pdf.
19. The Roadmap is available here: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf.
20. Consultation Paper 21/17 "Enhancing climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers" is available here: https://www.fca.org.uk/publication/consultation/cp21-17.pdf.
21. The ESG Reporting Guide is available here: https://en-rules.hkex.com.hk/rulebook/environmental-social-and-governance-reporting-guide-0.
22. The SFC circular dated 11 April 2019 is available here: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=19EC18.
23. The amended SFC circular dated 29 June 2021 is available here: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=21EC27.
24. The consultation conclusions are available here: https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP5.

25. The Green Plan is available here: https://www.greenplan.gov.sg/.
26. The SGX guidelines are available here: https://www.sgx.com/regulation/sustainability-reporting.
27. The MAS Guidelines are available here: https://www.mas.gov.sg/regulation/guidelines/guidelines-on-environmental-risk-management-for-asset-managers.
28. *Prepared Remarks Before the Principles for Responsible Investment "Climate Financial Markets" Webinar*, Chair Gary Gensler (28 July 2021) (*available at* https://www.sec.gov/news/speech/gensler-pri-2021-07-28) (the July Speech). Similarly, on 23 June 2021, Chair Gensler remarked at London City Week that he had asked the SEC staff for "recommendations on mandatory company disclosures on climate risk and human capital", "to consider potential requirements for companies that have made forward-looking climate commitments" and "to consider the ways that funds are marketing themselves to investors as sustainable, green, and 'ESG,' and what factors undergird those claims". *Prepared remarks at London City Week*, Chair Gary Gensler (23 June 2021) (*available at* https://www.sec.gov/news/speech/gensler-speech-london-city-week-062321). At least one current SEC Commissioner has publicly opposed adopting a prescriptive climate risk disclosure regime for reporting companies.
29. The landing page is available here: https://www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities.
30. *2021 Examination Priorities*, SEC Division of Examinations (3 March 2021) (*available at* https://www.sec.gov/news/press-release/2021-39).
31. *SEC Division of Examinations, Risk Alert*, the Division of Examinations' Review of ESG Investing (9 April 2021) (*available at* https://www.sec.gov/files/esg-risk-alert.pdf).
32. The Names Rule generally dictates that if a fund's name suggests exposure to a particular type of investment, then the fund must invest at least 80% of its assets in that type of investment. Given the lack of uniform definitions of "sustainability-related terms", Chair Gensler "asked staff to consider recommendations about whether fund managers should disclose the criteria and underlying data they use" as part of the SEC's "ongoing efforts to update the public company disclosure regimes on climate risk and human capital".
33. *Request for Comments on Fund Names*, SEC (2 March 2020) (*available at* https://www.sec.gov/rules/other/2020/ic-33809.pdf).
34. *Recommendations for ESG*, SEC Asset Management Advisory Committee (7 July 2021) (*available at* https://www.sec.gov/files/amac-recommendations-esg-subcommittee-070721.pdf).
35. *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, U.S. Dept. of Labor, 29 CFR Part 2550 (13 October 2021) (*available at* https://public-inspection.federalregister.gov/2021-22263.pdf).

Acknowledgments

The authors gratefully acknowledge the contributions of Philippa List and Tyler Payne to this chapter.

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U.S. Legal and Compliance Issues Relating to ESG for Private Fund Advisers

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Introduction

General

The use of environmental, social and corporate governance, or "ESG", factors in the investment decision-making process is rapidly increasing in prominence among private investment fund advisers in the United States and globally. The increased focus on ESG has been driven primarily by investor demand for ESG strategies, investor requests about the incorporation of ESG for all investment managers regardless of strategy as part of the due diligence process, and increased scrutiny by U.S. regulators (particularly the U.S. Securities and Exchange Commission (the "SEC") and the U.S. Department of Labor (the "DOL")). Many investors are conducting increased diligence on manager ESG policies and procedures (both at the time of selection and during ongoing diligence meetings) and some also request specific side letter representations and ESG reporting.

The U.S. regulatory focus on ESG has been exhibited through, among other things, the SEC's Division of Examinations' recent risk alert and annual examination focus areas for 2020 and 2021. Perhaps most notably, in the first quarter of 2021, a Climate and ESG Task Force was established within the SEC's Enforcement Division. The press release announcing the establishment of the Task Force (available here: https://www.sec.gov/news/press-release/2021-42) identified a number of objectives including analysing "disclosure and compliance issues relating to investment advisers' and funds' ESG strategies". In addition, in May 2021, the Biden administration issued an Executive Order (available here: https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/) requiring the development of a comprehensive, government-wide strategy regarding various climate issues, including, through the measurement, assessment, mitigation, and disclosure of climate-related financial risk.

Certain SEC commissioners have also indicated their focus on the consistency and accuracy of ESG-related disclosures, and in particular the tendency of certain managers to overstate the role of ESG within their firms (often referred to as "greenwashing"), in speeches or other public statements on a number of occasions. For example, in remarks before the European Parliament Committee on Economic and Monetary Affairs in September 2021 (available here: https://www.sec.gov/news/speech/gensler-remarks-european-parliament-090121), SEC Chair Gary Gensler noted that "[m]any funds these days brand themselves as 'green,' 'sustainable,' 'low-carbon,' and so on", and that he has "directed staff to review current practices and consider recommendations about whether fund managers should disclose the criteria and underlying data they use to market themselves as such".

In this chapter, we will discuss the key steps that a private fund adviser can take to integrate ESG in its investment process, as well as compliance considerations relating to the implementation of ESG by SEC-registered investment advisers ("Registered Advisers") and related considerations for investor communications. We will also discuss ESG considerations for private fund advisers raising capital from ERISA plans, for both plan asset and non-plan asset funds.

Background

There is no one generally accepted definition of ESG or one way to approach ESG as an investment manager. Accordingly, ESG investing can be implemented by private fund advisers in various ways. The prevailing modern approach to ESG investing involves a multi-faceted analysis that takes into account a broad range of considerations as part of the investment process, which can be referred to as the ESG-integration model. In this model, a manager includes ESG factors as part of its investment and risk management process, although, depending on the manager, these factors may not be dispositive. Environmental factors include, among others, considerations relating to climate change, greenhouse gas emissions and carbon footprint, as well as an issuer's use of renewable energy or engagement in sustainable initiatives. Social factors include, among others, considerations relating to employee health and safety, diversity and inclusion, ethical supply chain sourcing, privacy and data security, and human rights. Corporate governance factors include, among others, considerations relating to board independence and diversity, executive compensation, shareholder rights, business ethics and separation between an issuer's CEO and the chairman of its board. For the purposes of this chapter, we focus on this method of ESG implementation by a manager. However, managers also may use positive or negative screens with respect to certain types of investments or engage in economically targeted investing (i.e., impact investing). Impact investing focuses on making investments targeting specific social or environmental effects (e.g., increasing affordable housing or combatting climate change).

Developing ESG Policies and Procedures

A manager considering ESG integration within its investment process can first begin by engaging with the various stakeholders within the firm, including portfolio management, operations/finance, investor relations/business development and legal/compliance team members to determine the appropriate approach for its firm. At this stage, managers need to consider factors such as its size, culture and resources in order to ensure that the approaches identified will be practical and can be implemented within the firm. Once the manager has identified its overall approach, the adviser can begin to develop an ESG policy and related procedures. Due to the increased scrutiny by both investors (including pension funds, endowments, sovereign wealth funds and foundations) and U.S. and global regulators, ESG policies that are merely aspirational without providing specific, actionable steps are not sufficient. Instead, it is recommended that policies include specific details regarding the processes that will be utilised to integrate ESG into the investment process and should be tailored and designed based on the adviser's size, investment philosophy and strategy. Because there is no generally accepted definition of ESG and managers will vary in their approaches to ESG integration, it is crucial to include the firm's definition of and approach to ESG. For example, a manager that considers ESG factors in addition to other economic factors in identifying investment opportunities will have a very different ESG policy than a manager that is instead pursuing specific ESG-related goals in its investments. Similarly, a manager that advises private equity funds and is heavily involved with the management of a portfolio company or takes control positions will also have a very different ESG policy than a manager that is primarily investing in publicly traded, large capitalisation companies in the energy sector.

Investment Process

An important part of implementing ESG by a private fund adviser and developing an ESG policy is determining how ESG factors will be incorporated into the investment process. A manager can begin by reviewing its current investment and research process in light of ESG factors and formalising and enhancing certain practices, as needed. A manager should also memorialise the steps taken to reflect ESG considerations in its investment process, including, for example, by separating out the consideration of ESG factors in research notes, investment memoranda or investment committee meeting minutes. Managers may need to consider the different processes applicable to new investments and the monitoring of existing investments.

Determining the appropriate documentation to be used in the investment process will require a manager to evaluate the use of its resources, both in terms of personnel and cost, and the culture within the firm. There is currently no requirement for issuers in the United States to have specific ESG disclosure and, accordingly, it can be time consuming and difficult to consistently identify information relating to relevant ESG factors for each portfolio company in which a private fund adviser may wish to invest client assets. This can be particularly challenging for a manager that invests client assets in private companies, which typically have less information available for evaluation than public companies. An adviser will need to determine whether it will attempt to gather this data internally or whether it will utilise a third-party service provider, such as one that provides ESG scoring of companies, or both. If using ESG scoring, it is important to note that there are many different approaches as to how scores are determined. Accordingly, a manager should pay close attention to this when engaging service providers to provide ESG scoring. A manager can also seek to develop its own ESG scoring metrics, which will require additional internal resources and expertise. Finally, a manager will have to consider whether ESG scores are dispositive in the investment decision-making process or if they will be included among other factors.

An adviser will also need to determine how expenses related to ESG diligence and service providers will be allocated among the adviser and its clients. Advisers should document their rationale for these determinations as expense allocations continue to be an area of focus for the SEC. Advisers should also review their clients' governing documents to determine whether additional disclosure regarding these expenses is warranted and what expenses can properly be borne by clients.

Engagement with Management

Incorporating ESG factors into the investment process leads to the potential for an increase in corporate engagement, including through meetings with and/or letters to issuers' management teams and boards of directors relating to ESG issues, or through more formal actions, such as shareholder resolutions or proxy contests seeking to achieve ESG-related goals. There is no "one-size-fits-all" approach to this engagement, and advisers will often seek to be consistent with how they already engage with management on other material issues. However, it is important for managers to identify the types of engagement that they will utilise, if any, in their compliance policies and procedures. If a manager intends to be more active with respect to U.S. listed issuers, it will need to consider a variety of additional legal issues, including those related to material, non-public information, regulatory filing requirements (including Schedule 13D filings) and compliance with U.S. proxy rules. Even if a manager does not plan to engage with management on a more formal level (as described above), as part of implementing ESG considerations in its investment process, the manager should consider incorporating questions related to ESG factors into its standard due diligence process when meeting with portfolio company management teams and/or investor relations personnel. The types and breadth of questions may differ depending on a number of factors, including the level of investment by the client account, anticipated holding period, type of issuer, sector and geography.

Proxy Voting

A Registered Adviser is required to adopt and implement written proxy voting policies and procedures that are reasonably designed to ensure that the adviser votes client securities in the best interest of its clients. An adviser may vote proxies in a manner that reflects ESG principles, including with respect to corporate governance matters. However, it should first consider whether its proxy voting policies need to be amended to reflect how the adviser intends to incorporate ESG factors into its voting process. As with any policy, it is important for an adviser to make sure that its proxy voting actions are consistent with its written policy and that it does not begin diverting from its policy until an amended policy reflecting current intentions is adopted. In addition, if the adviser uses a third-party proxy advisory firm, the adviser needs to conduct due diligence to, among other things, confirm that it approves of the ESG factors used in the firm's voting process and understands the role these criteria play in making voting recommendations. The adviser should also seek to satisfy itself regarding the proxy advisory firm's ability to consistently obtain current and accurate information regarding ESG factors.

Monitoring and Review by the Adviser's Compliance/Legal Team(s)

Once an adviser has developed and implemented its ESG policy and procedures, it is important that the adviser's compliance/

legal team(s) continue to monitor the effectiveness of, and internal compliance with, the policy and procedures. This will require the adviser to have compliance/legal staff responsible for, among other things, reviewing investment memoranda and related back-up materials regarding the firm's consideration of ESG factors, reviewing support for proxy votes and checking actual votes for consistency, reviewing investor reporting and other disclosures to ensure accuracy and consistency with the policy and procedures, and ensuring that investment and other personnel within the firm are maintaining sufficient documentation regarding the consideration of ESG factors in the investment decision-making process.

Additional U.S. Compliance Considerations for Registered Advisers

SEC Exam Focus Areas and Enforcement Division Task Force

As noted above, the SEC has recently demonstrated an increased focus on ESG. This has been displayed in part by the annual Examination Priorities issued by the Division of Examinations for both 2020 (available here: https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf) and 2021 (available here: https://www.sec.gov/files/2021-exam-priorities.pdf). As part of the Division of Examinations' focus on Registered Adviser compliance programmes, the Division of Examinations noted that it would focus on the consistency and sufficiency of Registered Advisers' disclosures to clients regarding ESG and seek to determine whether advisers' actual practices and procedures match those disclosures. The Division of Examinations also stated that it would review fund marketing and advertising for false or misleading statements relating to ESG, and review proxy voting policies and procedures and actual votes for inconsistencies.

Shortly following the release of the 2021 Examination Priorities, the SEC announced the creation of the Climate and ESG Task Force within the Enforcement Division, which is expected to work closely with other SEC Divisions and Offices (see the press release announcing the establishment of the Task Force, available here: https://www.sec.gov/news/press-release/2021-42).

Division of Examinations' Risk Alert and Guidance

The Division of Examinations also released an ESG-focused risk alert in April 2021 (available here: https://www.sec.gov/files/esg-risk-alert.pdf) (the "Risk Alert"). The Risk Alert suggests that it was prompted by, among other things, the rapid growth in investor demand for investment vehicles that incorporate ESG factors into the investment process, the lack of standardised and precise ESG definitions, and the resulting confusion that can result among investors. The Risk Alert provides examples of deficiencies, as well as effective practices, related to ESG investing observed by the Division of Examinations in its examinations of advisers and funds, and is described as intended in part to assist advisers in developing and enhancing their ESG-related compliance practices. The Division of Examinations noted the following observations of common deficiencies in the Risk Alert:

- Portfolio management practices that were inconsistent with disclosures about ESG approaches in various documents prepared by the adviser.
- Inadequate controls for maintaining, monitoring and updating clients' ESG-related investing guidelines, mandates and restrictions based on an adviser's current practices.
- Inconsistent proxy voting policies and procedures compared with disclosure provided to clients.
- Unsubstantiated or otherwise potentially misleading claims regarding ESG approaches and the performance of ESG-oriented strategies.
- Inadequate controls to ensure that ESG-related disclosures and marketing materials are consistent with an adviser's practices.
- Compliance programmes that did not adequately address relevant ESG issues, such as investing analyses, decision-making processes, or compliance review and oversight.

One common deficiency that the Risk Alert identified was lack of adherence to a global ESG framework, such as the UN Principles for Responsible Investment, when an adviser claimed such adherence in its disclosures to investors. This serves to illustrate a primary lesson of the Risk Alert, which is that advisers that disclose that they are engaged in ESG investing (whether through ESG integration or via a dedicated strategy) need ESG policies, procedures and practices that are (i) tailored to their business, (ii) accurately, clearly and consistently disclosed across all documents and filings, including, without limitation, Form ADV Part 2A, fund offering documents, advisory agreements, marketing materials, side letters, due diligence questionnaires and request for proposal ("RFP") responses, and (iii) demonstrable and consistently followed by all firm personnel, and maintained, monitored and amended as needed by effective compliance personnel.

The Risk Alert did include some observations of effective compliance practices relating to ESG investing, including tailored and precise disclosure, detailed ESG policies and procedures, and advisory compliance personnel that are knowledgeable about ESG practices. Examples of practices of effective compliance personnel identified in the Risk Alert include providing meaningful reviews of the adviser's public disclosures and marketing materials, testing the adequacy of existing ESG policies and procedures and determining whether enhanced or new ESG-related policies and procedures are necessary, assessing whether the adviser's portfolio management processes conform to its stated ESG investing practices, and testing the sufficiency of documentation related to ESG factors taken into account in investment decisions.

In addition to observations of ESG-related deficiencies and effective practices, the Risk Alert also identifies three general focus areas by the Division of Examinations during examinations of Registered Advisers that disclose that they engage in ESG investing (whether through a dedicated product or more generally as part of an adviser's overall investment process), which are portfolio management, performance advertising and marketing, and compliance programmes (e.g., policies and procedures and compliance oversight).

Disclosure of ESG Practices

Consistent with a private fund adviser's fiduciary duty to its clients and the requirement that all material information be disclosed to investors in connection with the offering of private fund interests, an adviser will need to ensure that full and fair disclosure regarding its ESG policy, procedures and practices is included in its Form ADV Part 2A (as further discussed below) and fund offering documents as well as other documents such as advisory agreements, marketing materials, side letters, due diligence questionnaires and RFP responses, as applicable. Further, advisers should consider and identify any material risks and conflicts of interest that may arise from the use of ESG factors in the investment process and provide full and fair disclosure of those risks and conflicts to investors. If an adviser is seeking to incorporate ESG into the investment strategy for an existing fund, it should also consider whether the integration of ESG represents a material change in the strategy or could be considered adverse to existing clients, in which case the adviser should consider seeking the consent of the applicable clients or offering investors the opportunity to withdraw from the fund prior to the implementation of that change.

A Registered Adviser is required to submit a publicly filed Form ADV in order to register with the SEC and must amend its Form ADV at least annually. Preparation of an adviser's annual amendment presents an opportunity for the firm to review its current disclosure, including those items that may be particularly affected by ESG-related considerations. In particular, Item 5 (Expenses), Item 8 (Methods of Analysis, Investment Strategies and Risk of Loss) and Item 17 (Proxy Voting) should be reviewed to ensure that the disclosure is accurate and specific.

Investor Communications – Marketing Materials, Side Letters, Reporting

In addition to an adviser's more formal disclosures, such as those made in Form ADV Part 2A or a fund's offering documents, an adviser that includes ESG factors in its investment process will likely also make additional disclosures regarding ESG in marketing materials, investor reporting (either generally or in response to specific side letter requests), due diligence questionnaires and responses to RFPs. Advisers may also receive other requests relating to requirements or practices specific to certain U.S. states or non-U.S. jurisdictions (e.g., the EU Sustainable Finance Disclosure Regulation). As noted above, an adviser needs to ensure that its ESG-related disclosures are consistent and accurate across all of these documents and disclosures and be careful to avoid "greenwashing". It is important for firms to take a holistic approach to ESG by involving and educating different groups throughout the firm (e.g., the investment team, investor relations team and compliance team) regarding the firm's ESG policies, procedures and practices. For example, to the extent a manager has dedicated investor relations professionals, these individuals will often be the direct recipients of investor requests relating to ESG and will need the knowledge and training to appropriately, accurately and consistently respond to such requests, as applicable, and may also need to coordinate with other areas of the firm to address such requests. Similarly, as side letter requests relating to ESG continue to become more specific and tailored, an adviser may also need to provide additional reporting requested in such side letters. In addition, if an adviser that does not currently have an ESG-dedicated fund or ESG policies and procedures receives a side letter request relating to ESG, it will need to consider whether it needs to develop ESG policy and procedures or enhance its existing policies and procedures before granting the side letter request.

ERISA Considerations

For the past 25 years, the DOL has struggled to interpret the conditions imposed by ERISA's duties of prudence and loyalty on investments producing collateral benefits, including ESG-type benefits. The DOL's guidance has vacillated depending on whether there was a republican or democratic administration.

The Trump administration addressed ESG investing in two regulations, "Financial Factors in Selecting Plan Investments" (85 Fed. Reg. 72846 (Nov. 13, 2020)), and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (85 Fed. Reg. 81658 (Dec. 16, 2020)) (collectively, the "2020 Rules"). The 2020 Rules sought to ensure that plan fiduciaries do not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to any non-pecuniary objective or promote non-pecuniary benefits or goals. This could have required ERISA fiduciaries to analyse a fund's or investment manager's prospectus, marketing materials and investment strategy for any non-pecuniary factors being used in the investment process and confirm that proxy voting decisions and other exercises of shareholder rights would be made solely in the interest of providing plan benefits to participants and beneficiaries. In March 2021, however, the Biden administration announced a non-enforcement policy regarding these regulations, and in October 2021, the DOL released a Proposed Regulation entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (the "Proposed Rule"), which would replace the Trump administration's regulations.

If finalised as proposed, the Proposed Rule would generally treat ESG factors as material to an investment's value/risk-return and allow 401(k) plan investment menus to include options that incorporate climate change and other ESG considerations. The Proposed Rule states that a fiduciary making an investment decision may often be required to evaluate ESG factors in its risk-return analysis. While the 2020 Rules acknowledge that ESG factors could be pecuniary, this represents a clear acknowledgment that ESG factors have material risk/return implications and should provide greater comfort to investment advisers who consider ESG factors when investing ERISA plan assets. The Proposed Rule would also make it easier for 401(k) plans to include ESG funds in the plan's list of available investments but would require disclosure of the ESG-themed nature of such funds to the plan participants. If adopted, the Proposed Rule could result in ERISA plan fiduciaries allocating significantly more plan assets to ESG-dedicated funds and vehicles that intend to broadly implement ESG integration.

Conclusion

The growing popularity and investor demand related to ESG has brought it into the focus of the U.S. government and U.S. regulators, exhibited by, among other things, the Division of Examinations' inclusion of ESG in its Examination Priorities for both 2020 and 2021, the Risk Alert released by the Division of Examinations in April 2021, the Enforcement Division's creation of a Climate and ESG Task Force, and the Biden administration's Executive Order on climate-related financial risk. Accordingly, managers seeking to launch a new fund that incorporates ESG into its investment strategy as well as managers seeking to incorporate ESG into the investment strategy for an existing fund should not do so without careful planning and consideration. Such advisers will need to (i) develop an ESG policy and ESG procedures that are tailored to their business and accurately reflect how ESG is incorporated into the investment process, (ii) ensure that their ESG policy and procedures, and related risks and conflicts, are accurately, clearly and consistently disclosed across all documents and filings, as applicable, and (iii) be able to demonstrate that their ESG policy and procedures are consistently followed by all firm personnel, and amended as needed. Further, it will be important for such advisers to stay apprised of developments relating to ESG as further guidance, rules and regulations are released, both in the United States and globally.

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The Dangers of Doing Good: Litigation Risks from Public ESG Statements and How to Mitigate Them

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Introduction

Governments, international organisations, financial institutions, investors, consumers, and employees are increasingly focused on the manner in which businesses affect the Earth and the welfare of its living creatures. These stakeholders want to know what companies are doing to: address climate change and environmental pollution; eradicate human rights abuses; improve diversity, equity, and inclusion (DEI); and protect individuals' private information in the digital age. All of these issues fall under the purview of Environmental, Social and Governance (ESG), which includes a variety of factors that stakeholders consider in assessing the character of a company beyond its bottom line and its critical decision-making.

ESG concerns have led stakeholders to push companies to change their practices. For example, BlackRock, a leading institutional investor, has requested all companies in which it invests to, among other things, follow the reporting recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board, and develop plans to bring their business models to meet net zero greenhouse gas emissions by 2050.[1] Some non-profit organisations prompt change by backing shareholder proposals for strict compliance. For example, As You Sow advanced proposals for certain petrochemical companies to disclose information on plastic pellet spill prevention and remediation.[2] Consumers seek change by voting with their wallets – purchasing products from companies they believe to have strong privacy protections and excellent DEI and human rights track records and strong privacy protections.

This stakeholder pressure has prompted companies across many industries to increase transparency, correct misconceptions, alter existing practices, and offer new, more ESG-friendly products and services. Companies may inform the public of these efforts in a variety of ways, including product labelling, traditional advertising mediums, social media, company websites, statements to the press, and sustainability or ESG reports.

The danger to companies from failing to discuss their ESG efforts is loss of stakeholder support. But companies' public statements on these efforts can also create numerous risks if perceived as false, disingenuous, or "too little too late".

Resolving complex ESG concerns is beyond the scope of this chapter. Rather, this chapter focuses upon these two questions: When a company makes public statements about ESG, what possible litigation and other related risks are created, and how can the company mitigate those risks? This chapter identifies the manner in which litigation risks have arisen in the context of companies' public statements and actions on environmental, human rights, DEI, and cybersecurity issues. It concludes with options for companies to mitigate litigation risks and ancillary issues.

Environmental Sustainability

The "E" in ESG focuses, of course, on the environment. To address stakeholder concerns about climate change and environmental contamination, companies are increasingly speaking out about the environmental effects of their products and services. These statements may have unintended consequences for the companies, leading to "greenwashing" claims and securities litigation if the statements are perceived as misleading.

Greenwashing Claims

"Greenwashing" describes claims that companies have portrayed themselves or their products as being more environmentally friendly – or "greener" – than they really are. Greenwashing claims may allege that a company has lied about an environmental issue or a company's statements were misleading.

Governments have brought many notable greenwashing legal actions. These actions, in turn, paved the way for lawsuits brought by non-governmental actors. In 2011, then-California Attorney General Kamala Harris brought what was described as "a first-of-its-kind 'greenwashing' lawsuit against three companies that allegedly made false and misleading claims by marketing plastic water bottles as '100 percent biodegradable and recyclable'".[3] The lawsuit ended in settlements that required two defendants to, among other things, pay small monetary penalties and provide certain marketing notices for their products.[4] Since then, non-profits have filed similar greenwashing lawsuits in California related to companies' alleged misrepresentations about recyclability. Greenwashing lawsuits related to climate change have been filed across the United States against energy companies.

Greenwashing allegations are increasing outside of the United States. In August 2021, for example, the Australasian Centre for Corporate Responsibility filed a greenwashing lawsuit against an Australian oil company in relation to its statements on clean fuel and path to net zero emissions.[5] In November 2020, the European Commission and national authorities examined 344 "seemingly dubious" claims and announced they had reason to believe that 42% of them "may be false or deceptive and could therefore potentially amount to an unfair commercial practice under the Unfair Commercial Practices Directive (UPCD)".[6] National authorities planned to contact companies with "seemingly dubious" claims and "ensure that these [issues] are rectified where necessary".[7]

Securities Claims Related to Statements on Environmental Issues

Companies' statements on environmental issues – or lack thereof

– can also be the basis of securities claims. These claims have already arisen in the climate change context, even in the absence of explicit rules defining the information public companies must disclose about how climate change could affect their businesses and steps taken by the companies to remediate their actions.

In 2017, shareholders sued the Commonwealth Bank of Australia. The shareholders alleged that the Bank's issuance of its 2016 annual report violated the Corporations Act of 2001 by failing to disclose alleged financial risks from climate change.[8] The shareholders sought a court order requiring the Bank to disclose climate change-related financial risks, but dropped the lawsuit when the Bank pledged to analyse climate change risk in its 2017 and subsequent annual reports.[9]

Perhaps the most publicised climate change-related securities case was the New York Attorney General's lawsuit against ExxonMobil. The New York Attorney General alleged that ExxonMobil was disclosing a different proxy cost of carbon – an estimate of the cost of potential future regulation – than it was using for internal purposes, thereby misleading the public.[10] However, the court ruled in ExxonMobil's favour on all claims after a bench trial. Similar cases brought by the Massachusetts Attorney General and shareholders are still pending.

Although sustainability-related securities lawsuits are relatively few in number, the international trend in favour of increased climate change and sustainability-related risk analysis and disclosures for public companies will lead to increased claims for failure to comply with disclosure requirements. Some jurisdictions, like New Zealand and the UK, have announced plans to require disclosures that comply with TCFD recommendations. In the United States, the Securities and Exchange Commission (SEC) has announced plans for rulemaking on climate-related disclosures. As disclosure requirements increase, so does the potential for liability for falling short of those requirements. Accordingly, securities litigation related to statements on environmental concerns is an issue to watch. And it takes only one adverse ruling to open the litigation floodgates.

Human Rights

Recognition of the importance of fundamental human rights – part of the "S" in ESG – is not new. In 1948, the United Nations General Assembly adopted the Universal Declaration of Human Rights, which identifies 30 universally protected fundamental human rights, including, *inter alia*: the rights to freedom, life, liberty, security and equality; the prohibition of slavery and forced labour; and the right to "freedom of thought, conscience and religion".[11] In 1966, the General Assembly adopted the International Covenant on Civil and Political Rights and the International Covenant on Economic, Social and Cultural Rights. Today, the key definitions of human rights are set forth in the United Nations Universal Declaration, nine core international human rights treaties, and nine optional protocols.[12]

A more recent development than the general recognition of human rights is an expanded awareness of the impact of human rights violations on businesses, their operations and their people. As stakeholders demand a higher commitment to corporate responsibility, corporations are changing their practices. The United Nations Guiding Principles on Business and Human Rights provide a framework to guide companies with respect to human rights by defining fundamental principles and identifying human rights violations that impact companies both directly and indirectly.[13]

Beyond a company's moral obligations and business interest in preserving its consumer base, companies should also be cognisant of an increasing trend of claims brought by individual plaintiffs and human rights activists seeking to hold companies, as well as directors and senior management, accountable for human rights abuses committed by the company or within its supply chain. Because compliance with the United Nations Guiding Principles is voluntary, several lawsuits that, at their core, rest on allegations of human rights violations in a company's supply chain, have been filed seeking relief under a variety of tort and other legal theories.

In particular, the Alien Tort Statute (ATS) grants federal courts jurisdiction to hear claims brought "by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States", 28 U.S.C. §1350. Two agribusinesses, for example, were sued by six alleged survivors of child slavery claiming that the U.S. companies' arrangement with the Ivory Coast cocoa farms aided and abetted child slavery. In June 2021, the U.S. Supreme Court held that, to support domestic application of the ATS, plaintiffs must allege more domestic conduct than general corporate activity.[14] The Supreme Court remanded the case for further proceedings.

In another pending case, International Rights Advocates filed a lawsuit against technology companies and a car manufacturer on behalf of 13 Congolese families and others similarly situated, alleging that their children were killed or injured while mining for cobalt in the Democratic Republic of the Congo.[15] Cobalt is a key component of rechargeable lithium-ion batteries of the type allegedly used in electronic devices manufactured by the five defendants.

The lawsuit alleges that the children mining the cobalt are "being regularly maimed and killed by tunnel collapses and other known hazards common to cobalt mining in the DRC",[16] and that the "modern tech boom brought on a new wave of brutal exploitation to the people of the DRC".[17] Depending on the outcome of defendants' currently pending motion to dismiss, the case will be one to watch in the human rights abuse area, particularly for companies interested in assessing and disclosing potential human rights risks in their supply chains.

There have also been several U.S. cases that have attempted to impose liability on companies for their public statements related to their human rights-related practices. For example, the National Consumers League sued several retailers over corporate responsibility statements related to supplier Codes of Conduct, alleging that retailers sold goods manufactured by child labour in violation of the retailers' Codes of Conduct.[18] Before the parties settled, the court found some of the Code of Conduct statements at issue to be merely aspirational in nature and incapable of influencing consumer purchasing decisions. But the court determined that other statements contained specific, verifiable facts that could be material to those consumer decisions. In another case, plaintiffs sued a retailer, claiming that it sold prawns harvested through the use of slave labour and human trafficking, despite representations in the retailer's Code of Conduct and Disclosure Regarding Human Trafficking and Anti-Slavery. However, the court dismissed the case because the plaintiffs failed to allege facts tracing the prawns purchased to the alleged human rights abuses and failed to allege that consumers relied on the retailer's public human rights statements in making their purchasing decisions.

Diversity, Equity, and Inclusion

DEI – which arguably falls under both the "S" and "G" of ESG – is vitally important to stakeholders. Despite the benefits to companies of improving DEI metrics, the attention and scrutiny on DEI practices can also create numerous risks for the company, including: (i) cultural risks; (ii) disclosure risks; and (iii) litigation and regulatory risks.

The cultural risks relate to whether the company has a culture of respect, inclusion, fairness, and non-discrimination. The disclosure risks arise when the company makes representations regarding its DEI efforts or its metrics of compliance, including whether those metrics are accurate and whether there are problems of which the company is or should be aware.[19] Finally, the litigation and regulatory risks follow on the heels of the first two: if the company's culture is not healthy and/or if the company's disclosures are misleading or inaccurate, the company runs the risk of lawsuits and regulatory action.

Regulators are taking an active role in demanding DEI by public companies, through the promulgation of new rules and regulations regarding human capital and board diversity. SEC leadership in particular has been explicit in its intent to promulgate additional DEI rules.

As stated by the then-acting SEC Chairperson: "[T]here is growing recognition that a lack of diversity represents a significant reputational risk for companies and may hamper their ability to recruit and retain top talent."[20] Accordingly, in November 2020, the SEC implemented new human capital disclosure rules, requiring that public companies disclose the number of employees and a description of its human capital resources, if material to the business.[21]

In August of 2021, the SEC approved new Nasdaq Board Diversity Rules.[22] The Rules include two key components. First, companies listed on Nasdaq will be required to annually disclose statistical information about their board members' voluntary self-identified gender and racial characteristics. Second, companies must have (subject to certain exceptions) one diverse board member by 2023, and a second diverse board member by 2025. If a company fails to comply, it will have to disclose the reasons why it cannot comply. California has already implemented similar rules, and other states may follow.

In the UK, the Financial Conduct Authority is proposing new transparency rules that would require listed companies to disclose whether they have met (or explain why they have not met) certain gender and racial diversity targets on their boards and in their management.[23]

Of course, any public statement explaining why a public company has been unable to comply with board diversity requirements will likely be carefully scrutinised. If the stated reasons are deemed unpersuasive, the company may experience negative consequences, including, at the very least, public consumer disapproval and investor dissatisfaction.

Cybersecurity

Cybersecurity falls within both the "S" and "G" of ESG. Modern corporate governance requires a sound appreciation and management of ever-growing cyber risks; additionally, a business's social values may include a commitment to consumer privacy and data security. Investors consider a company's so-called cyber "resilience" an important factor for the company to generate sustainable earnings.[24]

A cybersecurity attack is an event that can disrupt a business's operations, rob it of its intellectual property, and compromise sensitive personal information that the business maintains about its employees and customers. Many aftershocks can quickly follow the attack, including: stock price drops; forensic analysis; costs to repair system damage and improve cyber protection; notification of consumers of the loss of their sensitive data (under tight deadlines); regulatory inquiries and enforcement actions; and private litigation.

Investors are deeply interested in a company's public statements about cyber risks and vulnerabilities and the measures taken to prevent cyber incidents or plans to mitigate such events. Material cyber-related misstatements, including those made during an ongoing breach and its immediate aftermath, can form the basis for a securities class action litigation. Shareholders may claim that the announcement of the breach led to a decline in stock prices, that the breach was caused or exacerbated by mismanagement or negligence, or that the company materially misrepresented the practices and processes that led to the breach.

There are several examples of such claims. Yahoo! settled a securities class action in which investors accused Yahoo! of repeatedly failing to disclose two data breaches impacting hundreds of millions of consumers, and falsely reassuring the public that its cyber systems were strong and that it would disclose security vulnerabilities promptly upon discovery.[25] Equifax settled a securities class action alleging that it made misrepresentations about the strength and integrity of its cybersecurity systems and its compliance with data protection laws, as well as the scope of the sensitive personal information that had been comprised in the breach.[26] A securities class action against Google is ongoing in which investors allege that Google falsely represented in its Form 10-Qs that there were "no material changes" to its cyber risk factors despite purportedly knowing of cybersecurity vulnerabilities in its systems.[27] Other class actions have been dismissed at the pleading stage for failure to allege material misrepresentations or omissions of past or present facts by which a "reasonable investor" could be misled,[28] as opposed to aspirational or forward-looking statements.

The SEC is also bringing enforcement actions involving inadequate cybersecurity disclosures. By the end of summer 2021, the SEC had settled actions against two organisations that, according to the SEC, did not properly disclose information about pre-breach steps to mitigate risk and material cybersecurity breaches.[29]

The SEC has issued guidance to reporting companies on cybersecurity-related disclosure.[30] The guidance grounds cybersecurity reporting in existing disclosure obligations, and recommends disclosure of the following categories of information: (i) prior cybersecurity incidents; (ii) probability and potential magnitude of future cyber incidents; (iii) preventative actions taken by the organisation; (iv) associated costs of maintaining cybersecurity protections including, if applicable, cybersecurity insurance coverage; (v) business- and industry-specific cybersecurity risks; (vi) potential reputational harm in the event of a breach; (vii) existing or pending laws or regulations that may impact the organisation's cybersecurity requirements; and (viii) litigation, regulatory investigation, and remediation costs associated with cybersecurity incidents.

The SEC cautions against framing actual cyber risks as hypothetical events: "[I]f a company previously experienced a material cybersecurity incident involving denial-of-service, it likely would not be sufficient for the company to disclose that there is a risk that a denial-of-service incident may occur." Such statements suggest that the SEC will increasingly focus upon cyber disclosures and related issues.

Options for Mitigating Risk from Public ESG Statements

Companies' statements on ESG-related issues can create risk of claims that the companies have made material misrepresentations or material omissions of fact. This section discusses several steps that companies can take to help mitigate their litigation risk.

First, when developing an ESG strategy, consider and account for each company's particular vulnerabilities, which vary from company to company based on size, the nature of the business, and the jurisdictions in which the company conducts business.

Certain companies may be subject to a heightened litigation risk in one ESG area but not another. For example, an oil and gas company may have a heightened need to focus on environmental matters, while a technology company may have a heightened need to focus on cyber and supply chain issues.

Some ESG risks are higher in certain jurisdictions than others. And, clearly, global companies must take into account the laws of many jurisdictions when formulating an ESG strategy. For example, a company based in a jurisdiction that lacks ESG regulations may purchase raw materials from suppliers in jurisdictions with robust ESG laws. In such a case, the company may need to adopt policies and procedures that account for the added litigation risk.

ESG strategies will also vary depending on the regulatory oversight of the company's operations. A public company's ESG strategies should take into consideration shareholder expectations and regulators' requirements, which may vary by jurisdiction. For example, in the United States, officers and directors may want to memorialise ESG policies and compliance to later show that they complied with their duties to act with care and diligence in making ESG-related business decisions. Developing tailored ESG policies and procedures may ameliorate risk.

Second, when integrating their ESG strategies into their operations, companies should cohesively integrate them at all operational levels including governance, controls, operations, research and development, workforce, vendors, supply chain, and technology. Again, each company's unique ESG goals will guide how a particular ESG strategy is incorporated into the company. For example, to achieve a pledge to become carbon-neutral, a company may need to focus on incorporating that strategy into research and development and supply chain management. By contrast, an ESG goal focusing on gender equality may need to focus on operations and workforce.

Some ESG goals will require different types of strategic implementation plans as well. For example, an ESG strategy concerning data protection may be implemented with stricter policies, updating technology security, and training. However, an ESG strategy concerning employee wellness may require a combination of straightforward actions, such as implementing a written policy of employment and a practice of hiring diverse employees, working with individuals who require assistance, and then determining to change culture, which goal may be less straightforward and harder to measure and achieve. Company-wide efforts should be undertaken to consistently implement ESG policies and goals.

Third, companies should accurately track and report ESG data in a methodical manner. Accurately tracking ESG data is important to measuring the results of specific ESG strategies, determining which strategies have been successful by comparing data, and revising or updating strategies as needed. Accurately tracking ESG data is also imperative to ensure that companies can present a compelling – and *accurate* – story about how they have mitigated ESG risks, particularly for the areas each company identifies as an area of heightened need and risk.

Accurately measuring ESG goals will allow companies to avoid making statements that overstate their ESG positions by, for example, appropriately categorising data as a forward-looking goal or a present or historical position. When discussing ESG data publicly, companies should also consider the big picture. Plaintiffs or regulators may allege that a truthful statement is nonetheless misleading because of the context – or lack of context – in which the statement is made. Thus, the more accurate data and context given by a company in its ESG reporting, the less risky its disclosures may become.

Fourth, companies should consider ESG implications for actions at all stages of a company's lifecycle. Public companies may consider mitigating ESG risks around the time of public announcements by implementing robust ESG disclosure training to their investor relations professionals. Because a company's ESG exposure may change over time, each company should continually monitor its compliance with its disclosure and the ever-changing business environment.

Companies should also evaluate the ESG practices of the organisations with whom they do business in order to mitigate their own risk of being drawn into lawsuits based on their mere affiliation with other organisations. For example, plaintiffs have attempted to attribute the alleged ESG failings of various organisations (like non-profits or trade associations) to affiliated companies, particularly if those companies are larger and better funded. Regardless of whether these attempts are successful, defending against them can be costly. By conducting diligence on the ESG practices of organisations the companies support or affiliate with, companies can better assess and mitigate the risk that their operations may create.

Conclusion

The path to a more sustainable and equitable future is fraught with pitfalls, but it is still worth the journey. Although ESG progress, and telegraphing that progress, may put companies in a damned-if-you-do-damned-if-you-don't situation, the options above can help companies mitigate their litigation risk.

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Acknowledgments

The authors acknowledge with thanks the contributions of Victoria Corder and Allison M. Lange Garrison to this chapter.

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ESG Considerations in Project, Energy, and Infrastructure Finance

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Introduction

Long before Environmental, Social, and Governance ("ESG") entered the corporate world's vernacular, these principles were very much present in various aspects of project development and in the policies and procedures of owners and investors. ESG in project finance has always been key to understanding risk, due to the long-term nature of the investment. Now, the increased prominence of ESG presents a new dimension of investment, credit, and even reputational risk for a range of projects, from infrastructure to energy assets.

A report released by S&P Global Ratings in 2020 confirmed that lenders and investors financing projects face similar, and in some cases more pronounced, ESG risks as compared to traditional companies.[1] With ESG at the forefront, companies bear responsibility not only to their shareholders, but also to the public and the planet. A focus simply on the "bottom line" of short-term profitability and shareholder returns is not tenable. Since projects are long-term investments in the infrastructure, industry, or public services of a community, investors must consider the long-term stability of a project and its effects on a broad set of stakeholders, including employees and local communities. Projects depend on buy-in from the local community and adaptability in light of pressing climate risks and changing regulatory environments. ESG risks are particularly pronounced for projects related to fossil fuels and coal power, where new and anticipated regulations could constrain operations and impact viability, ultimately undermining their long-term investment rationale.

Public policies increasingly favour investments in energy and infrastructure projects that further environmental and social justice goals by mitigating the impacts of climate change, decarbonising the energy and transportation sectors, and improving both clean drinking water supplies and digital broadband connectivity in historically underserved or low-income communities.[2]

At the same time, investors and shareholders are demanding greater ESG transparency and accountability by means of ESG risk assessment, measurement, and reporting to better understand and address the impact of their investments. This is evidenced by the recent shakeup at Exxon, where an activist hedge fund proposed an alternative slate of Exxon directors and, with the aid of proxy advisors, institutional investors, and fund managers focused on ESG concerns, gathered enough votes to seat two directors who they expected to affect corporate policy to better mitigate and manage the climate change impacts facing the energy sector.[3]

Project companies increasingly leverage interest in ESG to maximise opportunities to obtain financing or to obtain favourable financing terms. ESG is a key consideration and top of mind for investors, according to a study conducted by *Harvard Business Review* of 70 senior executives at 43 global institutional investing firms, including the three largest asset managers – BlackRock, Vanguard, and State Street.[4] In fact, ESG investing has been seeing record growth in 2021, and the head of BlackRock's iShares has predicted that ESG-driven investing will grow to $1 trillion by 2030.[5] To meet this investor interest, there has been a proliferation of green and sustainability bonds and other ESG financial instruments. Project companies and investors of these instruments should use tailored ESG reporting frameworks that take into consideration the risks and opportunities specific to their project.

ESG Considerations and Risks for Investors, Lenders, and Project Companies

The three factors of ESG – environmental, social, and governance – describe considerations that go beyond traditional financial criteria and relate to sustainable growth, environmental and social impacts, and the governance arrangements of the project company. There are other terms used to express similar ideas to ESG, including the "triple bottom line" (also known as the "three P's", which are profit, people, and planet), "corporate social responsibility", and "socially responsible investment". In project finance, although the term ESG is not always used, it is highly present in various aspects of project development and in the policies and procedures of owners and sponsors. For example, since 2003, many financial institutions (including banks) have implemented a risk management framework known as the Equator Principles for determining, assessing, and managing environmental and social risk in project finance.[6] As of November 2021, more than 125 financial institutions have adopted the Equator Principles. The Equator Principles are primarily intended to provide a minimum standard for due diligence to support responsible decision-making based on the careful assessment of risk and can trigger a need to conduct certain actions with respect to any environmental or social issues that have been identified. The Equator Principles apply across industry sectors, including renewable energy, and have helped spur the development of responsible environmental and social management practices in the financial sector and banking industry.

Characteristics of Project Financings that Enhance ESG Risks

Project financings have particular characteristics that provide protections to creditors – such as all-assets pledges, structures, and covenants to reduce volatility in project cash flows and waterfalls prioritising debt servicing over equity distributions –

that allow project companies to have higher leverage ratios than traditional companies while maintaining similar credit quality. Nevertheless, project finance lenders and investors are exposed to similar or enhanced ESG risks. Projects that involve infrastructure and construction work can have effects on the environment and require interactions with local stakeholders. Costs associated with compliance with environmental regulations and coordinating with local communities may impact projected cash flows in the operations phase of a project. To the extent that project risks are allocated to third parties, reducing commercial and technical risks, a credit analysis should identify the extent to which those third parties may be exposed to ESG risks that could affect costs, revenues, or supply chains.

ESG issues are important for debt and equity investors in project companies. Failure to properly address these issues can adversely impact the development and performance of projects vulnerable to ESG risks and weaken a project company's credit position and profitability. ESG factors can also create financing and refinancing challenges for projects the asset life of which is uncertain, particularly considering new environmental regulatory pressures.

For example, S&P in 2020 downgraded the senior secured debt of the operator of a coal plant in West Virginia, noting that as investors increasingly shy away from coal projects, it may become more difficult to arrange an extension or refinancing of the debt facility. Even after the company's restructuring and emergence from bankruptcy later in 2020, Moody's assigned a lower subprime rating to the company's debt in 2021, reflecting the company's overall weak credit position in light of risks associated with decarbonisation and the energy transition, anticipated federal regulatory policy that could adversely impact the coal sector, and increasing investor concerns relating to ESG factors, all of which contributed to elevated refinancing uncertainty and liquidity risk for the project.

Negative social and governance events led S&P to downgrade debt issued by an owner and operator of a highway project under construction in Lima, Peru to speculative grade due to the resulting erosion in the risk profile of the project. From a social perspective, protesters destroyed a new toll plaza facility over concerns of toll charges and their impact on wealth inequality and affordability. Subsequently, the municipality of Lima suspended toll payments at the facility, which resulted in a loss of revenues. From a governance perspective, one of the company's sponsors had been involved in a probe for paying bribes in Latin America to win concessions. The project's relationship to this sponsor carried reputational risks, which in turn affected its ability to secure additional financing.

Environmental, Social, and Governance Considerations in Project Finance

ESG considerations are relevant to all types of large, long-term infrastructure projects, from highways and bridges to energy projects (including renewable energy projects), rail lines, and water or water treatment facilities. Additionally, ESG factors can be interrelated and sometimes inversely related. When a coal power plant is shut down for environmental reasons, for example, there can be cascading impacts on social issues if the shutdown results in layoffs and unemployment for local communities.

Environmental

Environmental considerations have always played a central role in project development and primarily relate to the siting of projects and proper disposal of materials after a project is decommissioned. The "E" can also overlap with the "S" in the areas of local community relations, environmental justice, preservation of archaeological and cultural resources, and Indigenous rights.

- *Project siting* impacts may be temporary or permanent in nature. For example, the siting of temporary construction access roads may disturb wetlands or other sensitive habitats. Other impacts may be more permanent, such as harm to protected species. Projects and associated infrastructure (such as transmission lines for energy projects) can require a large amount of acreage, which is often agricultural or other prior undeveloped land. Project development can require tree clearing, regrading of the land, and dredging/filling of wetlands. Temporary or permanent access roads or staging areas need to be placed, and ground disturbance such as excavation and filling for foundations must occur. These activities may disturb the habitat of a variety of wildlife depending on location, such as fish and other aquatic species for hydroelectric dam projects, and in some instances, projects may even result in intentional or incidental animal death. Also falling under the umbrella of environmental are impacts to safe airspace travel; some types of projects can cause sight hazards or disrupt flight patterns for aircraft, especially if located in proximity to an airport, and have the potential to disrupt national air defence networks. In many jurisdictions, a project will be required to comply with a statute, such as the National Environmental Policy Act in the United States, that can trigger the need for a comprehensive review before issuance of certain permits or other governmental action. These laws require that a project company thoroughly review the environmental impacts of the proposed project and mitigate those impacts to the extent possible. Project companies should be mindful to comply with all other environmental laws, including those that regulate sensitive resources such as wetlands and protected species.
- *Community relations, cultural resources, and Indigenous rights* are critical aspects of determining how and where a project should be sited. ESG reflects an increasing social awareness of the impacts a project may have on the surrounding community. For example, if a project is located in proximity to important cultural or Indigenous resources, sovereignty concerns should be assessed and mitigated, with Indigenous community involvement throughout the process. The Equator Principles specifically require that all projects affecting Indigenous Peoples will be subject to an informed consultation and participation process and must comply with the rights and protections for Indigenous Peoples contained in relevant national law, including laws implementing host country obligations under international law.[7] Appropriate mitigation can include performing studies and surveys of the area and preparing mitigation and preservation plans.
- *The concept of environmental justice* more broadly strives for the fair treatment of all people when considering the siting of projects. There are legitimate concerns regarding project siting near vulnerable communities and the associated risks of pollution and disturbances resulting from noise, runoff, excavation, and other features of project operation and development. This is compounded when a community already has several similar projects within its borders. Projects are almost always subject to an approval process that requires an opportunity for public comment, which can raise these concerns and result in a better project with fewer community impacts.

- *Proper disposal and recycling of materials* at the end of the project life cycle is an oft-overlooked project consideration. Decommissioned project components must be disposed of in ways that preserve the health and safety of the physical environment and of individuals and communities. The Equator Principles can trigger the need for a decommissioning plan, even if not required by a host country's laws.

Social

The social aspects of project finance encompass labour and human rights, supply chain considerations and the ethical procurement of materials, and diversity, equity, and inclusion ("DEI").

- *Labour and human rights* considerations include improving working conditions, addressing work stoppage risks, preventing modern slavery, and preventing the acquisition of materials from industries or jurisdictions identified as being vulnerable to labour exploitation and forced labour in violation of international standards. Child labour, slavery, and general compliance with employment and fair wage regulations are a few examples of risks that should be mitigated or avoided, including by contractual means.
- *Supply chain* considerations arise during the procurement of materials for a project. Project companies should conduct supply chain due diligence to understand the business and employment practices of their vendors and suppliers and ensure that materials are not sourced from environmentally fragile locations or using illegal or unethical employment practices. Enhanced supply chain due diligence should be implemented when procuring materials from countries where human rights and forced labour issues are prevalent, or from suppliers that source inputs from such countries. A resource for identifying goods produced by child or forced labour is the U.S. Department of Labor's List of Goods Produced by Child Labor or Forced Labor.[8]
- *DEI* measures should involve the representation and participation of a diverse workforce across all levels of a project up to leadership. DEI considerations have not traditionally been a focus in project financing, but diversity can strengthen a project company's reputation and bring in different perspectives and ideas. When diversity is coupled with equity and inclusion, it has been shown to drive innovation and produce better outcomes through increased productivity and profitability. Project companies can demonstrate this commitment through onboarding and developing diverse talent internally. Project companies are also able to mandate certain diversity standards and guidelines when they hire outside vendors, such as construction companies, engineers, and attorneys.

Governance

"Governance" is a term that has an increasingly broad reach, encompassing not only traditional notions of corporate governance, but also the structures in place to manage significant areas of risk for the project company, such as transaction requirements imposed by lenders and sponsors, cybersecurity and data privacy, anti-corruption, and trade compliance.

- *Corporate governance* relates to the composition and procedures of supervisory bodies. Additional considerations include proper separation of a project company with the sponsor or holding company. An important feature of corporate governance is regulatory compliance and the maintenance of compliance policies, procedures, and controls designed to promote compliance with relevant laws and regulations and mitigate risks associated with the jurisdiction, sector, and operations of the project.
- *Transaction requirements* can include information disclosures and reporting requirements. Investors may build these requirements into project financing documentation to improve transparency and strengthen the integrity of a project. Such requirements may include documentation that will allow financial institution investors to verify the identity of project company borrowers and their beneficial owners, pursuant to their obligations under anti-money laundering laws. Transaction governance can also include internal processes to manage the proceeds of green or sustainability financing and track the allocation of funds.
- *Cybersecurity and data privacy* issues, if not addressed, can pose significant operational and financial risks, and can halt an entire project. Project companies should review their corporate security and business continuity plans and invest in strengthening their data and cyber protection and resiliency systems. They can look to guidance issued by the White House,[9] the U.S. Federal Trade Commission,[10] and the U.S. Securities and Exchange Commission ("SEC")[11] to understand what is considered reasonable cybersecurity practice.
- *Ethics and anti-corruption* strategies should promote accountability, transparency, and integrity, both internally and externally with customers, suppliers, and third-party agents. Project companies, particularly project companies with meaningful non-U.S. dealings and interactions with foreign governments, including through suppliers or distributors, should be mindful of their obligations under the U.S. Foreign Corrupt Practices Act and other anti-corruption laws and should develop policies and procedures to promote ethical behaviour and prevent bribes and other corrupt payments.
- *Trade compliance* considerations related to sanctions and import/export controls may restrict a project's ability to engage certain customers, suppliers, distributors, or other counterparties, or to import certain raw or finished materials. For example, in recent years, the U.S. Department of the Treasury's Office of Foreign Assets Control has imposed sanctions on a number of Chinese individuals and entities in connection with human rights abuses in the Xinjiang province of China.[12] Also, U.S. Customs and Border Protection has issued several Withhold Release Orders preventing goods produced through forced labour in Xinjiang from being released from U.S. ports of entry. Certain silica-based products have been the target of these measures.[13] Solar project companies, which rely on silica as a raw material in the production of solar panels, should be aware of these restrictions and implement appropriate diligence and screening procedures.

Financial Instruments for ESG Investment in Projects

There are a number of financial instruments available to project companies engaged in ESG activities. These include green, social, and sustainability bonds, whose proceeds are linked to ESG activities, as well as sustainability-linked bonds, whose financial terms are linked to ESG metrics.

Green Bonds, Social Bonds, and Sustainability Bonds

Green, social, and sustainability bond financing are activity-based bonds that link the proceeds of the financing or refinancing provided to project companies to ESG activities, such that project companies must use the proceeds in a manner that meets criteria as "green" or "social" activity, or a mix of the two for sustainability bonds.

The eligibility of projects to qualify for this type of financing can be based on a multitude of frameworks, including the International Capital Market Association's ("ICMA") Green Bond Principles,[14] Social Bond Principles,[15] and Sustainability Bond Guidelines.[16] The four core components for alignment with these principles are related to the following: (i) use of proceeds; (ii) process for project evaluation and selection; (iii) management of proceeds; and (iv) reporting.

Use of Proceeds and Project Selection

Green bonds are instruments where the proceeds are used solely to finance projects with environmental benefits. They can include projects in renewable energy, energy efficiency, land and water management, biodiversity conservation, clean transportation, pollution prevention and control, and climate change adaptation. The proceeds for social bonds meanwhile finance projects that address a social issue, by mitigating social harms or attempting to achieve positive social outcomes. Such projects can seek to improve a community's access to, or the affordability of, essential services, housing, infrastructure, employment, and food, and may be aimed at socioeconomic advancement and empowerment. Sustainability bonds are bond instruments whose proceeds are used to finance a particular goal (such as decarbonisation) or a combination of "green" and "social" projects.

Proceeds Management and Reporting

Project companies issuing these types of bonds should implement an internal process to manage the proceeds and for reporting on uses of proceeds. Issuers should report on the use of bond proceeds by describing the projects and their impact, at least on an annual basis. It is recommended that issuers use both qualitative and quantitative performance indicators. For projects where the actual impact cannot be calculated until projects are completed and operational, which may not be at bond issuance, issuers can report on the estimated impact of their projects. This is common for social projects like the construction of affordable housing or healthcare facilities. Green bonds are generally certified at issuance by an independent third party. Of late, credit ratings agencies are introducing ratings methodologies for debt that is intended to be sustainable or to meet green or social goals of the issuer.

For green bonds, the Harmonised Framework for Impact Reporting,[17] developed by multilateral development banks and international financial institutions, lays out principles and recommendations for impact reporting. Harmonised frameworks have been released for energy efficiency and renewable energy projects, sustainable water and wastewater management projects, sustainable waste management and resource-efficiency projects, clean transportation projects, green building projects, biodiversity projects, and climate change adaptation projects. The frameworks offer sector-specific recommendations for reporting, including core principles, metrics, and indicators for reporting. For example, the suggested core indicators for renewable projects include: (i) annual greenhouse gas emissions reduced or avoided; (ii) annual renewable energy generation; and (iii) capacity of renewable energy plants constructed or rehabilitated. The frameworks do not dictate a single commonly used standard for the calculation of indicators, and issuers may follow their own methodologies. Issuers are encouraged to use this guidance to develop their own reporting that is adapted to their own circumstances and their own approaches to the management of proceeds.

For social bonds, a working group has been established to develop a harmonised framework. The outcome of the working group is a document that sets out principles for reporting.[18] In addition to reporting on the use of bond proceeds and on the expected impacts, issuers are encouraged to identify the target populations for which the project is expected to result in positive socioeconomic outcomes, and why the selected target population is considered underserved or vulnerable. For projects addressing broad social issues that impact the general population, like health issues and water supply, issuers are still encouraged to identify any particular segments of the population that are expected to especially benefit from the project.

In addition, multilateral organisations have established internal standards for their financing of "green" projects. For example, green bond financing by the International Finance Corporation ("IFC"), a member of the World Bank Group, may include investments in the following types of projects: (i) investments that result in a reduced use of energy per unit of product or service generated; (ii) investments that enable the productive use of energy from renewable resources such as wind, hydro, solar, and geothermal production; (iii) investments to improve industrial processes, services, and products that enhance the conversion efficiency of manufacturing inputs, like energy, water, and raw materials, to saleable outputs; (iv) investments in manufacturing of components used in energy efficiency, renewable energy, or cleaner production; and (v) investments in sustainable forestry.

In addition to meeting green bond eligibility criteria, any project financed through green bond proceeds must also meet IFC's investment process, which includes rigorous due diligence, including disclosure and consultation requirements and integrity due diligence using IFC's Environmental and Social Performance Standards[19] and Environmental, Health and Safety Guidelines.[20] Projects must also comply with IFC's Anti-Corruption Guidelines, with potential penalties for entities engaging in fraud and corruption being sanctions and debarment from financing from IFC and other international financial institutions and multilateral development banks.[21]

Sustainability-Linked Bonds

Sustainability-linked bonds are performance-based bond instruments, for which proceeds can flow to general corporate activities, unlike with green, social, and sustainability bonds. Instead, the interest rate, payment, or other financing terms are linked to ESG factors and may be adjusted if certain sustainability performance targets are met. Sustainability performance targets are tracked by key performance indicators, which should be measurable and reportable, such as emissions reductions.

The Sustainability-Linked Bond Principles,[22] also developed by the ICMA, can be used to determine eligibility for sustainability-linked bonds. These principles have five core components related to: (i) selection of key performance indicators; (ii) calibration of sustainability performance targets; (iii) bond characteristics; (iv) reporting; and (v) verification.

Accordingly, project companies issuing sustainability-linked bonds should implement internal processes and procedures to ensure proper monitoring, disclosure, and verification of key performance indicators. Projects should report on key performance indicators regularly, and in any case for any date or period that may be relevant for assessing the status of sustainability performance targets that are established as trigger events leading to a potential adjustment of the bond's financial or structural characteristics.

Frameworks for Accurately Assessing Whether a Project Meets ESG Standards

As noted above, there is significant investor appetite for understanding and measuring the ESG benefits and risks of a project. There are a plethora of frameworks that project companies can use or take inspiration from to identify relevant and material indicators for reporting on ESG metrics. They include international agreements and standards adopted by countries, such as the UN Sustainable Development Goals ("SDGs"), which establish 17 political goals related to peace, climate action, affordable and clean energy, clean water and sanitation, infrastructure, ending poverty, and reducing inequality, among others. The SDGs are defined by 169 targets that are tracked by 232 indicators.[23] The Paris Agreement was formed by 197 countries with a goal of reducing the increase in global average temperatures to 1.5 degrees Celsius and has been reinforced by subsequent international agreements, most recently at COP26 in Glasgow, Scotland in November 2021.[24]

UN Principles for Responsible Investing ("PRI") is an initiative of the United Nations with large institutional investors that lays out six principles for responsible investments relating to the incorporation of ESG issues into investment analyses, decision-making processes, ownership policies and practices, and disclosures from the entities in which they invest.[25] PRI, in collaboration with the UN Global Compact and UN Environment Programme, has also issued practical guidance on the integration of ESG into investment analyses and decisions. The UN Guiding Principles on Business and Human Rights, voluntary principles adopted by the UN Human Rights Council, set forth the responsibility of companies to respect human rights and provide a remedy when adverse impacts occur.[26]

Project companies can also look to guidance or tools such as those developed by the Global Reporting Initiative ("GRI"),[27] Sustainability Accounting Standards Board ("SASB"),[28] and Task Force on Climate-Related Financial Disclosures ("TCFD").[29] Both GRI and SASB have published sets of universal standards that provide guidance on disclosures across companies, as well as sector-specific standards that account for the sustainability context of a particular sector. SASB has developed a set of 77 sector-specific sustainability accounting standards, which identify financially material sustainability topics and their associated metrics for a typical company in that sector. Recently, in November 2021, Value Reporting Foundation, which houses SASB, announced it would consolidate with the Climate Disclosure Standards Board to form the International Sustainability Standards Board ("ISSB"). ISSB aims to combine existing disclosure frameworks and develop an integrated, comprehensive baseline that would make it easier for companies to distil and report information to investors.[30] The Financial Stability Board established the TCFD to develop recommendations for more effective climate-related disclosures that could inform investment, credit, and insurance underwriting decisions, and enable investors to better understand climate-related risks to a company and its counterparties, including its suppliers. Project companies can also rely on benchmarks and data houses such as S&P Dow Jones Indices that supply datasets providing industry-specific and financially material ESG opportunities and risks.[31]

Each project company should consider the most appropriate framework that is tailored to its activities. Ultimately, though, the metrics that a project company adopts will inevitably reflect what its investors are demanding.

Mechanisms to Manage and Mitigate ESG Risks

There are a multitude of positive effects on the "triple bottom line" when project companies, sponsors, lenders, and investors take ESG seriously during project development and funding. There can also be risks associated with the failure to properly apply ESG metrics to a project. Investors and lenders may choose to decline to fund projects that do not place emphasis on ESG. There can be impacts to credit quality – positive or negative – caused by reviewing a project against ESG standards. For example, in the energy industry, a renewable energy project may receive a more favourable credit rating, while projects producing or using fossil fuels may receive a worse rating due to uncertainty around future regulatory policy or environmental impacts. Project location may also receive heightened scrutiny, and construction in areas vulnerable to extreme weather events may require higher liquidity reserves and insurance policies. For projects that are less resilient or have higher ESG risks, insurance may become more expensive or less available.

The lack of a unified conceptualisation and parameters for ESG and the variability of ESG factors by sector has led to challenges with ESG reporting. Since projects can involve a wide variety of sectors, harmonisation of metrics and comparability and reliability of reporting is an issue. In the current formal regulatory vacuum, it can be difficult to choose which ESG framework to apply and understand how to properly assess ESG metrics. Other contributing factors are the voluntary nature of the frameworks, difficulties of monitoring and measurement, and the absence of mandatory external auditing and verification.

Further, ESG is not a static concept. ESG considerations and evolving ESG standards are fundamentally a reflection of the present zeitgeist, and the current events that inform policy objectives, the interests of consumers and investors, and technological developments. The field of ESG is just as complicated and nuanced as the world that informs it. As these features evolve and change, so do the factors that make up ESG and the methods of assessing their interconnectedness.

These challenges have made ESG reporting susceptible to "greenwashing", where some companies overreport sustainability, cherry-pick metrics, or otherwise engage in an inaccurate portrayal of ESG practices to look better to investors or to qualify for funding. Proposed new ESG disclosure requirements under securities laws and the establishment of more objective, consistent standards for claimed environmental attributes or other ESG metrics may address this complex issue.

Another concerning trend involves companies that engage in "brownwashing", which has taken on different meanings. It could mean investors that are betting against ESG and acquiring fossil fuel assets at discounted prices relative to projected cash flows. The term has also been used to describe companies that sell fossil fuel assets to private equity funds or other buyers so that their balance sheets appear greener to consumers or investors. "Brownwashing" may also refer to companies underreporting their ESG credentials, which may be intentional or may be due to a lack of understanding of ESG issues or inadequate management of ESG monitoring.

While approaches to ESG reporting remain in flux, investor demand for "consistent, comparable, and decision-useful" disclosures related to ESG risks remains strong, as has been highlighted by SEC Chair Gary Gensler.[32] Taking heed of these demands, the SEC has been developing proposals on potential disclosure requirements. Though the nature and implementation of the SEC's anticipated ESG disclosure rules remain to be seen, Chair Gensler's public comments indicate that such disclosure rules will be based on principles of consistency and comparability and that the SEC will take guidance from existing third-party frameworks, standards, and metrics such as those included in the TCFD and SASB frameworks. In response to investor demand for harmonisation, there have also been efforts to develop a common reporting framework by the World Economic Forum, the Big 4 accounting firms, GRI, and SASB.[33]

Project companies should take steps to leverage opportunities and mitigate risks by understanding the ESG considerations of a project from the very beginning of the development and procurement process. Site selection and initial design and engineering should reflect ESG goals and risks, for example, by intentionally choosing to site a project in a location that would not adversely affect vulnerable communities and that would be more resilient to extreme weather events. Investors and lenders that embrace ESG goals should create a contractual framework to hold project companies accountable and encourage incorporation of ESG into project development. Increased transparency, verification, and reporting will be important to maintain a robust market for green, social, and sustainability bonds and other financial instruments and to bolster the integrity of market standards for project financings in the future.

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Acknowledgments

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Australia has a federal system of government, in which there is a federal or Commonwealth legislature that has power to pass laws on matters listed in the Constitution. The states and territories are separate jurisdictions with their own legislatures. ESG-related matters are addressed across a wide variety of Commonwealth and state and territory laws.

Australia has no overarching source of ESG regulation, rather a patchwork of regimes operating at the Commonwealth and state and territory levels for different ESG areas. We explore some key areas below.

Environment

Environmental compliance is regulated at both the Commonwealth and state and territory levels of government and there are several substantive environment legislative regimes at both levels, as well as related matters regulated by local government. There is a range of regulation coordinated between the Commonwealth, states and territories relating to contamination, waste and sustainability matters such as packaging. A general environmental duty to minimise risk of harm applies in a number of jurisdictions, backed by varying levels of enforcement powers.

Environmental impact assessment is typically required for activities that may have significant environmental impacts or that meet certain thresholds for emissions or discharge. Each state and territory has its own approach to environmental impact assessment and licensing legislation. At the Commonwealth level, environmental impact assessment for matters of national environmental significance is regulated under the *Environment Protection and Biodiversity Conservation Act 1999*.

Carbon emissions from major facilities are regulated through the Safeguard Mechanism statutory rule administered by reference to reporting obligations under the Commonwealth *National Greenhouse and Energy Reporting Act 2007*, with renewable energy and emissions reduction targets or requirements set under a range of legislation across the jurisdictions.

Social

Traditional ownership and cultural heritage

Native title land rights of Aboriginal and Torres Strait Islander peoples are addressed under the *Commonwealth Native Title Act 1993*, with corresponding legislation in states and territories. Potential impacts to Aboriginal cultural heritage are predominantly addressed through state and territory legislation, although Commonwealth legislation also applies. There are also non-litigious pathways for the recognition of traditional owners' rights, such as the *Traditional Owner Settlement Act 2010* in Victoria.

Workers' rights and labour law

Australian labour law and workers' rights are enshrined in both Commonwealth and state and territory legislation. The vast majority of Australian employees are covered by the *Fair Work Act 2009*, which creates the national workplace relations system. This national workplace relations system establishes 11 minimum National Employment Standards that must be provided to all employees covered by the *Fair Work Act*, as well as the national minimum wage and awards that apply across Australia for specific industries and occupations.

Safe Work Australia is the statutory body responsible for developing national policy relating to workplace health and safety (**WHS**) and workers' compensation in Australia. While the Commonwealth, states and territories are each responsible for enforcing and regulating WHS laws in their jurisdiction, the laws across the various jurisdictions are broadly consistent.

Commonwealth and state and territory laws also provide for equal employment opportunity and anti-discrimination in the workplace. At a federal level, discrimination on the basis of race, sex, disability and age is governed by the Australian Human Rights Commission. Each state and territory has its own anti-discrimination legislation to protect employees against a more extensive list of forms of discrimination.

Human rights

There is no overarching human rights legislation in Australia, although some principles are reflected in the Australian Constitution, the common law and some legislative regimes. Each of Victoria, the Australian Capital Territory and Queensland have a local *Human Rights Act* with some variations as to scope and application. The UN Special Rapporteur on Human Rights and the Environment's 2019 report to the

Human Rights Council identified that Australia is one of the 20% of countries where there is no explicit legal recognition of the right to a healthy environment.

1.2 What are the main ESG disclosure regulations?

ESG disclosure requirements arise from a number of sources. Mandatory ESG disclosures are principally made in a company's annual reporting suite. Pursuant to the *Corporations Act*, companies' annual reports must contain a directors' report in which the board is required to provide any information that shareholders would reasonably require to make an informed assessment of the entity's operations, financial position, business strategies and prospects for future financial years. Regulatory guidance provides that this should include a discussion of ESG risks facing the company where those risks could affect the entity's achievement of its financial performance or outcomes disclosed, taking into account the nature and business of the entity and its business strategy.

For publicly listed companies in Australia, the Australian Securities Exchange (**ASX**) Corporate Governance Council Principles and Recommendations (4th edition) set out recommended corporate governance practices for entities listed on the ASX against which they have to 'comply or explain' in an annual Corporate Governance Statement. Under Recommendation 7.4, a listed entity should disclose whether it has any material exposure to environmental or social risks, and if it does, how it manages or intends to manage those risks.

The Australian government is introducing requirements for medium-to-large-sized corporates to report on an increasing number of ESG areas, for example:

- Greenhouse gas emissions: The *National Greenhouse and Energy Reporting Act* requires reporting by Australian companies that meet certain thresholds of greenhouse gas emissions, emissions removal or reduction projects, and energy consumption and production.
- Modern slavery: The Commonwealth *Modern Slavery Act 2018* requires certain entities with consolidated revenue over A$100 million to prepare an annual statement reporting on the risks of modern slavery in their operations and supply chains and actions to address those risks.
- Diversity indicators: The Commonwealth *Workplace Gender Equality Act 2012* requires non-public sector employers with 100 or more employees to submit a report to the Workplace Gender Equality Agency. The reporting questionnaire is related to an organisation's policies and strategies, employee movements, governing bodies, employer actions and consultations, as well as support for flexible working, carers and parents, and policies for sex-based harassment and family or domestic violence.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

The evolving Australian ESG reporting landscape, and the proliferation of voluntary reporting standards globally, have produced a diversity of approaches to voluntary ESG disclosure among Australian companies.

The Australian Council of Superannuation Investors (**ACSI**) annual report on ESG reporting by the ASX200 (published in May 2021) (**ACSI 2021 ESG Report**) found that 43% of ASX200 companies (translating to 76 cents in every dollar invested in the ASX200) make comprehensive and transparent ESG disclosures on a range of material ESG risks. While many companies make ESG disclosures in their annual reports, a significant number of large listed companies now opt to voluntarily publish standalone sustainability or ESG reports. Some companies have also taken a market-leading approach by publishing targeted reports focused on specific ESG topics, such as climate change resiliency.

Most ASX100 companies, and an increasing number of ASX200 companies, report against the Task Force on Climate-related Financial Disclosures (**TCFD**) recommendations. ACSI's 2021 climate change disclosure report (August 2021) (**ACSI 2021 Climate Report**) found that 80 ASX200 companies have adopted, or committed to adopting, the TCFD recommendations in the year ending 31 March 2021 (an increase from 52 in the year ending 31 March 2019). Since 2019, Australian regulators including the Australian Securities and Investments Commission (**ASIC**), the Australian Prudential Regulation Authority (**APRA**) and the ASX have published guidance that endorses the TCFD disclosure framework.

Many ASX100 companies also use the Global Reporting Initiative (**GRI**) standards, which represent global best practice for economic, environmental and social impact reporting, and the Sustainability Accounting Standards Board (**SASB**) industry-specific standards to frame their voluntary ESG disclosures.

Reporting against the UN Sustainable Development Goals (**UN SDGs**) also continues to rise, with the ACSI 2021 ESG Report finding that more than half of the ASX200 companies released reports in 2021 that either mapped risks against, or used the framework to guide, their ESG reporting.

1.4 Are there significant laws or regulations currently in the proposal process?

Given the range of environmental and associated social regulation across multiple jurisdictions, there are often proposed changes to laws or regulations that are significant to a particular issue or jurisdiction. A couple of prominent areas are outlined below.

Environment

We are seeing an increase in policy development relating to the protection of biodiversity, addressing climate change and the transition to a lower carbon economy, some aspects of which are yet to play out in formal regulation or legislation.

Governance – Corporate criminal responsibility

Corporate criminal liability has been an area of focus for a number of proposed reforms. The recommendations of the Australian Law Reform Commission (**ALRC**) Final Report on Corporate Criminal Responsibility (August 2020) are expected to influence future law reform in this area. From an ESG perspective, key proposals include the potential extension of 'failure to prevent' offences to other forms of transnational crime (beyond foreign bribery) and future consideration of a new 'system of conduct' or 'pattern of behaviour' offence to criminalise systemic and reckless corporate misconduct.

1.5 What significant private sector initiatives relating to ESG are there?

The Australian private sector has been relatively quick to adopt global trends for private sector initiatives concerning ESG. Australia has a strong system of compulsory superannuation, with a large number of substantial superannuation (pension) funds. As the peak industry body for superannuation investors, ACSI has taken a leading role advocating for enhanced ESG standards and disclosures across a broad range of issues including gender diversity, modern slavery, ESG disclosure and climate change.

Environment – Climate change

Of significance to the Australian private sector are several key movements related to climate change, emissions reduction and decarbonisation.

Investor groups such as the global investor-led initiative Climate Action 100+ are active in Australia, with a number of prominent Australian investors participating in the initiative. Such investors have committed to engaging with the companies they invest in to take necessary action to reduce greenhouse gas emissions throughout their value chain, and to enhance disclosure and corporate accountability for climate change risks.

At the local level, there has also been growing focus on developing a framework for the Australian financial services sector to grow and support sustainable investing and financing. The Australian Sustainable Finance Initiative (**ASFI**) continues to be influential in relation to alignment of the finance sector with ESG initiatives and, in particular, a low-carbon economy.

There are a number of other working groups and initiatives focusing on providing forums to discuss climate change issues; for example, the Climate Change Coalition established by CEOs from some of Australia's largest businesses across different industries. Part of their mandate is to work with suppliers and customers to encourage them to reduce their greenhouse gas emissions.

In the energy space, we are seeing private sector energy investors wanting to partner with industrial specialists or financiers to drive development and uptake of sustainable technologies, e.g. green hydrogen.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

The endorsement of ESG as a key area of focus for global and domestic asset managers has significantly influenced the attitudes of Australian companies to ESG issues as they strive to meet increasing informational demands and demonstrate their resilience to ESG risks. The emergence of private sector-led ESG initiatives, such as ASFI and Climate Action 100+, highlights the extent to which large institutional investors are engaging with ESG issues and places pressure on large companies to embed ESG in their strategy and operational footprint.

The Australian regulatory regime is conducive to shareholder activism, and an increasing number of companies are being targeted by retail shareholder activist campaigns on ESG matters. The process commonly used by retail shareholder activists is to requisition additional resolutions for consideration at a company's upcoming annual general meeting (**AGM**) under the *Corporations Act*. The 'Say on Climate' movement, which advocates for companies to voluntarily put an advisory shareholder vote to their AGM in relation to companies' climate transition strategies and progress, has also gained traction in Australia with a number of prominent listed resources companies agreeing to put climate reporting to a non-binding, advisory vote starting at their 2022 AGMs. Notably, over the past two to three years, there has been a noticeable increase in the level of institutional shareholder support for ESG-related activism, including shareholder requisitions and 'Say on Climate' votes. Many institutional shareholders now expect companies to make and publish granular commitments to climate action and demonstrate performance against them.

In other jurisdictions, institutional investors have supported external board nominations off the back of retail shareholder climate campaigns. The success of these campaigns may encourage similar campaigns at Australian companies; however, such campaigns seem unlikely to achieve the same levels of success in this market given the small pool of credentialed candidates willing to join an overtly activist ticket.

Increasingly, ESG is being factored into portfolio selection and management as well. As with other jurisdictions, Australia has seen continued growth in ESG and 'sustainable' investment products, which in turn has seen asset managers increasingly deploying positive and negative ESG screening in the portfolio selection process, as well as the inclusion of ESG factors in investment mandates and due diligence processes.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Although there has been an emergence of private sector-led ESG initiatives in Australia, there is not a 'united front' of private-sector attitudes towards ESG. However, the increasing focus of asset managers and institutional investors on ESG issues reflects the growing expectations of broader stakeholders regarding ESG risk management by Australian businesses and, in particular, the clear expectation of Australian governments, regulators and the broader community that companies will manage the ESG impact of their business operations (and demand for investment in companies that do so).

Insurers are also increasingly influencing companies' responses to climate change, reflecting the risk insurers bear regarding climate change, including: the physical risk for natural disaster insurance claims; the transition risk to a low-carbon economy; and liability risk for climate change class actions. Insurers in Australia primarily exert influence through their expectations of risk assessment, including development of new industry standards, and by market statements; for example, announcing changes to the asset classes that will be insured, or foreshadowing increased premiums in respect of certain asset classes.

Environmental activist groups have been vocal stakeholders in Australia for decades. There is often coordination between a group of local stakeholders and a broader campaign. As well as requisitioning shareholder resolutions to influence corporate decision making (see question 2.1 above), other activist trends include campaigns of formal challenges to project approvals and strategic litigation relating to government decision making, policy, or seeking compensation for environmental or social impacts. For discussion of climate change litigation trends, please refer to question 2.5 below.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

There is a multiplicity of government agencies and regulatory authorities whose remits concern specific ESG issues.

Governance

- **ASIC** is the Australian corporations and financial markets conduct regulator. In August 2021, ASIC released its corporate plan for 2021–2025, which states that greenwashing of financial products and disclosure around climate risk and governance practices will continue to be a focus area for the 2021–2022 period.
- **APRA** is responsible for the prudential regulatory oversight of financial institutions in the banking, insurance and superannuation industries, to protect the interests of

depositors, insurance policyholders and superannuation fund members. APRA has been increasingly involved in developing the financial sector's approach to managing climate-related risks, given the issue's significance for the prudential management, and potentially capital adequacy, of key financial institutions into the future.

- For ESG-related matters that may lead to potential corporate criminal exposure, there is no overarching, single regulatory agency. Commonwealth criminal matters (such as breach of foreign bribery or sanctions laws) are typically investigated by the Australian Federal Police, and then referred to the Commonwealth Director of Public Prosecutions to decide whether a prosecution should be commenced.

Social

- The **Fair Work Ombudsman** (**FWO**) monitors, investigates and enforces compliance with Australian workplace and labour laws. The FWO takes a strong stance against systemic wage underpayments, including undertaking large-scale audits for compliance with workplace laws, and taking enforcement action against employers who violate workplace laws by underpaying employees. The FWO has also signalled an intention to increasingly focus on modern slavery and labour rights issues as part of its agenda going forward.
- WHS is regulated separately. Safe Work Australia is the statutory body responsible for developing national policy relating to WHS. Safe Work Australia does not regulate or enforce WHS laws, as this is the responsibility of the regulator in each state and territory.

Environment

- There is a different regulator for each environmental regime at Commonwealth and state and territory level, which brings complexity. Generally, the regulators are keen to see compliance, and there is a strong trend towards active management of risk rather than simply response to incidents and bare compliance with standards and reporting.

2.4 Have there been material enforcement actions with respect to ESG issues?

Enforcement action relating to ESG issues can be taken by various regulators.

Environment

Environmental laws generally provide a range of enforcement mechanisms, and prosecution remains relatively rare. Most environmental laws provide for liability of directors and officers for offences committed by a company.

Regarding cultural heritage, in October 2021, a federal parliament inquiry released its final report on the destruction of cultural heritage sites in Western Australia's Pilbara region. The final report makes a number of recommendations, including for cultural heritage protection legislative reform and for development of Australian minimum standards for management of cultural heritage (including requirements for compliance, enforcement and transparency). More broadly, the report is likely to influence practices of consultation in the cultural heritage space.

Governance

ASIC is the primary corporate regulator and has a number of avenues for bringing enforcement action, including potential action for breaches of directors' duties, market disclosure laws and corporate accountability requirements applying under the *Corporations Act*. Such action may be brought against companies or against individual directors or officers of those companies. While ASIC has not yet commenced enforcement proceedings through these routes for ESG-specific issues, ASIC has:

- Intervened in an energy company's public offering regarding the company's Net-Zero commitments in its prospectus. This resulted in the Net-Zero statements being removed and reframed as a 'vision' to operate in a Net-Zero manner, with work proposed to achieve the vision and the uncertainties and risks associated with achieving the vision.
- Increasingly exercised its supervisory functions to encourage corporate attention on ESG matters, and particularly climate change risks. ASIC has publicly acknowledged that disclosing and managing climate-related risk is a key director responsibility and has undertaken market surveillance to assess how companies are managing and disclosing exposure to climate change risks. There have also been calls by climate activists for ASIC to investigate companies for alleged misleading forecasts of coal demand.

Prosecutions of Australian companies for corporate criminal misconduct related to ESG issues, such as bribery or sanctions breaches, have been limited to date. Despite some notable examples, there is recognition that the regulatory enforcement environment in Australia for corporate criminal misconduct is still developing. This has been one of the key drivers behind the ALRC's Review of Corporate Criminal Responsibility.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Australia is a leading jurisdiction for climate change litigation. The Grantham Research Institute on Climate Change and the Environment report of July 2021 found that, between 1986 and May 2021, Australia had the second-highest level of climate change litigation in the world, behind the US. Climate change litigation in Australia has involved challenges to project approvals for high emissions activities on administrative law or human rights grounds, civil proceedings against companies for alleged breaches of continuous disclosure obligations or seeking production of documents, and challenges to government entities for an alleged failure to adequately regulate climate change impacts. There is also an increase in litigants testing novel pathways to litigation, including for misleading or deceptive conduct for 'greenwashing' environmental credentials, and seeking to establish a novel duty for a decision maker to take reasonable care to not cause Australian children harm from climate change when deciding whether to approve a fossil fuel project. Complaints to Australia's National Contact Point in relation to the Organisation for Economic Co-operation and Development (**OECD**) Guidelines have also raised climate change issues in relation to bank financing of fossil fuel products.

2.6 What are current key issues of concern for the proponents of ESG?

There is a broad range of current key issues of concern, including:

Climate

As explained in question 2.5 above, climate change is increasingly becoming a litigation risk for project proponents, banks and superannuation funds, as well as the Commonwealth and state and territory government entities in Australia. While companies and decision makers in the energy and resources sector continue to be the targets of climate change litigation, we are also seeing a rise in claims against other companies, including financial institutions.

Australian companies, in particular in the energy and resources sector, continue to face pressure from shareholders to increase disclosure, accountability and mitigating action with respect to reducing emissions throughout their value chains. We are seeing a significant rise in ASX200 companies making Net-Zero emission pledges. The ACSI 2021 Climate Report analysed annual reporting of ASX200 companies in the year ending 31 March 2021 and found that 49 companies now have Net-Zero commitments (up from 14 in the previous year) and these companies have a collective market capitalisation of over A$1 trillion.

Environmental protection laws

Compliance with general environmental protection laws and regulations also poses complex financial and reputational risk for many Australian companies. The agenda of broader sustainability ESG issues is evolving, and activists are increasingly focusing on the health impact of environmental degradation on human rights.

Companies are responding to shareholder pressure to demonstrate how their businesses reflect evolving community expectations in respect of environmentally responsible investment and operation, including broader consideration of social value of a company's activities beyond social licence.

Environmental impact assessment is evolving and, while current practice generally reflects a risk management approach, there remains significant variation in integrated assessment, availability of data for cumulative impact assessment, and in ultimately determining the appropriate balance of environmental, social and economic factors in decision making and management.

Rights of Indigenous Australians

Recognition and response to the rights of Australia's Indigenous peoples is an important aspect of the ESG landscape in Australia, and impacts on cultural heritage are a focus in multiple jurisdictions. There remains significant uncertainty as to the Australian government's implementation of a response to the Uluru Statement from the Heart, which sought to establish a representative body under the Constitution to provide a First Nations Voice to the federal legislature.

Corporate ESG considerations include addressing existing disproportionate disadvantage, including through investment decisions, and a company's potentially disproportionate environmental or social impacts of activities on Indigenous communities. The extension of requirements regarding 'free, prior, informed consent' through Equator Principles 4 continues to influence discourse and approach to stakeholder engagement with Indigenous communities in Australia. Evolving international expectations in relation to consultation and participation, and protection of cultural heritage, are likely to continue the emerging emphasis on best practice rather than lawfulness.

Modern slavery and human rights

Modern slavery legislation introduced in Australia in 2018 amplified the focus on the reputational, regulatory and financial risks associated with violations of human rights in supply chains for large companies operating in Australia. While the initial focus of businesses was on modern slavery and compliance with the new legislation, many of the programmes undertaken have been directed at reflecting broader human rights commitments in company policies and practices.

While the Australian modern slavery legislation imposes a reporting obligation only, key areas that are required to be addressed in companies' modern slavery statements include their areas of exposure to modern slavery risks and information about what (if anything) they do to manage those risks. Recognising the public nature of the disclosure has led to greater diligence being conducted on companies' operations and supply chains and has brought Australia in closer alignment with the various jurisdictions that have introduced, or are considering introducing, mandatory obligations in relation to human rights due diligence.

Wage underpayment

In Australia, systemic wage underpayments continue to feature heavily as an important area of ESG risk. Australia has a complex industrial relations system and a number of companies have uncovered non-compliance with applicable industrial agreements in their operations, in some cases resulting in financial obligations to remediate wage underpayments to workers. Ongoing investigations by the FWO and an increased understanding of the potential risk of systemic underpayment issues have also created greater focus on the issue by Australian companies and the broader community. This has in turn led to more issues being identified and emerging litigation (including class actions) regarding the financial, reputational and operational outcomes of systemic non-compliance with the relevant labour laws in Australia.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Under Australian corporate law, shareholders of companies vest the board of directors with the power to manage the affairs of the company under the company's constitution. The board has ultimate responsibility for overseeing the management of the company, including with respect to ESG issues; however, in practice, it will delegate day-to-day operational management to the company's management team. On that basis, responsibility for ESG issues is generally shared between the board and management team, with the board establishing the framework for oversight and governance of ESG issues and the management team delivering the company's strategy and operations within that framework.

While the *Corporations Act* permits directors to delegate some of their powers, the board must retain ultimate oversight and decision-making power in respect of the matters so delegated. With respect to ESG issues, a key aspect of the board's responsibility for oversight is ensuring there is an appropriate system of risk management in place to address ESG risks and ensuring it is receiving appropriate reporting on the company's performance against that system.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Companies may adopt a range of approaches to supervising the management of ESG issues. The most common approach is for ESG issues to form part of the company's broader risk management system, where emerging and existing ESG risks are identified, monitored and mitigated by the company alongside other risk exposures. In some cases, material ESG risk exposures may be 'elevated' for review and consideration on a standalone basis given their significance for the company.

Recognising the oversight role undertaken by the board (see question 3.1 above), the board will typically, either itself or through board committees, establish policies and processes for managing ESG risk issues and receive periodic reporting from the management team on the appropriateness of current policies and the company's adherence to that policy framework. A common approach is for the board to develop and document a 'risk appetite' within which the company is expected to operate, alongside a system for identifying, monitoring and mitigating specific risk exposures (including with respect to ESG risks). Common mechanisms used for identifying, considering and reporting ESG risks include risk registers, management steering committees and periodic board briefings (i.e. ESG updates and/or general risk updates including ESG issues). This risk management framework may be supplemented with codes of conduct and specific ESG policies dealing with issues such as anti-bribery and corruption, human rights, whistleblowing, and workplace diversity.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Over the past 10 years, it has been relatively common for Australian companies to include certain performance targets in senior management's short-term incentive arrangements that are aligned to improved ESG outcomes. Specific measures vary considerably from company to company, but often for senior management a portion of the incentive award would be conditional on achieving quantitative WHS targets (particularly, year-on-year reductions in the company's Total Recordable Injury Frequency Rate) and qualitative leadership and workplace culture assessments (particularly, 360-degree feedback on culture or employee engagement scores). It has, until recently, been relatively uncommon for senior management's long-term incentive arrangements to have targets directly linked to ESG outcomes, with shareholder return and profitability measures being more usual.

In the past 24 months, there have been several prominent examples of companies adopting ESG-driven performance targets in their long-term incentive arrangements, particularly directed at the achievement of greenhouse gas emissions reductions targets. Examples have included quantitative measures, such as reduction of Scope 1 and 2 emissions or increases to revenue from renewable energy sales, as well as qualitative measures, such as the development of strategies for managing and reducing Scope 3 emissions over time.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

While there is no uniform approach to integrating ESG into Australian companies' day-to-day operations, companies have tended to adopt one of two models. They have tended to either establish specialist functional teams dedicated to advising the business on ESG (for example, a dedicated sustainability team) or, less commonly, they have integrated specialist ESG employees into specific business units (for example, employing a sustainable procurement manager in the supply function). The role of such teams or specialists typically involves advising the company on relevant areas of ESG risk and how to manage them, as well as stakeholders' expectations regarding ESG issues. Typically, those teams or specialists would also take a leading role in developing the company's approach to ESG disclosure and reporting.

As regulation of ESG issues has increased, these models may increasingly come under pressure for the reason that specialist functional teams may not always be best placed to advise on ESG risk exposures (given their 'distance' from the operating business units to which the risks relate), and specialists within business units may not be best placed to advise the board on systemic ESG risks across the overall business. As a result, there may be continued reliance on top-down ESG risk management systems and policies (see question 3.2 above) in the future, with a mix of functional and business expertise operating within those frameworks. For example, disclosure, stakeholder engagement and external affairs may be managed at the functional level, with specific ESG risks being considered and mitigated by businesses' units through their product, investment, financing and risk reporting processes.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

In Australia, depending on the product, providers of debt and equity finance may rely on information internally prepared by the relevant issuer/borrower, including information obtained through direct engagement with the relevant company or information from the company's own sustainability reporting (which may be audited or supported by an independent verifier of the methodology).

Many product issuers have also voluntarily certified their investments under codes developed by industry bodies. This is particularly the case in the Australian green bonds market where 83% of issuances were certified under the Climate Bonds Standard (**CBS**) in the first half of 2019 and all green bonds issued by Australian entities during that period benefitted from at least a review by an external service provider.

4.2 Do green bonds or social bonds play a significant role in the market?

Following the first issue of green bonds in the Australian market in 2014, there has been a significant and sustained increase in green and social bonds in the Australian market. While green bond issuances slowed in the first half of 2020, likely as a result of the COVID-19 pandemic as governments and issuers sought to issue more traditional financial instruments, there was significant growth in social bonds and sustainability bonds during 2020 overall.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds and loans have only been issued in Australia since 2018. Nevertheless, the number of sustainability-linked bonds and loans issued in the Australian market has grown recently, with examples including issuances by both the government and private sector. Up until 30 August 2021, approximately 20 sustainability-linked bonds and loans were issued in the Australian market. The market has grown by nearly four times in the last year, from the A$1.8 billion issued in 2020 to the A$6.4 billion issued in sustainability-linked loans in the calendar year to 30 August 2021.

4.4 What are the major factors impacting the use of these types of financial instruments?

Government and regulatory policy has been a major factor in driving the use of ESG financial instruments in Australia. For example, the clean energy target for large-scale operations that called for 33,000GWh generated by 2020 had encouraged the increase in renewable energy capacity, which in turn may have contributed to the increase in green and sustainability-linked financing instruments.

In addition, the recent establishment of ASFI, which brings together major banks, superannuation funds, insurance companies, financial sector peak bodies and academics to develop a Sustainable Finance Roadmap, may be an important factor in the expansion in the use of ESG instruments in Australia going forward.

Other major factors to date include increased corporate engagement and shareholder action, as well as growth in impact investing and community investing in Australia.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

A substantial majority of Australian green bond issuances are certified under the CBS, which converts the Green Bond Principles (**GBP**) administered by the International Capital Market Association (**ICMA**) into assessable requirements and actions.

The following steps have been provided by the Climate Bonds Initiative (**CBI**) for an issuer to obtain and maintain CBS certification:

1. **preparation**: the issuer identifies assets that meet the relevant criteria and prepares a framework on how the proceeds will be used;
2. **engaging Approved Verifier**: the issuer engages a CBI-approved verifier (an **Approved Verifier**);
3. **Pre-Issuance Certification**: the issuer submits the Approved Verifier's report to the CBI and receives Pre-Issuance Certification prior to the issue;
4. **Post-Issuance Certification**: the issuer submits the Approved Verifier's Post-Issuance report within 24 months of issuance and receives Post-Issuance Certification; and
5. **annual reporting**: the issuer prepares an annual report for each year for the term of the bond to be provided to bondholders and the CBI.

There are also other methods for externally reviewing green bonds. These include:

- undertaking a review by a consultant with recognised expertise in environmental sustainability or other aspects of the administration of green bonds;
- engaging a credit rating agency that can score the instrument;
- obtaining verification by a qualified independent auditor against designated criteria; and
- the Asia Pacific Loan Market Association has also released Green Loan Principles, Social Loan Principles and Sustainability-Linked Loan Principles together with the Loan Market Association and the Loan Syndications and Trading Association. These principles apply concepts to the Australian loan market consistent with the equivalent principles adopted by the ICMA for the bond market.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

As at the date of writing this chapter, Australia has, relatively speaking, avoided the widespread and heavy loss of life that many other countries have experienced. Since the arrival of the pandemic in Australia, Commonwealth and state and territory laws and policies have been introduced or employed with the aim of suppressing the presence of COVID-19 in the community including significant restrictions on movement and association (source: Australian Human Rights Commission publication: *Australia's Response to the COVID-19 Pandemic* 2021, available here https://humanrights.gov.au/sites/default/files/2020-10/australias_response_to_the_covid-19_pandemic_-_australias_third_upr_2021.pdf).

In some ESG areas, corporate Australia has pushed on despite COVID-19. As reflected in the discussion in this chapter, the ASX200 are making substantial progress in: climate change and sustainability reporting; undertaking improved analysis and disclosure of potential impacts of climate change; and making more granular Net-Zero and other sustainability commitments throughout FY2021.

In other ESG areas, the ongoing impacts of COVID-19 have delayed or impacted progress. For example, the initial expectations by many of a 'Green Recovery' have continued to be deferred. Ongoing border closures and public health directions within Australia have disrupted project activity and have presented challenges for the short to medium term. A further example is that some ESG-related assurance has been unable to process due to access limitations; for example, modern slavery auditing of factories in a business' supply chain.

6 Trends

6.1 What are the material trends related to ESG?

Overall, we expect increasing sophistication in both Australia's formal regulatory regimes and in the accepted standards of industry practice in respect of ESG matters. We anticipate that the current key concerns in ESG will continue as we develop a more detailed and nuanced response to ESG considerations. In general, international developments in environmental regulation and in environmental and social litigation are expected to be influential in shaping Australia's approach to similar issues. In particular, COP26 in November 2021 is expected to influence Australia's national approach to climate change including emissions reduction, adaptation strategy, and transition to a lower carbon economy.

We anticipate that ESG regulation and practice will need to address convergence of multiple ESG considerations, including developing a methodology for assessing negative impacts, ascribing value to outcomes, and articulating how a company may seek to balance various ESG considerations with its commercial objectives. An example of these is the continued development of the renewable energy sector, where human rights considerations have arisen in relation to mining for necessary inputs to that technology.

Globally, there has been a significant rise in workplace activism, with workers becoming more vocal in holding organisations to account. While perhaps not as prolific as in other jurisdictions like the US, workplace activism has significance for organisations within Australia and poses a serious reputational risk for employers, which in turn can impact the desirability of organisations as employers.

6.2 What will be the longer-term impact of COVID-19 on ESG?

At this stage, predictions on the longer-term impact of COVID-19 on ESG are speculative only. The current level of engagement from industry organisations, institutional investors, and activists in relation to ESG to some extent reflects the historic trajectory of similar engagement on climate change. This may mean that we see more change in the ESG space as well, including a more holistic response to ESG taking into account the nuance and complexity where environmental and social considerations may not be easy to balance.

COVID-19 has also highlighted the need for businesses to be resilient under a wide range of circumstances, including those that may not have been contemplated (e.g. a global pandemic). ESG issues, such as modern slavery and supply chain considerations, and due diligence regulations, feed into risk management and resilience processes that have come to the fore as businesses cope with the impacts of COVID-19. We expect that business resiliency on ESG issues will continue to be part of these discussions going forward.

Acknowledgments

The authors would like to acknowledge Jon Evans in Herbert Smith Freehills' finance practice with respect to the input on sustainable finance trends and practices, as well as Natalie Gaspar in Herbert Smith Freehills' employment practice with respect to the input on labour laws, underpayments and workplace safety, and Mark Smyth, Georgia Roy and Soraya Pradhan in relation to litigation developments. Finally, the authors would also like to thank Paige Mortimer for her invaluable support in researching and drafting this chapter.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In Austria, there are various substantive ESG-related regulations. The principal sources of law in this regard are regulated in several federal laws as well as in state laws, such as the Environmental Impact Assessment Act, the Emissions Certificate Act 2011, the Waste Management Act, the Water Rights Act, the Animal Protection Law, the Labour Protection Act, the Stock Corporation Act, the Stock Exchange Act, the Austrian Commercial Code (*UGB*), the Federal Law on the occupation of children and adolescents, the Austrian Equal Treatment Act, the Act on the Employment of Disabled Employees, and the Consumer Protection Act. Furthermore, EU regulations and directives have become the main source for ESG-related regulations and must be considered accordingly.

1.2 What are the main ESG disclosure regulations?

In Austria, there are several regulations in place with respect to the disclosure of ESG criteria. The relevant disclosure regulations are partly contained in the substantive ESG-related regulations mentioned above, in particular, in the UGB. For example, since 2017, certain large companies are required to prepare a sustainability report on how they deal with environmental, social and employee matters, corruption, bribery and human rights. Such companies must include a non-financial report in the management report (*Lagebericht*) or prepare a separate non-financial report. In recent years, transparency requirements with respect to ESG factors have been further tightened. In particular, institutional investors and asset managers are required to supervise the companies in which they have invested with regard to certain ESG criteria and to publish an ESG-related policy.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

In Austria, we are not aware of a uniform voluntary and customary ESG disclosure. However, we increasingly see Austrian companies that are not directly subject to the disclosure regulations set out in question 1.2, but nonetheless disclose ESG-relevant information on their website or through other marketing tools, showing their commitment and long-term view with respect to ESG and their strategies with respect to sustainability risks considering international standards.

1.4 Are there significant laws or regulations currently in the proposal process?

Currently, we are not aware of any significant laws or regulations that are in the proposal process in Austria. However, the proposal process with respect to the Renewable Energy Extension Law (*Erneubaren-Ausbau-Gesetz*, *EAG*) has recently been completed and the EAG has been adopted. Austria aims to cover the electricity demand exclusively from renewable energy sources from 2030 and is aiming for climate neutrality from 2040. In order to achieve these goals, high investments in the expansion of generating capacities, as well as in the infrastructure network, are required. The EAG shall create the required legal framework in this context, which, *inter alia*, takes into account the generation technologies, specific subsidies and the required network reserve. Further, several EU regulations and directives aimed at, in particular, further tightening the transparency requirements and climate neutrality as well as sustainable corporate governance are currently being discussed in Austria, which need to be considered on a national level (in the near future).

1.5 What significant private sector initiatives relating to ESG are there?

Generally, we have observed in recent years that the private sector increasingly shows commitment regarding climate change and aims to reduce emissions and participate in the transition to a low-carbon economy. We have observed that the private sector – regardless of regulatory provisions – aims to comply with certain ESG criteria. For example, the promotion of gender diversity has been a prominent topic in recent years (since 2018, listed companies as well as certain large companies have been required to have a diverse supervisory board, i.e. at least 30% of the board members must be female).

Furthermore, we increasingly see investors conducting comprehensive due diligence with respect to ESG factors before entering into a transaction or a legal relationship with relevant third parties.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors and stakeholders increasingly support impact investing and aim to achieve more than financial profit with respect to their investments. Such investors are actively looking for opportunities that focus on ESG and thus promote positive social change. Investors, asset managers and other stakeholders increasingly conduct comprehensive due diligence with respect to ESG factors before entering into a transaction or a legal relationship with relevant third parties. Additionally, certain investors and asset managers have implemented specific transition strategies reflecting their (long-term) view with respect to specific ESG factors. Furthermore, institutional investors and asset managers are required by law to monitor the companies in which they have invested with regard to certain ESG criteria and to publish a corresponding participation policy (*Mitwirkunspolitik*).

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Please see question 2.1.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

As the ESG concept combines many different issues, such as human rights, equality and diversity, consumer protection and animal welfare, corporate governance issues and climate change, there are several regulators in Austria responsible for overseeing the various areas of ESG, such as:

(i) the Ministry of the Interior, responsible, in particular, for protecting human rights in Austria;

(ii) the Ministry of Economy, Family and Youth, responsible, in particular, for family affairs and the general implementation of the Austrian Trade Act, such as the issuance of gas trading permits;

(iii) the Ministry of Agriculture, Forestry, Environment and Water Management, responsible for general environmental affairs (e.g. air pollution control and environmental protection policies);

(iv) the Ministry of Transport, Innovation and Technology, responsible for environmental impact assessment procedures with respect to federal motorways and railways;

(v) several non-governmental organisations aiming at protecting and promoting nature, animals and the environment; and

(vi) several organisations aiming at protecting and promoting employees' rights (e.g. the Austrian Chamber of Labour).

Generally, managers of Austrian private equity funds, as well as financial institutions and publicly listed companies, are subject to the ongoing supervision of the Austrian Financial Market Authority (*FMA*). The FMA has recently published its draft consultation for a guide on how to deal with sustainability risks, and expects that the guide will be respected by the relevant companies.

2.4 Have there been material enforcement actions with respect to ESG issues?

Depending on the relevant ESG factor, ESG requirements can be enforced by the relevant regulator in different ways. For example, environmental requirements and laws are enforced by the relevant district authorities. Commonly, administrative fines are imposed with respect to the violation of the environmental laws, whereby, in case of severe breaches, the relevant permit may be revoked by the relevant authority. In Austria, we are not aware of any recent material enforcement action that is public information.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Generally, it is not surprising that poor ESG standards can damage the image of a company. Therefore, reputational risk and potential litigation are two of the main reasons why companies take ESG into account. ESG-related litigation risk may arise from shareholder activism. Most recently, an activist shareholder of a large Austrian listed company initiated a lawsuit to challenge a resolution to appoint members of the supervisory board for lack of gender diversity. Other than that, we are not aware of any recent material litigation regarding ESG issues in Austria that is public information.

2.6 What are current key issues of concern for the proponents of ESG?

In Austria, no consistent and comparable information with respect to the ESG criteria of Austrian companies exists. Austrian legislators are trying to increase the relevance, consistency and comparability of ESG-relevant data. However, this has not yet been entirely successful, as the quality of the information can, in most cases, be improved.

In general, there are currently no uniform regulations with respect to, for example, a type of seal of quality (*Gütesiegel*), meaning whether a product or service can be described as "ESG-compliant", "green" or "sustainable". However, the EU Taxonomy intends to remedy this at the EU level, i.e. by introducing binding criteria and framework specifications for a uniform classification system, which can be viewed as "environmentally sustainable economic activity". The mentioned EU Taxonomy regulation was recently supplemented by the EU Taxonomy Climate Delegated Act and a draft Delegated Act on Article 8 of the Taxonomy regulation. These acts will apply from 1 January 2022 to the extent they are not blocked by the European Parliament. It remains to be seen whether the ESG trend in general – regardless of the regulatory framework – will result in better information quality and more transparency with respect to ESG factors.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Under Austrian company law, the management board (*Vorstand*) in the case of a stock corporation, and the managing directors (*Geschäftsführer*) in the case of a limited liability company, are responsible for running the operations of the company. While certain measures, including, *inter alia*, setting the strategy of the company, require the approval of the supervisory board (in a stock corporation), or the shareholders (in a limited liability company), the "right of initiative" belongs to the management also in these areas. Pursuant to Sec. 70 of the Austrian Stock Corporation Act, the management board must act in the best interest of the company, duly taking into consideration the interests of shareholders, employees and the public interest ("stakeholder approach"). On this basis, the management board is thus responsible for (i) identifying where addressing ESG issues is either required under applicable rules and regulations or appropriate under best practice considerations as part of their general obligation to ensure compliance of the company with laws and to pursue the company's best interests, and (ii) proposing appropriate measures to be taken as part of their role *vis-à-vis* the supervisory board and/or shareholders (meeting). Having said that, in particular in listed companies, there is an increasing tendency to put considerably more focus on ESG in their strategic determinations. This includes, for instance, companies pursuing ESG ratings, including annual assessments by independent global ESG and corporate governance rating agencies.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Austrian companies' corporate governance at its core has a two-tier board system, comprising a management board and a supervisory board. In a limited liability company, depending on the number of its employees, respectively, shareholders and its registered capital, a supervisory board may not be mandatory, and the supervisory board's role may then be taken over by the shareholders' meeting. In stock corporations, and thus listed companies, a supervisory board is mandatory and plays a pivotal role in influencing a company's overall strategy alongside the management board, in particular as regards the inclusion of sustainability criteria and ESG factors.

The supervisory board (respectively, in smaller companies, the shareholders' meeting) is responsible for monitoring the conduct of the management and ensuring compliance with overall business strategy, etc. In addition, in a stock corporation, the supervisory board approves the annual accounts (unless the management board and the supervisory board decide to submit the accounts to the shareholders' meeting for approval). As noted above (see question 1.2), this includes a review of the management account (*Lagebericht*). The supervisory board must provide an annual report to shareholders stating how it conducted its affairs and exercised its duties of supervision and monitoring towards the management board.

The supervisory board of (*inter alia*) listed companies must set up an audit committee. Pursuant to Sec. 269 para. 3 of the UGB, an assessment whether the non-financial report (where required) has been prepared forms part of the annual audit.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

One of the core competencies of the supervisory board of an Austrian stock corporation is the right to appoint (and recall) the members of the management board. This goes hand in hand with the duty of the supervisory board to negotiate the terms of employment, including remuneration of the management board members.

Following implementation of the EU's 2nd Shareholder Rights Directive in Austria, supervisory boards of listed companies must draw up a remuneration policy for the management board. The remuneration policy must then be submitted to the shareholders' meeting for approval. While such vote is only of an advisory nature, the management board may only be compensated in accordance with a remuneration policy that has been put to a vote by the shareholders' meeting. In addition, an annual remuneration report needs to be prepared to ensure *ex post* transparency. In practice, (supervisory) boards have taken to including various ESG criteria in the determination of variable compensation components. The clear focus is on sustainability, and very often, performance in relation to ESG metrics also forms part of a wider "leadership assessment" of board members. The consequence is that management board members' (variable) remuneration is directly linked to how demonstrably successful and persistent a company is in pursuing its ESG agenda.

On staff levels below the C-suite, a variety of (fringe) benefits, internal policies and codes of conduct may be used to align employees' interest and performance with the wider strategic goals of a company.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

ESG is becoming increasingly more important for Austrian companies. As noted above, it forms, for instance, an integral part of the remuneration of management board members. This ensures direct exposure and scrutiny by shareholders, be it small investors or professional investors who increasingly tailor their investment criteria in order to take ESG topics into account (see also below at question 6.1). In addition, companies participate in international ESG rankings (such as, e.g., by ISS ESG, Sustainalytics or MSCI ESG Research) and regularly publish details on their sustainability and/or ESG goals.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

In our experience, prior to the issuance of ESG bonds (in particular, green bonds), issuers usually mandate a recognised second-party opinion provider, which is a provider of ESG research and analysis to deliver (an) ESG rating letter(s). However, we cannot assess to what extent providers of debt and equity finance rely on internally or externally developed ESG ratings for this purpose.

4.2 Do green bonds or social bonds play a significant role in the market?

In the Austrian market (i.e. for Austrian issuers), we see that the issuance of green bonds has been consistently increasing in the last few years and that green bonds play a significant role for (re-)financing purposes. In fact, even the Republic of Austria has announced that it will issue its first green bond in the first half of 2022. As regards private placements, there are currently 52 green and social bonds listed in the Vienna Stock Exchange – only two of which are social bonds. Thus, social bonds do not yet represent a significant volume of the Austrian market. It may be noteworthy, however, that the Republic of Austria has issued straight bonds; the proceeds of which have been dedicated to the financing of emergency relief funds as a reaction to COVID-19 in May 2020.

4.3 Do sustainability-linked bonds play a significant role in the market?

In 2021, the first sustainability-linked bonds – from UBM and VERBUND, for instance – were issued in Austria. It is expected that sustainability-linked bonds will experience a further rise as the Sustainability-linked Bond Principles offer issuers (and investors) additional guidance and transparency.

4.4 What are the major factors impacting the use of these types of financial instruments?

In our view, major factors include, but are not limited to, satisfying an increasing demand from (retail) investors, extension of the issuer's group of (potential) investors, compliance with investment guidelines of investors, reputation incentives for investors and issuers, pricing and other incentives to increase attractiveness (such as the amending law exempting companies cooperating for the purpose of an ecologically sustainable or climate-neutral economy from the cartel ban). We are not in a position, however, to comment on whether these instruments obtain favourable economic terms when compared to traditional debt.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The assurance and verification processes for green bonds are not yet regulated in the EU. However, on 6 July 2021, the EU Commission published a proposal suggesting a Regulation on a voluntary European Green Bond Standard (*EUGBS*). The four requirements under the proposed framework are the following:

(1) The funds raised by the bond should be allocated fully to projects aligned with the EU Taxonomy.

(2) There must be full transparency on how bond proceeds are allocated through detailed reporting requirements.

(3) All EU green bonds must be checked by an external reviewer to ensure compliance with the Regulation and that funded projects are aligned with the Taxonomy. Specific, limited flexibility is foreseen here for sovereign issuers.

(4) External reviewers providing services to issuers of EU green bonds must be registered with and supervised by the European Securities and Markets Authority (*ESMA*). This will ensure the quality and reliability of their services and reviews to protect investors and ensure market integrity. Specific, limited flexibility is foreseen here for sovereign issuers.

The core objective is to create a new "gold standard" for green bonds that other market standards can be compared to, and potentially seek alignment. This standard shall aim to address concerns on greenwashing and protecting market integrity to ensure that legitimate environmental projects are financed. Following its adoption, the Commission proposal shall be submitted to the European Parliament and Council as part of the co-legislative procedure.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

In its first stage in spring 2020, COVID-19 initially had the effect of slowing, or in certain cases even stopping (or at least pausing), investments and this hit a variety of companies, including companies with a strong ESG agenda. We believe this was primarily due to the short- to mid-term uncertainty that the pandemic brought with it and, furthermore, the need for companies to focus their attention on other, more pressing matters in the immediate aftermath of the (first wave of the) pandemic, such as, e.g., securing supply chain certainty, shoring up liquidity, and protecting the health and well-being of their staff.

In the medium term, in line with international expectations, we expect that awareness of long-term sustainability risks will increase in the aftermath of the COVID-19 crisis, and that this will be a positive catalyst for ESG. This is clearly a trend currently seen and borne out by the increasing focus of companies on ESG. In particular for listed companies, ESG has become a centrepiece of attention and that is irrespective of how COVID-19 will develop further.

6 Trends

6.1 What are the material trends related to ESG?

ESG investing has already moved up considerably, and is still moving up, on the agenda. Regulatory trends both in Austria and at the EU level reinforce this tendency and increase pressure on companies to put more emphasis on this topic. International institutional investors as well as proxy advisers play a pivotal role in this trend. Key investors have started to embrace ESG and sustainable investing in their investment strategies, and leading international financial advisers have started to build or expand dedicated research capabilities in both equity and index research into developing special ESG products. Companies thus need to be acutely aware that their governance structures, reporting standards and levels and overall strategies duly take ESG topics into consideration and are presented to stakeholders in a manner that allows market-standard review and assessment of their company. "Greenwashing", while to our knowledge not yet seen on the Austrian market, may well become a topic of interest the more ESG comes into focus and foreign/international regulators thus also put increasing emphasis on companies' compliance in this area.

6.2 What will be the longer-term impact of COVID-19 on ESG?

For Austria, as for many other jurisdictions around the world, the COVID-19 pandemic could become a turning point for ESG investments in the longer-term view. The pandemic, in many respects and areas, has accelerated the trend for a more sustainable approach in investing.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Brazil's legal system, since the 1988 Federal Constitution, has been guided by principles and guarantees aligned with the ESG agenda.

The Federal Constitution, by providing the foundations and fundamental objectives of the Federative Republic (articles 1 and 3), establishes that basic values for the ESG agenda are the basis of the national legal system.

In the same sense, the Constitution guarantees the economic order based on the valorisation of human labour and free enterprise (article 170), environment (articles 170 and 225), social (articles 6–11) and an extensive list of fundamental rights (article 5).

The Federal Constitution confers internal applicability to the International Conventions of Human Rights that Brazil has ratified, which will have supra-legal or constitutional status depending on the approval quorum. Such conventions are binding to public and private entities and will be applicable to corporate activities.

See below the main ESG-related regulations in each of their major areas:

Environmental

Brazilian legislation regulates corporate practices with potential and/or actual impacts caused to the environment. It aims not only at mitigating such impacts but also at promoting a positive effect.

There is no legislation that specifically provides for such environmentally concerned corporate practices, but their essence is engendered in the Federal Constitution as aforementioned, in the Brazilian National Environmental Policy (Law No. 6,938/1981) and in the Environmental Crime Act (Law No. 9,605/1998).

There are also specific laws regarding different environmental attributes, which can be exemplified by: the National Policy on Water Resources (Law No. 9,433/1997); the Forest Code (Law No. 12,651/2012); the National Policy on Solid Waste (Law No. 12,305/2010); and the National Policy on Payment for Environmental Services (Law No. 14,119/2021), which also has provisions on social impact, among others.

With special attention to climate change, the main regulation in Brazil is the National Policy on Climate Change (Law No. 12,187/2009), which formalises the Brazilian commitment to the reduction of greenhouse gas emissions.

Considering that all three levels of government (federal, state and municipal) are concurrently competent to legislate on environmental and human rights matters, states and municipalities may enact their own legislation, provided it is more stringent than the federal law or the federal law is silent on certain matters.

Social

Regarding the social component of ESG, there are sparse laws about enterprises' responsibility to comply with human rights (including labour and diversity matters), but overall, there is still a lack of legislation that regulates the compliance of the chain of production, establishing parameters, delimiting businesses' responsibility and the corresponding sanctions.

Labour rights are provided mainly by Decree No. 5,452/1943. Regarding diversity and inclusion, there are several laws in Brazil that provide for equality and non-discrimination, including the Federal Constitution. Violence and discrimination against minority groups are crimes in Brazil, including their practice in the work environment (sexual harassment – Penal Code article 216-A; racism and LGBTphobia – Law No. 7,716/1989; and people with disabilities – Law No. 13,146/2015). Affirmative action policies are encouraged through several internalised conventions, as well as national laws such as the Racial Equality Statute (Law No. 12,288/2010) and Law No. 8,213/91 (article 93), which establishes for companies a minimum mandatory percentage of employees with disabilities.

Brazil has voluntary regulations on business responsibility to respect human rights that comprehend the National Guidelines on Business and Human Rights (Decree No. 9,571/2018) and the National Guidelines for a Public Policy on Human Rights and Business (Resolution No. 05/2020 of the National Council for Human Rights).

States and municipalities can also enact other pieces of legislation, such as Municipal Decree No. 58,180/2018 of the city of São Paulo, which provides for the Human Rights and Diversity Badge to acknowledge actions that promote human rights in the workspace.

Governance

Brazil's business laws establish a series of minimum governance parameters for different types of organisations, starting with the Federal Constitution, as mentioned above, and followed by: (i) the Civil Code (Law No. 10,406/2002), which provides for general rules applicable to all businesses, especially the most recurrent in Brazil, the limited liability company; (ii) Law No. 6,404/1976, which provides for norms applicable for both closely and publicly held corporations; and (iii) the regulation issued by CVM (the Brazilian Securities and Exchange

Commission), which applies to all publicly held corporations, without prejudice to the rulings issued by specific government agencies, when applicable.

Financial Market

With respect to financial regulations, there have been some recent advances. The National Monetary Council and the Brazilian Central Bank published a package of resolutions in September 2021 that deal with the management of social, climate and environmental risks by banks and financial institutions that will become mandatory in 2022–2023.

The resolutions establish the Social, Environmental and Climate Responsibility Policy (Resolution No. 4,945/2021), provide for the risk management framework (Resolution Nos 4,943/2021 and 4,944/2021), and establish a series of social and environmental criteria for granting rural credit (Resolution No. 140/2021).

Other laws and public policies are pertinent for ESG-related issues. As an example, the Bidding Law, enacted in 2021, provides for corporate governance standards, human rights and environmental requirements.

1.2 What are the main ESG disclosure regulations?

In September 2021, the National Monetary Council and the Brazilian Central Bank launched a package of resolutions with new disclosure requirements for Social, Environmental and Climate Risks and Opportunities (Resolution BC No. 139/2021 and Normative Instruction BC No. 153/2021).

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

The National Guidelines on Business and Human Rights (Decree No. 9,571/2018), of voluntary application, encourage the adoption of public commitments to respect human rights by companies (with the participation of the higher levels of administration), and the incorporation of this perspective in their policies, codes of ethics and conduct, and operational procedures for effective implementation and publication on the company's websites and public channels (article 6, IV to VI).

The Guidelines provide for human rights due diligence as best practice and encourage companies to adopt transparency measures with the disclosure of relevant information and documents to interested parties, including human rights protection mechanisms (article 11).

1.4 Are there significant laws or regulations currently in the proposal process?

There are several ESG-related bills pending in the National Congress. With respect to the environmental aspect, there are two bills of law in progress that provide for ESG certification systems related to specific markets: Bill No. 5,123/2020 intends to establish such certification system for the oil and gas production chain; and Bill No. 4,478/2020 aims at establishing the certification system related to agricultural and livestock products cultivated or produced by companies or individuals.

Bill No. 2,041/2021, aiming to avoid greenwashing, intends to prohibit legal entities with environmental liabilities (related to environmental damages or to violation of environmental legislation) from promoting any kind of advertisement or publicity for an environmentally positive image or for association of companies' activities with concepts or criteria related to environmental sustainability.

Regarding climate change, there are also several bills in the proposal process. For instance, Bill No. 528/2021 aims to create a regulated domestic carbon market and a national system for registration of verified emissions reductions.

There are bills that provide for a mandatory photovoltaic electricity generation system for new buildings (Bill No. 2,523/2021), tax benefits for individuals for the acquisition and permanent withdrawal of verified greenhouse gas emissions reductions (Bill No. 2,012/2021), tie-breaker preference in bidding processes for companies that prove to have undertaken climate change mitigation measures (Bill No. 835/2021), and the prohibition of sale of new cars and light commercial vehicles powered by gasoline and diesel oil as of 2030 (Bill No. 5,332/2020), among others.

In regard to the social aspect, there are several bills discussing diversity issues and the creation of public seals for corporations (for instance, Bill Nos 5,415/2020, 497/2015 and 2,062/2021), but there is still a lack of bills concerning unified regulation for the corporate responsibility to respect human rights or for mandatory human rights due diligence. The National Council for Human Rights published Resolution No. 5/2020 with directives to draft a national public policy on business and human rights. Such policy is yet to be enacted.

At the end of 2020, Resolution No. 2 was approved in the National Investment Committee of the Chamber of Foreign Trade, part of the Ministry of Economy. It stipulates a mandate for the development of a Responsible Business Conduct Action Plan, which is in the elaboration process and aims to strengthen the implementation of the OECD Guidelines for Multinational Enterprises and the role of the OECD National Contact Point in Brazil.

Recently, Bill No. 3,284/2021 was proposed to establish the National System of Investments and Impact Businesses (Simpacto) and to institute the qualification of "benefit corporations" to encourage social impact businesses with the creation of a hybrid corporate qualification.

Regarding data protection, Brazil already has a law that regulates the treatment of personal data, in effect since 2018 (Law No. 13,709/2018); however, a constitutional amendment bill that seeks to insert the protection of personal data as a fundamental right (PEC No. 17/2019) is in process.

With respect to the financial market, CVM opened a process of public consultation to review Instruction No. 480 addressing the inclusion of ESG criteria in the issuance of market securities.

1.5 What significant private sector initiatives relating to ESG are there?

There are several private sector initiatives that have given prominence to the ESG agenda in the past few years. We can highlight the active participation of the largest business groups in the country, with revenues accounting for a high percentage of GDP and over 1 million direct jobs affiliated to CEBDS (the Brazilian Business Council for Sustainable Development), a non-profit civil association recognised as the main business sector representative. CEBDS takes a leadership role in several national and international forums concerning ESG-related areas.

The Brazilian Network of the Global Compact has an important role as an articulation point between Brazilian private actors and the United Nations in the promotion of actions, workshops, and training on human rights and ESG issues.

In the certification field, "Sistema B" plays an important role in measuring the social and environmental performance that companies generate during their operation due to the significant increase in the number of Brazilian companies certified "B" in the last few years.

Some of the significant private sector climate change initiatives are: "Race to Zero", a CDP Latin America initiative; "Companies for Climate Platform", organised by FGVces (the Center for Sustainability Studies of Fundação Getulio Vargas); and the ticket log initiatives "Sustainable Fleet" and "Carbon Credit".

In addition, companies have created private funds and projects for the financing of initiatives related to the sustainable development of the Amazon biome, through the conservation and restoration of the forest, increasing the productivity of already explored areas through the implementation of agroecological systems and investments in research.

In the financial market, some initiatives have gained prominence regarding ESG, such as the CFA Society Brazil, an association of finance and investment professionals with an ESG Committee that launched, in partnership with AMEC (the Association of Capital Market Investors), the new Brazilian Code of Stewardship in 2021, updating the AMEC Code of Stewardship created in 2016.

B3, Brazil's Stock Exchange, plays an important role in encouraging companies to disclose information about their ESG performance, through its Corporate Sustainability Index (ISE) and its Carbon Efficient Index (ICO2), which guide the construction of stock portfolios with assets from companies with a recognised commitment to sustainability and transparency regarding their emissions.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

The demand by investors and asset managers toward ESG has been growing. It is illustrated by several perspectives, of which the following are worth highlighting: the increase in green and/or sustainability-linked bonds issued in the country; the opening of agribusiness funds; the accreditation of agribusiness participants in the Brazilian Stock Exchange, to register, for example, "*Cédula de Produto Rural*" (CPR), which is a security representing a promise of future delivery of agricultural produce; and the increase in agribusiness in regulatory standards such as Fiagro, a type of investment fund in agroindustrial chains, created by Law No. 14,130 of March 2021, which aims to allow individuals or legal entities, including foreigners, to invest in Brazilian agribusiness.

Presidential Decree No. 10,828, released on October 1, 2021, regulates the issuing of green CPRs. It creates the "*Cédula de Produto Rural Verde*" (Green CPR) for payments for environmental services. The financial instrument remunerates the rural producer for environmental preservation. With the Green CPR, the rural producer is encouraged to produce while preserving and starts receiving payment for environmental services, thus achieving an extra income. The instrument will allow companies interested in mitigating their greenhouse gas emissions to acquire the bonds through the producer's commitment to maintain the conserved area. The Green CPR links the company that wants to be environmentally sustainable with the rural producer. In practice, the Green CPR represents the largest national instrument of immediate and large-scale operationalisation of payment for environmental services. It is based on the carbon stock of native vegetation, on the absorption of carbon credits from agricultural and livestock production, and on other ecosystem benefits. The Ministry of Economy estimates a potential market of R$30 billion in four years, taking into account the certification of carbon credits of Brazilian forests.

Even in traditional financial and capital market transactions, whose object and/or purpose is not linked to ESG issues, investors, collateral agents, and regulatory institutions have been increasingly rigorous in contractual clauses and in demands and analysis for due diligence in this regard, in order to mitigate risks related to non-compliance with local and global ESG standards.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Although discussions on sustainable development worldwide have been ongoing for a long time, the pressure for its embodiment within corporate practices has significantly increased in the last few years due to a change in investment funds' view towards ESG relevance when defining funds allocation. In addition, such stakeholders also encourage the enactment of new legislation and regulations regarding ESG.

With growing media coverage of the subject and increasing social and environmental consciousness, citizens (playing both consumer and investor roles) have begun to give more importance to ESG-related aspects when buying or investing in certain products or companies, respectively.

Brazilian organised civil society is strong and composed of many non-governmental organisations (NGOs) and social movements that closely monitor the activities of companies in the areas covered by ESG. These actors have the capacity to exert pressure through the organisation of campaigns, national and international denunciations with great media repercussion, and public actions and protests. Respect for national and international environmental and climate standards, human rights, transparency, and the fight against corruption are crucial to the trust and respectability of companies before civil society.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

With respect to ESG issues, in general, the main regulatory bodies are the National Congress in the exercise of its legislative competence and the Presidency of the Republic, through the exercise of its regulatory power.

Regarding the environmental aspect, CONAMA (the National Environmental Council) issues normative resolutions, and environmental agencies (federal and state) are increasingly requiring from companies the adoption of measures to identify new cost-viable technologies or other alternatives to reduce the impacts caused by their activities.

Regarding climate change issues, the competence division among regulators is currently not very clear. After the Kyoto Protocol took effect, the Brazilian government created an Interministerial Committee on Climate Change, formed by the Science and Technology Ministry and the Environmental Ministry, which was responsible for regulating climate change matters. However, after the Paris Accord, this Committee was revoked. There are some regulatory initiatives that intend to establish new regulating bodies, such as Bill No. 528/2021, but they depend on final approval.

Regarding the social aspect, there is a broad structure of social control that, despite progressive weakening in recent years, works by issuing resolutions and recommendations. In this sense, there is the National Council for Human Rights and other thematic councils.

Regarding the governance and financial market aspects of ESG, the regulatory bodies are the Brazilian Central Bank and CVM, which issues resolutions and normative instructions with criteria for financial institutions and for publicly held corporations.

2.4 Have there been material enforcement actions with respect to ESG issues?

As the environmental aspects of corporate practices are not new to Brazilian legislation, there is a solid system for enforcement of obligations and liabilities related to environmental matters. Besides the previous control of potentially pollutant activities by means of environmental licensing proceedings, all three levels of government (federal, state and municipal) are entitled to inspect such activities and impose sanctions and/or request the adoption of measures to regularise the situation.

Concerning the social aspects of the corporate conducts, the Ministry of Labour and Social Security has organised, since 2003, the so-called "Slave Labour List", which gathers companies where workers were found in conditions analogous to slavery. Today, the list is the main negative registry consulted by companies in Brazil seeking to prevent the existence of slave labour in their supply chain.

Regarding diversity, inclusion and accessibility, there has been an increase in the number of public interest lawsuits, administrative procedures and inquiries conducted by the Public Prosecutor's Office. Some of the key themes are lack of accessibility – with emphasis on the defence of the rights of the visually impaired – and "diversity washing" and discrimination against minority groups (based on gender, race, LGBTI+).

Currently, there are some investigative procedures that arise as risks regarding past association of companies with the dictatorial regime in Brazil. In 2020, Volkswagen signed a multimillion-dollar settlement for having collaborated with human rights violations committed during the dictatorship in Brazil.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

ESG-related litigation is becoming more common, notably those filed by public bodies. There are ongoing discussions on the adequate conflict resolution methods for ESG-related disputes involving public bodies, and mediation and arbitration have gradually been considered.

Considering that Brazilian environmental legislation extensively regulates environmental aspects of corporate practices, material litigation other than enforcement actions is unusual. Depending on the case, a Consent Agreement may be executed among the parties.

In certain circumstances, parties legitimised to file public civil or class actions may claim for adoption of measures and/or fulfilment of obligations other than those provided for in the applicable legislation, claiming for unconstitutionality or illegality of certain laws or regulations.

As pointed out in Conectas Direitos Humanos' 2019 report, experts estimate that the issues to be most targeted by climate litigation will be the reduction of greenhouse gas emissions, mechanisms for adaptation of the population to the effects of climate change, reparation of losses and damages caused by climate change, and risk management. In Brazil, climate litigation is still relatively recent, and it is worth mentioning specifically the role that the superior courts in Brazil have been assuming, with high commitment to the environment in the interpretation of the law.

Regarding business and human rights, there are already at least two convictions in the Regional Labour Courts, concerning work and safety issues, using Decree No. 9,751/2018, which establishes the National Guidelines on Business and Human Rights. Human rights violations are frequently addressed judicially, including racism, lack of accessibility, disasters, slavery and child labour. In the last few years, model cases have been filed. For instance, lawsuits were filed discussing the responsibility of companies to plan, identify and mitigate the potential negative impacts arising from the decision to terminate manufacturing plants, the responsibility for accidents or violence committed by suppliers, and social washing due to the lack of diversity in a company.

There is a risk of increasing litigation for companies regarding the use of ESG as an image cleaning tool (green, social and diversity washing). The assumption of ESG public commitments has served as a basis for lawsuits arising from the non-implementation of corresponding measures in the company structure.

Besides the paradigms of domestic litigation, the negative impacts on ESG in Brazil have been taken to foreign courts. Two transnational lawsuits stand out for their potential litigation risks for transnational corporations in their host countries for negative impacts in Brazil: the £5 billion lawsuit brought in the UK by the victims of the Fundão dam collapse, which has been reopened in 2021; and the lawsuit submitted also in 2021 by indigenous people of the Brazilian and Colombian Amazon against a mass-market retail group in France, under the law of duty of care, for alleged environmental damage in its supply chain.

2.6 What are current key issues of concern for the proponents of ESG?

Because of the broad concept of ESG and the lack of specific regulation for its implementation and certification, there is a current favourable and undesirable scenario for greenwashing practices (in the same way as for social and diversity washing practices), which refers to dissemination of unfounded or intentionally misleading information so as to present a fake responsible image.

There is a great challenge in delimiting the scope of the legal responsibility of corporate and financial agents with respect to human rights, especially with respect to the supply chain. The Brazilian legal system is composed of many sparse laws and lacks a normative rule that unifies the provisions and establishes clear standards of respect for human rights for companies.

The current key issues regarding climate change are the carbon market regulation and carbon pricing, with debates about climate integrity, illegal deforestation, energy sources transition and renewable energy.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Brazilian laws hold the controlling shareholders accountable for decisions that do not consider the so-called "social function" (externalities to other stakeholders) and the interests of the community in which the corporation operates. It is mandatory that officers and Boards of Directors, supported by advisory committees, address ESG topics within the scope of business management. Boards should collaborate with executives to enhance the understanding of the fast-evolving significance of ESG to the corporation's stakeholders and adapt their value proposition while acting to meet growing demands for ESG information, governance and performance.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The Board of Directors exercises a critical role during periods of adjustment and crisis, especially when a company is incorporating new external trends into the strategy. Boards must be involved throughout the strategy-setting process, strongly encourage continuous learning about ESG and related trends at both the full board and individual levels, and continuously assess their effectiveness in addressing ESG risk, in terms of both their own fiduciary responsibilities and their oversight of management activities. The existence of technical advisory committees to the Board of Directors also helps in the supervision of ESG topics, especially when they are intended to address the main risks for the company, such as audit, personnel, compensation and corporate governance committees.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Although the practice is still being disseminated among Brazilian companies, linking goals associated with ESG themes to variable remuneration, or bonuses, paid to executives or even employees, is a practice used to encourage the commitment of executives with ESG goals. This alignment is expressly recommended by Brazilian corporate governance codes and publications, such as those issued by IBGC (the Brazilian Corporate Governance Institute).

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Some examples of ESG integration into day-to-day operations are: (i) the existence of an independent Board of Directors; (ii) diversity in the composition of the Board of Directors, including members of different genders, races and other characteristics, striving for inclusion; (iii) advisory committees directly or indirectly dedicated to ESG discussions and projects; (iv) the establishment of compensation incentives for members of the Board of Directors that take into account the achievement of ESG goals; (v) the existence and disclosure of corporate policies that require board members, executives and even employees in general to comply with ethical standards linked to ESG values; and (vi) voluntary, coherent, and consistent corporate disclosure related to ESG issues.

Another example of ESG integration is the development of full-scale ESG and human rights due diligence processes, which are being conducted by some large corporations based in Brazil, with the objective of mapping the risks and negative impacts in all areas, including the supply chain, transnational operations, and internal public.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Depending on the sector in which the debtor or issuer operates and, consequently, the risks they may cause to the environment, as well as the social impacts omitted for diversity and the mitigation of social inequality, debt and equity finance, providers are more stringent in their assessment criteria during due diligence and contractual clauses. In this context, although it is not a legal obligation for these transactions to have a standard ESG rating established by law or by rating agencies, it is necessary as a market practice to present internal ESG criteria and metrics by debtors and/or issuers to obtain better rates, better compliance, and better acceptance by current creditors in case of debt renegotiation, by potential creditors for contracting new financing, by stakeholders and/or by current and potential investors.

4.2 Do green bonds or social bonds play a significant role in the market?

The volume and amount of green bonds and social bonds are growing in the Brazilian market, especially in the industrial sector, which has higher rates of environmental damage and requires funding or equity operations to sustain itself, especially in times of economic and financial crisis. So far, there are more registrations of green bonds than social bonds. The key to achieving this funding issuance, with more stakeholder buy-ins, greater interest from a more diverse investor base, including domestic and international investors, and obtaining better rates, is to create ESG targets. With these incentives, these bonds have a relevant role in the market.

4.3 Do sustainability-linked bonds play a significant role in the market?

The volume and amount of sustainability-linked bonds are significantly increasing in the Brazilian market, since they do not need to stamp the destination of the resources, but only set corporate goals. The key to achieving this funding issuance, with more stakeholder buy-ins, greater interest from a more diverse investor base, including domestic and international investors, and obtaining better rates, is to create ESG targets.

4.4 What are the major factors impacting the use of these types of financial instruments?

The main factor is increasing the diversified investor base. The next is the issuer's strategic positioning with its stakeholders. Finally, it is the question of a more favourable interest or term, which is already starting to be perceived in some cases but is not yet the rule.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The processes in Brazil for green bonds are not currently regulated. Green, social and sustainability-linked bonds maintain the same regulatory process as any other traditional bond. However, as a market practice, these issuers must obtain third-party sustainability certifications or opinions for certifying that the proceeds will be used for eligible green and/or social purposes and that they are aligned with international standards, such as, but not limited to, the UN's Sustainable Development Goals, the Green Bond Principles issued by the International Capital Market Association, the Climate Bonds Standard and any other applicable standards, whether local or international.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

In a context in which good ESG practices have increasing relevance in the corporate environment, the COVID-19 pandemic has caused a paradigm shift in the work models that were consolidated until then. As a result, ESG best practices are driving organisations to assess aspects of corporate citizenship, as well as inclusion and diversity efforts to adjust their relationship with workers and other stakeholders.

The economic crisis has meant a significant reduction in public investments in social and environmental policies, and a dramatic increase in inequality and poverty. However, the pandemic came as a catalyst for the implementation of ESG strategies. CVM issued a letter in 2020 that highlighted the importance of social and environmental issues. In 2020, the volume of sustainable bonds traded broke records worldwide and doubled in volume. In 2021, the Brazilian bonds issued with an ESG profile reached 2020's volume in January alone.

Concerns about climate change, the environment, and the need for diversity and inclusion in companies have never been more evident. While the gender-focused diversity agenda has been gaining attention for some years now, there is still progressive awareness of the need for greater racial representation in boards and in corporate management.

The COVID-19 pandemic has produced a picture of pressing national business, and market adaptation needs to meet emerging regulatory demands and to build an attractive economic environment for sustainable investment.

6 Trends

6.1 What are the material trends related to ESG?

Aiming to avoid the misuse of ESG concepts and green, social and diversity washing practices, as well as to make ESG more palatable, public and/or private certification systems related to ESG responsible actions and companies are likely to increase.

Regarding climate change, the most relevant trends are the implementation of a regulated carbon market, the stimulus to the voluntary carbon market under the umbrella of corporate social responsibility, and the propagation of information and awareness regarding the subject.

Considering the recent advances in Europe with respect to mandatory human rights due diligence, there is a trend that such laws will impact the Brazilian market, imposing obligations to implement due diligence processes in the states of operation and supply chain integration of European companies.

Regarding diversity, companies have increasingly developed specific programmes for hiring women, afro-descendants and LGBTI+ people. In 2020, a model trainee programme directed solely to black candidates was launched and several companies are following the trend and opening programmes and job positions directed to women, afro-descendants, transgender people and other minorities or vulnerable groups.

With respect to the governance aspect, an ESG-related trend is the increasing relevance of social factors. Elements such as diversity, inclusion and combatting inequality will be important for these assets.

In response to the crisis caused by the COVID-19 pandemic, many companies have sought to provide support to their employees, customers, other stakeholders and society as a whole, such as: (i) prioritising care for employees and third parties; (ii) flexible work and remote work; (iii) carrying out donation campaigns to support the most needy; (iv) provision of financial assistance; (v) support for the provision of emergency and health services; (vi) voluntary suspension of activities; (vii) assistance to vulnerable communities; and (viii) modification/adaptation of production lines.

Furthermore, there has been a growing discussion regarding a minimum quota for women on Boards of Directors of publicly held corporations, a gradual phenomenon that will likely require a statutory law to speed up this inclusion process.

Also worthy of note are the financial market advances in discussing and regulating the agenda. The sustainable debt market (encompassing green, social and sustainability bonds) is breaking records year after year and with international projections for the growth of ESG-related investment funds in the coming years, the Brazilian market has been on the move in the development of investment tools (such as responsible investments, sustainable investments and impact investments).

CVM opened public consultations this year to review Instruction No. 480. The existence of ESG committees in organisations such as the CFA Society Brazil is symptomatic of the growing importance of the ESG agenda for the financial market.

6.2 What will be the longer-term impact of COVID-19 on ESG?

One thing is certain, the COVID-19 pandemic has generated and will continue to generate profound impacts on stakeholders' expectations of risk management by companies. The adoption of ESG policies and strategies in the present will prepare companies for possible disruptive events in the future.

The incorporation of ESG due diligence processes in companies' operations will be fundamental to offering security and stability to the investor and the market in the post-pandemic world.

There is no reason to imagine a regression of the ESG agenda in Brazil and worldwide after the pandemic. On the contrary, the period of the COVID-19 pandemic will be seen in the long run as a period of advancement in the area.

Acknowledgments

The authors acknowledge with thanks the contributions to this chapter of Partner Alexei Bonamin and Associates Danilo Lambert Vieira de Sous, Gabriela Nunes Machado, Luiz Carlos Silva Faria Junior and Raphaela Azevedo de Mello Silva.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

There are a variety of ESG-related regulations applicable to federally and provincially incorporated companies; however, the focus of this chapter will be on public companies that qualify as "reporting issuers" under applicable Canadian securities and corporate laws, with references to general Canadian corporate law and specific section references to the federal Canada Business Corporations Act (the "**CBCA**").

In compliance with the CBCA, corporate directors are required to manage, or supervise the management of, the business and affairs of a company; and in doing so, directors must comply with their fiduciary duty and duty of care. The duty of care standard requires directors to act honestly and in good faith with a view to the best interests of the company. Recently, consistent with the Supreme Court of Canada's decision in *BCE Inc. v. 1976 Debentureholders* (2008 SCC 69), section 122 of the CBCA was amended to specifically provide that when acting with a view to the best interests of the corporation, directors may consider, but are not limited to, factors such as the interests of shareholders, employees, retirees and pensioners, creditors, consumers and government, as well as the environment and the long-term interests of the corporation. When exercising their duty of care and taking corporate action that will affect stakeholders, directors should treat each stakeholder group equitably and fairly and, in resolving competing interests, the directors should evaluate and assess stakeholder interests alongside the best interests of the company with the view of creating a "better" company.

As ESG incorporation relates to the consideration of environmental, social and governance considerations in respect of a business, a director's fiduciary duty, broadly speaking, could encompass a duty to manage and oversee ESG-related matters relevant to the company, especially in the application of risk management, risk mitigation and governance, which may include actively addressing certain challenges and opportunities in the context of specific environmental and social ("**E&S**") matters.

In Canada, the regulation of capital markets is a matter of provincial and territorial jurisdiction, and while each province and territory has its own securities laws, regulations and rules administered by a local securities regulator, these local securities regulators who form the Canadian Securities Administrators (the "**CSA**") have adopted national instruments and policies that apply in all Canadian jurisdictions. Collectively, these securities laws, policies, rules and instruments are referred to in this discussion as the "**Canadian securities laws**".

Substantive ESG-related requirements are prescribed by the CSA under applicable Canadian securities laws and the rules of the Toronto Stock Exchange (the "**TSX**") and, for the most part, securities laws relating to ESG-related requirements, disclosure and best practices have been harmonised through national instruments and national policies adopted by all of the Securities Commissions. Corporate governance disclosure and best practices are governed by National Instrument 58-101 *Disclosure of Corporate Governance Practices* (the "**Corporate Governance Rule**") and National Policy 58-201 *Corporate Governance Guidelines* (the "**Corporate Governance Guidelines**").

By mandating corporate governance-related disclosure, which is generally to be included in an issuer's management proxy circular, the goal of the Corporate Governance Rule is to provide greater transparency on how issuers apply various corporate governance principles. While the CSA require issuers to disclose how they deal with certain matters, they also recognise that many corporate governance matters cannot be prescribed in a "one size fits all" manner and neither the Corporate Governance Rule nor the Corporate Governance Guidelines are intended to prescribe or restrict specific governance matters. The Corporate Governance Guidelines are thus meant to reflect "best practices" that have been formulated with desirable corporate governance principles in mind. Issuers can choose to apply or follow the best practices as set out in the Corporate Governance Guidelines, in whole or in part, depending upon their own unique circumstances, or to explain how they achieve the goals of the related corporate principles.

The "best practices" set out in the Corporate Governance Guidelines include the requirement to adopt a **written code of business conduct and ethics, which applies to not only the employees but also the board of directors of the issuer**. Although the content and tone of the code are left to the issuer's discretion, the Corporate Governance Guidelines recommend that the following matters be covered by the code: conflicts of interest; protection of corporate assets; confidentiality of corporate information; fair dealing with security holders and others; compliance with laws; and reporting of illegal or unethical behaviour. While these subject areas may be seen to form the core "ethical" components of an internal ESG framework, given the broad scope of matters covered by ESG, a number of social and governance matters have evolved to be covered expressly under applicable codes of conduct or ethics. These include human rights protection, anti-harassment and workplace wellness, supply chain governance and community relations as well as anti-bribery and corruption, environmental protection, equity and inclusion. However, these are often, if not always, accompanied by more specific ESG-related policies, reports or disclosures.

The TSX also substantively regulates governance through various policies or restrictions. These include requirements relating to director independence, as well as restrictions against staggered boards and slate voting through the requirement for annual elections for individual directors. The TSX also requires its listed companies to adopt majority voting policies, which require voluntary resignation by directors who fail to garner a majority of "for" votes in director elections.

More recently, there has been a concerted effort at both the federal and provincial levels to strengthen and enhance climate-related disclosure. In January 2021, Ontario published its "Capital Markets Modernization Taskforce" (the "**Ontario Taskforce**") final report, in which it recommended "mandating disclosure of material ESG information, specifically climate change-related disclosure" through regulatory Ontario Securities Commission ("**OSC**") filing requirements. The Ontario Taskforce recommends a phased approach to implementation of this new requirement based on an issuer's market cap and encourages the CSA to implement a similar requirement across Canada. Similarly, the federal government budget has sought to strengthen climate-related disclosures by mandating Canada's large corporations in 2022 to adopt the Task Force on Climate-related Financial Disclosures ("**TCFD**") standards or more rigorous, acceptable standards as applicable. In 2022, Crown corporations will also be required to implement gender and diversity reporting. In efforts to provide further clarity and facilitate consistency and comparability among issuers, in October 2021, the CSA published CSA Consultation Climate-related Disclosure Update and CSA Notice and Request for Comment Proposed National Instrument 51-107 *Disclosure on Climate-related Matters* ("**NI 51-107**"), which would introduce disclosure requirements regarding climate-related matters for reporting issuers (other than investment funds). The proposal is being published for a 90-day comment period (ending January 17, 2022). The proposed disclosure would be included in an issuer's management information circular and is related to four core elements: governance; strategy; risk management; and metrics and targets.

Also noteworthy is the *Notice relating to modern slavery disclosure requirements* (the "**Notice**") published by Quebec's securities regulator, the *Autorité des marchés financiers*. The Notice seeks to provide guidance to reporting issuers on the disclosure of issues involving modern slavery, a term defined by the International Labour Organization as any work or service performed by a person involuntarily and under the threat of any penalty. Although it does not modify existing regulatory requirements, the Notice draws the attention of issuers to certain requirements that may be related to the issue of modern slavery in the disclosure of their risks, social policies and code of conduct and ethics. Furthermore, the Notice states that when carrying out their oversight duties, boards of directors, audit committees and certifying officers should examine, among other things, management's assessment of the materiality of issues related to modern slavery and satisfy themselves that the disclosure provided in the documents filed under securities regulation is consistent with that assessment.

1.2 What are the main ESG disclosure regulations?

Reporting issuers are subject to specific reporting requirements in periodic disclosure documents required to be filed under applicable Canadian securities laws. These include Financial Statements (in accordance with the International Financial Reporting Standards), Management's Discussion & Analysis ("**MD&A**", under Form 51-102 F1), Annual Information Forms ("**AIFs**", under Form 51-102 F2), and Information Circulars (under Form 51-102 F5), which include Executive Compensation (under Form 51-102 F6) and Disclosure of Corporate Governance Practices (under Forms 58-101 F1 and F2).

In addition to these periodic disclosure requirements, reporting issuers are also required to make timely disclosure of material changes (under Form 51-102 F3) and, under applicable TSX Rules, timely and accurate disclosure of material information. These general periodic and timely disclosure requirements encompass various disclosures relating to ESG issues under Canadian securities rules, and the CSA encourage reporting issuers to demonstrate ESG considerations in their applicable disclosure filings. Certain of these requirements are discussed in further detail below.

Pursuant to the Corporate Governance Rule and Form 58-101 F1 *Corporate Governance Disclosure* ("**Form 58-101 F1**"), reporting issuers are required to disclose certain prescribed information relating to board and committee duties and responsibilities as well as board independence, composition, education, and board and committee self-assessments (which requirements differ among venture companies and those listed on the TSX or other non-venture exchanges). While these requirements have remained relatively static since inception, they were substantively expanded to include prescribed disclosure with respect to the representation of women on boards of directors, in the director identification and selection process, and in executive officer positions (the "**Diversity Disclosure**").

Generally, the Diversity Disclosure follows a "comply or explain" model, which does not require issuers to adopt any particular form of policy with respect to board appointments and the appointment of senior management. Rather, the approach provides flexibility and allows issuers to determine the considerations and policies with respect to board nominations and the appointment of senior management that are appropriate to their particular circumstances.

Under these rules, an issuer is required to include disclosure as set out in Form 58-101 F1 in its management information circular any time that the issuer solicits a proxy from a security holder for the purpose of electing directors to its board of directors (or the equivalent).

Under Form 58-101 F1, each TSX-listed reporting issuer to whom the Corporate Governance Rule applies, is required to disclose the following:

- Whether the board has adopted term limits for directors or other mechanisms for board renewal, and, where adopted, a description thereof.
- Whether the issuer has adopted a written policy relating to the identification and nomination of women directors, and, where adopted, a summary of its objectives and key provisions, the measures taken to ensure that the policy has been effectively implemented, annual and cumulative progress by the issuer in achieving the goals of the policy and whether and, if so, how the board or its nominating committee measures the effectiveness of the policy.
- Whether and, if so, how the board or nominating committee considers the level of representation on the board in identifying and nominating candidates for election or re-election to the board.

- Whether and, if so, how the issuer considers the level of representation of women in executive officer positions when making executive officer appointments.
- Whether the issuer has adopted targets for women on the board and in executive officer positions, and, if adopted, disclosure of the target and the annual and cumulative progress of the issuer in achieving such target(s).
- The number and proportion (as a percentage) of directors on the issuer's board and of executive officers of the issuer and its major subsidiaries who are women.
- Where an issuer has not adopted any of the components described above (i.e., term limits, policies, targets) or does not consider the representation of women on its board or among its executive officers in identifying candidates for such positions, the issuer must disclose why it has not done so.

Under the Corporate Governance Rule and Corporate Governance Guidelines, the CSA may periodically review compliance with these requirements and may order prospective and/or corrective disclosure, but also have the authority to enforce these through other enforcement mechanisms.

While the Corporate Governance Rule focuses on gender representation, amendments to the CBCA that came into force in 2020 expand annual disclosure requirements respecting term limits, diversity policies, and statistics regarding representation of women to include Aboriginal peoples, persons with disabilities and members of visible minorities. These amendments to the CBCA are further discussed in questions 1.4 and 2.2. To assist CBCA-incorporated issuers in addressing the CBCA disclosure requirements, Innovation, Science and Economic Development Canada ("**ISED**") published guidelines intended to encourage more consistent diversity disclosure. Notably, corporations are encouraged to disclose information in tabular format, separate disclosure with respect to boards and senior management, and specifically indicate timelines for targets. CBCA issuers are also reminded that filing a proxy circular on SEDAR will not satisfy the requirement to send diversity information to Corporations Canada. Rather, CBCA issuers must also submit this information to Corporations Canada either through their Online Filing Centre or by email to IC.corporationscanada.IC@canada.ca.

Following the amendments to the CBCA, in April 2021, ISED published Canada's first annual report on the diversity of boards and senior management of federal distributing corporations, encompassing a review of 469 distributing corporations (the "**CBCA Issuers**"), namely the *Diversity of Boards of Directors and Senior Management of Federal Distributing Corporations 2020 Annual Report*. Similarly, in March 2021, the CSA also published Multilateral Staff Notice 58-312, *Report on Sixth Staff Review of Disclosure Regarding Women on Boards and in Executive Officer Positions*, which summarises the review of the disclosure of 610 TSX-listed issuers with year-ends between December 31, 2019 and March 31, 2020 (the "**TSX Issuers**"). Differences between the results of the ISED and Staff Notice 58-312 studies are noticeable as the CBCA Diversity Disclosure requirements apply to all "distributing corporations" incorporated under the CBCA, which includes venture issuers, and addresses more facets of diversity, namely women, visible minorities, Indigenous persons and persons with disabilities. The findings of ISED establish a baseline that will be used to measure progress over the years. According to Staff Notice 58-312, 79% of TSX Issuers reviewed had at least one woman on their board, while ISED found that only 50% of CBCA Issuers had at least one woman on their board, suggesting that venture issuers generally have fewer women on their boards. Further, 20% of board seats of TSX Issuers were held by women, in comparison to 17% of CBCA Issuers. In regard to executive positions, 65% of TSX Issuers and 47% of CBCA Issuers had at least one woman in an executive officer position.

With respect to specific issues related to environmental compliance, risks and opportunities, the CSA have published guidance under Staff Notice 51-333 *Environmental Reporting Guidance* to provide insight on satisfying existing continuous disclosure requirements with respect to environmental concerns.

In the context of a wide range of environmental issues, Staff Notice 51-333 focuses on the following types of disclosure:

- *Environmental Risks and Related Matters*. The five key disclosure requirements in National Instrument 51-102 that relate to environmental matters are: environmental risks; trends and uncertainties; actual and potential environmental liabilities; asset retirement obligations ("**AROs**"); and the financial and operational effects of environmental protection requirements, including the costs associated with these requirements.
  - Environmental Risks: Issuers are required to disclose risk factors relating to the issuer and its business under item 5.2 of Form 51-102 F2. These risks include litigation risks, physical risks, regulatory risks, reputational risks, and risks relating to business model.
  - Trends and Uncertainties: The MD&A should include a narrative explanation of material information not fully reflected in the financial statements relating to applicable trends and uncertainties, including those that have affected or may affect the financial statements.
  - Environmental Liabilities: Environmental liabilities can arise from past or ongoing business activities that could impact the environment or could involve potential environmental liability due to ongoing or future business activities. With a potential liability, an issuer may be able to prevent liability by changing practices or adopting new practices to reduce negative impacts on the environment.
  - AROs: Item 1.2 of Form 51-102 F2 requires disclosure about an issuer's financial condition, results of operations and cash flows including disclosure on commitments or uncertainties that are reasonably likely to affect the issuer's business. Assets are considered retired if they are sold, abandoned, recycled or otherwise disposed of. An ARO is a requirement to perform a procedure rather than a promise to pay cash; as such, legal obligations resulting from the retirement of an asset could manifest.
  - Financial and Operational Effects of Environmental Protection Requirements: An issuer should disclose financial and operational effects of environmental protection requirements under item 5.1(1)(k) of Form 51-102 F2, including on capital expenditures, earnings, and competitive position.
- *Environmental Risk Oversight and Management*. Two key sets of disclosure requirements provide insight into a reporting issuer's oversight and management of environmental risks: environmental policies implemented by the issuer; and the issuer's board mandate and committees. In relation to environmental policies, a reporting issuer should explain the purpose of its environmental policies and the risks they are designed to address and evaluate, and describe the impact that the policies may have on its operations. For an issuer's board mandate and committees, the reporting issuer should disclose the board of directors' (or any delegate committee's) responsibility for the oversight and management of environmental risks in a manner that is meaningful to investors.

- *Forward-Looking Information Requirements.* Issuers are advised that disclosing goals or targets with respect to greenhouse gas emissions or other environmental matters may be considered forward-looking information or future-oriented financial information and would be subject to the disclosure requirements generally applicable to such information, including requirements to identify material assumptions and risks.
- *Governance Structures Around Environmental Disclosure.* Staff Notice 51-333 provides that a meaningful discussion of environmental matters in an issuer's MD&A and AIF is critical in ensuring fair presentation of the issuer's financial condition. Issuers should therefore consider discussing what environmental matters are likely to impact the business and operations in the foreseeable future and the potential magnitude of anticipated environmental risks and liabilities. An issuer should also have adequate systems and procedures to provide structure around its disclosure of environmental matters, including disclosure controls. The CSA also encourage voluntary reporting and disclosure responsive to third-party frameworks as a means to provide additional information to investors outside of continuous disclosure requirements.

More recently, in 2019, the CSA published CSA Staff Notice 51-358 *Reporting of Climate Change-related Risks*. This guidance was motivated by increased investor interest in climate change-related risks, particularly among institutional investors, the CSA's view that issuers' existing disclosure with respect to climate change can be improved, and the large number of reports on climate change disclosure and other environmental governance topics over the last several years.

The Notice highlights the respective roles of management and the board (and audit committee) in strategic planning, risk oversight and the review and approval of an issuer's annual and interim regulatory filings. While intended solely as an educational or guidance tool, Staff Notice 51-358 generally suggests the following practices for an issuer's board of directors and management:

- Ensure that the board of directors and management have, or have access to, appropriate sector-specific climate change-related expertise to understand and manage climate change-related risk.
- Establish disclosure controls and procedures designed to collect and communicate climate change-related information to management to allow for the assessment of materiality and, as applicable, timely disclosure.
- Consider whether climate change-related risks and opportunities are integrated into the issuer's strategic plan.
- Assess whether the issuer's risk management systems and methodology, including business unit responsibility, appropriately identify, disclose and manage climate change-related risks.
- Review the CSA's select questions for boards and management designed to inform the assessment of climate change-related risk. These questions include:
  - *whether the board provided appropriate orientation and information to help members understand sector-specific climate change-related issues;*
  - *whether the board was comfortable with the methodology used by management to capture the nature of climate change-related risks and assess the materiality of such risks; and*
  - *whether the board considered the effectiveness of the disclosure controls and procedures in place in relation to climate change-related risks.*

With respect to materiality, Staff Notice 51-358 emphasises that climate change-related risks and their potential financial impacts are mainstream business issues. While climate change-related risks may differ from other business risks due to our evolving understanding of these risks, the potential difficulty in quantifying these risks and the potentially longer time horizon, boards and management should take appropriate steps to understand and assess the materiality of climate change-related risks to their business.

In this context, Staff Notice 51-358 highlights certain specific considerations for determining materiality in the context of climate change-related risks:

- **Timing** – Issuers should not limit their materiality assessment to short-term risks. The uncertainty and time horizon of a risk occurring may impact the assessment of whether the risk is material but not whether it needs to be considered and analysed as to materiality.
- **Measurement** – Boards and management should consider the current and future financial impacts of material climate change-related risks on the issuer's assets, liabilities, revenues, expenses and cash flows over the short, medium and long term. Where practicable, issuers should quantify and disclose the potential financial and other impact(s) of climate change-related risks, including their magnitude and timing.
- **Categorisation of Risk and Potential Impact** – The Notice provides helpful guidelines for thinking about climate change-related risk and its potential financial, operational and business impact, including:
  - the **physical risks** of climate change, including acute (i.e., event-driven) or chronic changes in resource availability and climate patterns, including their impacts on sourcing, safety, supply chains, operations and physical assets;
  - the **transitional risks** arising from a gradual change to a low-carbon environment, including reputational risks, market risks, regulatory risks, policy risks, legal risks and technology risks; and
  - **opportunities** that may become available as a result of efforts to mitigate and adapt to climate change.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Depending on the business and industry of the reporting issuer and its specific shareholder or investor focus, there are a number of voluntary ESG-related disclosures that issuers may provide. These are impacted or skewed to a certain extent by the prevalence of resources issuers in Canadian capital markets. As such, voluntary disclosures are often focused on the environmental impact of the issuer's operations, including stewardship and sustainability, emissions reduction, water use and management, supply chain governance and asset retirement or reclamation. However, there has also been an increasing focus on governance and social issues, including community relations, health and safety, human rights and diversity. Voluntary corporate sustainability reporting often includes disclosure relating to a company's environmental, social and economic priorities, performance and impacts, governance and implementation of how these priorities are managed by an organisation, and has a broad focus on sustainability reporting to a broader group of stakeholders as opposed to a primary focus on investors and financial analysts. A recent survey of the disclosure practices of the S&P/TSX Composite Index constituents indicates that 71% of companies released a sustainability report (or ESG report) in 2020, up from 58% in 2019. Corporate S&P/TSX 60 issuers with dedicated ESG reports also increased to 92% in 2020 from 73% in 2019 and 48% in 2018, a figure substantially higher than the 71% in 2020 and 58% in 2019 of the broader S&P/TSX Composite

Index (Millani, *Millani's Annual ESG Disclosure Study: A Canadian Perspective* (September 2021)). Although ESG reporting is not standardised, the majority of companies continue to favour the Global Reporting Initiative ("**GRI**") framework as discussed further in question 4.1 below. Also noteworthy is the trend in TSX 60 companies regarding the disclosure of climate-related goals. According to Hugessen, in 2021, 54 companies disclosed such goal with 25 declaring a carbon neutral goal and 2050 most frequently the target set.

1.4 Are there significant laws or regulations currently in the proposal process?

As noted above, the Canadian Federal Government has recently expanded disclosure on board and executive composition disclosure beyond gender. Since January 1, 2020, all distributing corporations incorporated under the CBCA are required to include additional information about the diversity of their boards and senior management in annual proxy circulars. These amendments broaden the Diversity Disclosure requirement beyond gender and have been implemented to expand disclosure requirements to designated groups under the Employment Equity Act – being women, Indigenous persons (First Nations, Inuit, and Métis), persons with disabilities, and members of visible minorities.

Further amendments have also been adopted that will require prescribed corporations to develop an approach with respect to the remuneration of the directors and members of senior management and hold an annual, non-binding vote on such approach (generally referred to as a "say-on-pay" resolution). As is typical for "say-on-pay" votes, the results of the vote are required to be disclosed but are not to be binding on the corporation. Additional amendments will require disclosure of "the recovery of incentive benefits or other benefits", more commonly referred to as clawbacks, on an annual basis. Note that the coming into force of these amendments is tied to the implementation of corresponding regulations. Accordingly, in early 2021, Corporations Canada launched public consultations on proposed regulations under the CBCA related to such recent amendments.

In addition, due to the lack of standardised framework for ESG disclosure, the Ontario Taskforce suggests public issuers provide enhanced disclosure of material ESG information, including forward-looking information. Such disclosure may set the foundation for greater access to global capital markets and promote an equal playing field for issuers. The Ontario Taskforce has also proposed that TSX-listed companies adopt written policies that "expressly addresses the identification of candidates who self-identify as women, black, indigenous and people of colour ("**BIPOC**"), persons with disabilities or LGBTQ+ during the nomination process" and public issuers set aggregate targets of 50% for women and 30% for BIPOC, persons with disabilities, and LGBTQ+, with implementation to be completed within five and seven years, respectively. It remains to be seen whether the Ontario Taskforce's recommendations will be adopted.

The 2021 federal budget also proposes a public consultation on measures that would adapt and apply the CBCA diversity requirements to federally regulated financial institutions. The goal is to promote greater ethnic, racial, gender and Indigenous diversity among senior ranks of the financial sector and ensure that more Canadians have access to such opportunities.

As noted above, there is also a CSA proposal under NI 51-107, which would introduce disclosure requirements regarding climate-related matters.

1.5 What significant private sector initiatives relating to ESG are there?

ESG integration into private sector investing decisions continues to evolve. While responsible investing ("**RI**") as a component of risk mitigation is not new, there is a growing transition to focus on RI as an integral component of the value generation analysis. This correlates to growing pressure from the private sector for better standardisation and benchmarking of both disclosures and performance. As a result, the support for development of evaluation standards, rating indexes, and research organisations dedicated to evaluating ESG strategies, performance, responsibilities and risks, such as the Carbon Disclosure Project ("**CDP**"), the Dow Jones Sustainability Index, the ISS ESG, the MSCI ESG Index, and Sustainalytics, are beginning to develop. This also correlates to proxy advisory firms, including Institutional Shareholder Services ("**ISS**") and Glass Lewis ("**GL**"), as well as shareholder groups such as the Canadian Coalition for Good Governance placing a heightened emphasis on ESG factors for the upcoming proxy seasons. Further, the Securities Commissions, through the proposal under NI 51-107, are recommending the implementation of the TCFD Framework or that the proposed instrument is based on the TCFD Framework.

Recently, the CEOs of eight leading pension plan investment managers called for increased transparency from issuers regarding ESG matters and asked issuers to disclose ESG data in a standardised way, pointing to the Sustainability Accounting Standards Board ("**SASB**") standards and the TCFD Framework; along with the 2021 TSM Climate Change Protocol, which aims to support mining companies in managing climate-related risks and opportunities, such as associated mitigation and adaptation strategies, reporting and target-setting. Further, the "360° Governance: Where are the Directors in a World in Crisis?" report, published in February 2021, provides 13 guidelines for modifying corporate governance procedures in order to improve the financial and ESG performance of companies. These guidelines relate to the following categories: corporate purpose; board's duty, definition of stakeholders; Indigenous peoples; reporting on stakeholder impact; stakeholder committee; stakeholder conflicts; compensation policies; board refreshment; board diversity, organisational diversity; climate change; and corporate activism.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

ESG is growing rapidly, with assets in Canada being managed using responsible investment strategies increasing from CA$2.1 trillion at the end of 2017 to CA$3.2 trillion as of December 31, 2019. Assets affected to responsible investment accounted for 61.8% of total Canadian assets under management in 2019, up from 50.6% in 2017 (Responsible Investment Association, *2020 Canadian Responsible Investment Trends Report* (November 2020)). Relatedly, a recent survey indicates that almost 90% of Canadian institutional investors use ESG factors as part of their investment approach and decision-making.

Asset managers in many sectors are focused on the ESG performance, rating and/or evaluation of issuers, with many having specific requirements with respect to expectations or ratings, particularly with respect to environmental stewardship and management, and thus require reports or disclosure responsive to these concerns in order to make investment decisions. However, there are a range of approaches taken to apply their principles to investing decisions. These range from screen or exclusion by restricting investments in certain sectors (such as tobacco or weapons manufacturing), to full ESG integration into investment analysis. Full ESG integration is growing with the gradual increase in recognition of the correlation between ESG and value generation. Asset managers also exert influence through direct and indirect engagement, including through implementation of proxy voting policies and policy-based voting. In this respect, Canadian institutional investors have generally reviewed their voting and engagement policies to increase the focus on ESG risks.

The Canada Pension Plan Investment Board and PSP Investments are among some of the global leaders participating in the ESG Data Convergence Project with the aim towards advancing an initial standardised set of ESG metrics and mechanism for comparative reporting. Initiated by the California Public Employees' Retirement System and global investment firm Carlyle, the collaboration efforts from the ESG Data Convergence Project are intended to consolidate and streamline the private equity industry's approach to collecting and reporting ESG data to create a critical mass of material, performance-based, comparable ESG data from portfolio companies. A primary goal of the project is to provide opportunities for deeper analysis and correlative studies between ESG factors and financial outcomes, with the goal to ultimately result in more meaningful benchmarking and to highlight the more critical ESG issues that have potential for greater impact. The ESG Data Convergence Project will examine the following initial six metrics: Scopes 1 and 2 greenhouse gas emissions; renewable energy; board diversity; work-related injuries; net new hires; and employee engagement.

Further, more than 20 financial organisations in Quebec have signed the Statement by the Quebec Financial Centre for a Sustainable Finance with an aim to solidify Quebec's leadership in sustainable finance and the financial institutions' commitments to sustainable finance and ESG principles. In responding to the climate emergency and pledging a commitment to the statement, the signories have agreed to undertake, pursue or accelerate initiatives within their organisations as well as within their business networks, which include the development of Quebec-based experts in sustainable finance and investment, the expansion of sustainable finance products and services, the advancement of sustainable finance best practices and the enhancement of ESG integration into operations.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Stakeholder views on responsible investment and ESG remain strong, with a growing focus on diversity and inclusion. In a 2020 survey conducted by the Responsible Investment Association, 72% of respondents were interested in responsible investment, with an overwhelming majority concerned about diversity in corporate leadership, particularly with inclusive workspaces free of discrimination.

The lack of BIPOC representation in Canadian corporate leadership has shifted the narrower focus on the issue of gender parity to a more expansive lens of diversity. As previously mentioned, on January 1, 2020, amendments to the CBCA required reporting on specified diverse groups for all distributing corporations under the CBCA. With this level of transparency, a 2021 study, conducted by Stikeman Elliott LLP, showed that amongst S&P/TSX 60 CBCA issuers, only 6.21% of board members and 6.11% of executive officers identified as visible minorities, 0.59% of board members and 0% of executive officers identified as Indigenous persons (First Nations, Inuit, and Métis), and 0.59% of board members and 0.14% of executive officers identified as a person with a disability.

Issues on the environment and climate change also remain important to stakeholders with influence in support of these views exerted through E&S proposals. In 2021, out of the 24 E&S proposals made, nine were environment-related shareholder proposals and three related to diversity matters. This represents an increase from the 2020 figures of 18 E&S proposals, seven of which related to environment matters and another seven of which related to diversity issues. However, it should be noted that overall, the total number of shareholder proposals declined to its lowest since 2013, primarily because many proposals were withdrawn due to companies successfully negotiating away a majority of proposals. Of particular interest is the continued focus of shareholder proposals regarding the carbon-rich assets of banks. A proposal filed by SumOfUs at Royal Bank of Canada ("**RBC**") received over 30% support of votes cast, and requested RBC adopt company-wide, quantitative, time-bound targets and annual reporting on the progress (Institutional Shareholder Services, Katerin Caseles, Rishima Kathuria, Shehrbano Khan *et al.*, *Canada 2021 Proxy Season Review*, pp 11–12).

Still, amongst the most notable developments is the commitment by two Canadian companies (CN Rail and CP Rail) to adopt a non-binding "Say on Climate" vote. This development is of interest given that "Say on Climate" was one of the dominant issues of the 2021 proxy season globally.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The principal regulators of ESG issues are the CSA, the TSX, and the Canadian Federal Government through amendments to the CBCA. These regulators are focused on proper governance and stewardship, board and executive gender diversity with a shift towards diversity more generally, and E&S issues, including environmental and climate change-related risks, risk management and disclosure. In late September 2021, the CSA hosted a virtual roundtable discussion concerning ESG-related issues in asset management, noting the importance of enhancing ESG-related fund disclosure so that investors are informed about the ESG-related aspects of a fund, and can make informed investment decisions. In particular, the discussion highlighted that CSA staff are in the process of developing guidance on ESG-related investment fund disclosure, which would clarify the CSA's current disclosure requirements applied to ESG funds and would cover a number of areas including fund names, investment objectives and strategies, proxy voting and shareholder engagement, risk disclosure, sales communications and ESG-related changes to existing funds. The aim of this guidance is to enhance the ESG-related aspect of disclosure documents and ensure that sales communications are not untrue, misleading or inconsistent.

2.4 Have there been material enforcement actions with respect to ESG issues?

Reporting issuers are subject to specific requirements relating to disclosure of material information as discussed above, including timely disclosure of material changes. In addition to exposure to sanctions and regulatory enforcement for failing to comply with these disclosure obligations, issuers also risk secondary market liability for actions relating to misrepresentations and failure to make timely disclosure. With respect to ESG matters, particular areas of risk include inadequate assessment and/or disclosure of the impact of ESG factors on operations, particularly in respect of environmental and climate change-related liabilities, including changes to applicable regulations.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

As voluntary ESG metrics proliferate the financial market along with regulatory requirements, there is increasing pressure for companies to ensure the adopting of and conformity with ESG standards. Corporate accountability for ESG reporting appears to be on the rise as claims for company ESG policy misstatement and performance litigation has increased, with the prevailing theme being challenges on the truthfulness of ESG statements in conflict with corporate activity and claims directly contesting the conformity of company activities and performance to generally accepted standards and frameworks.

A recent decision of the Ontario Court of Appeal in *Barrick Gold Corporation* (*Drywall Acoustic Lathing and Insulation, Local 675 Pension Fund v. Barrick Gold Corporation*, 2021 ONCA 104) illustrates this risk. In *Barrick Gold*, plaintiffs filed a class action against the corporation with respect to disclosure regarding an important gold mining project that was terminated after four years. Amongst others, plaintiffs argued that the corporation had failed to disclose material facts relating to serious environmental non-compliance regarding the project. While both the motion judge and the Court of Appeal found that plaintiffs had failed to establish environmental misrepresentations by omission, these allegations have led to careful judicial consideration of the context in which the disclosures were made.

In Canada, there appears to be a growing focus on climate change-related litigation involving tort claims against corporations with pressure exerted by the Crown, municipalities, First Nations, private citizens and environmental non-governmental organisations.

With the Supreme Court of Canada's decision in *Nevsun Resources Ltd v. Araya* in early 2020, social factors within ESG also present litigation risk for corporations. In *Nevsun*, Eritrean plaintiffs alleged that the Canadian mining company violated customary international law by allowing human rights abuses in the partly owned Bisha mine (*Nevsun Resources Ltd v. Araya*, 2020 SCC 5). The majority decision to allow the plaintiffs to bring their claim in Canada represents a progression in Canadian judicial thinking on the responsibilities and legal accountability of corporations operating abroad where human rights abuses may occur. ESG disclosure and compliance with ESG metrics is gaining importance as corporate liability is expanding.

A comparable and equally important risk to a company for failure to comply with internal ESG policies is the reputational damage in the marketplace from misinformation or underperformance on ESG metrics.

2.6 What are current key issues of concern for the proponents of ESG?

In the absence of standardised ESG methodology or frameworks, the implementation and evaluation of ESG strategies and ESG strategy outcomes can be challenging for companies and their various stakeholders. Furthermore, the lack of standardised ESG methodology also makes it challenging to provide comparisons across organisations and markets. As such, the lack of standardisation will continue to be a key issue for proponents of ESG with a push to adoption of standardised methodologies or frameworks. In recognition of this issue, in October 2021, the CSA formally supported the establishment of the International Sustainability Standards Board ("**ISSB**") in Canada and offered to host the ISSB headquarters in Canada.

There is a growing trend among investors to focus on ESG analysis rather than ESG investing, the former incorporating ESG-based criteria as a fundamental part of investment analysis utilising a measurable and consistent approach that is fully integrated into the investment process, as opposed to use of ambiguous criteria resulting in only perceived rather than actual value. ESG integration is defined as "the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions", and the expectation over the long term is that "ESG investing" will be so intricately intertwined and integrated into the investment analysis that ESG investing will be the norm as opposed to the exception (CFA Institute, *ESG Integration in Canada* (2020)).

In terms of key areas of focus, there has been a growing focus on social issues including diversity, equal opportunity and inclusion as well as employee health and well-being. Proponents of ESG are pressing for incentive-based compensation structures that reward executives for incorporating and achieving ESG metrics with a focus on health and safety measures. In addition, climate change, emissions reduction and water scarcity continue to remain key environmental issues.

Cybersecurity risk, including data security, is another top-ranked ESG concern for institutional investors as it engages companies' governance and social risks. As the cyberattacks that roiled large corporations in 2019 and 2021 have shown, malicious cyber activity can inflict serious financial, operational and reputational harm on firms. The global COVID-19 pandemic is adding another layer of cybersecurity risk with the continued reliance on a remote-working environment that will likely continue to prevail to a large extent in the long term. The new work-from-home reality is creating new potential avenues for unauthorised access to company data and information technology systems on the part of hackers and cyber criminals.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Generally, ESG strategy is directed by senior management, with relevant responsibilities divided among applicable business units or functions that are accountable and report to the board. Increasingly, there is integration across particular E&S factors given the growing trends of companies to provide consolidated external reports and disclosures, coupled with a shift towards a top-down approach as boards and board committees continue to expand on their direct oversight of E&S-related performance.

As we see investors push for greater ESG disclosure, proxy advisor firms have also made changes to their guidelines, which will influence how management, boards and board committees make decisions. Starting in 2021, GL began noting as a concern when S&P/TSX 60 issuers did not provide clear disclosure regarding the board-level oversight of environmental and/or social issues. GL will generally recommend voting against the chair of the governance committee of an S&P/TSX 60 issuer who fails to provide explicit disclosure concerning the board's role in overseeing E&S matters for shareholder meetings held after January 1, 2022 (Glass Lewis, *2021 Proxy Paper Guidelines, An Overview of the Glass Lewis Approach to Proxy Advice* (2021)). In regard to E&S issues, ISS has adopted a global approach and will generally vote on a case-by-case basis, primarily examining whether implementation of the proposal is likely to enhance or protect shareholder value. Effective for meetings of shareholders being held on or after February 1, 2021, ISS considers, among other things, the existence of significant controversies, penalties, fines, or litigation associated with the company's environmental or social practices in vote recommendations (Institutional Shareholder Services, *Canada, Proxy Voting Guidelines for TSX-Listed Companies Benchmark Policy Recommendations* (November 2020); Institutional Shareholder Services, *Canada, Proxy Voting Guidelines for Venture-Listed Companies Benchmark Policy Recommendations* (November 2020)).

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Board and board committee oversight of ESG strategies is important to ensure that the relevant ESG policies and practices are being incorporated and evaluated to align with the company's broader corporate strategy, while mitigating risk and capitalising on opportunities. Oversight may be achieved with the already established governance committee, while certain organisations elect to form specific ESG-focused committees, including those with mandates focused on matters such as risk management, safety and sustainability, human resources, etc. Notably, Stikeman Elliott's internal 2021 study found that 27 of the S&P/TSX 60 issuers have "specialised" committees related to corporate social responsibility and health, safety and environment. From the board's perspective, holistic ESG integration starts with setting the corporate culture, and then integrating key matters through risk management, corporate strategy, evaluation and compensation and disclosure. Implementation of a robust enterprise risk management framework is often the key component, with governance and accountability and ultimate oversight by senior management and the board.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

The most common approach to compensation and remuneration is the integration of ESG-related targets and metrics into incentive-based compensation, with 63% of the TSX 60 constituents implementing at least one ESG metric into their incentive plan, with an average weight of 20%. Notably, energy and materials companies are leaders in implementing environmental metrics into incentive plans. However, these metrics typically relate to compliance and environmental risk management rather than greenhouse gas emissions and climate strategy (Hugessen Consulting, *2021 Proxy Season Overview Highlights from the TSX 60* (2021)). While these are more prevalently included under qualitative assessment components, there is an increasing trend towards assignment of quantitative weightings; however, the challenges with this approach include selecting components with a direct correlation to desired outcomes (i.e., business strategy, risk mitigation, etc.), ability for a meaningful individual impact, accuracy and measurement, external comparability, consistency and independent verification.

Common ESG metrics include occupational health and safety practices and outcomes, environment and sustainability goals, and diversity and inclusion factors in workforce composition and governance, with targets for health and safety and fatality rates being the most common social factors. Approaches with respect to integration also continue to evolve and include increased weighting, application of ESG modifiers and incorporation into long-term incentives. It is recognised that pairing executive compensation and remuneration incentives with long-term strategic plans including ESG strategies may contribute to the positive delivery of sustained shareholder value creation. However, it is critical for boards to discuss and monitor the selection, design and verification of comprehensive metrics, goals and related achievements associated with executive compensation consistently, and because ESG reporting and evaluation metrics are not standardised, boards should consider engaging independent third-party ESG experts to assist with the verification of ESG data and predetermined metrics to inform board members on company and executive performance. Boards should also consider which ESG factors are most relevant to their business and which factors will materially impact financial and operational performance and create long-term sustainable value. Further consideration should be given to an organisation's stakeholder base, as different stakeholders have called for the use of certain reporting frameworks.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Companies use a variety of mechanisms to integrate ESG into their day-to-day operations. These include specific ESG-related policies and requirements, including the incorporation of ESG-related targets and goals into procurement activities, thoughtful recruiting and hiring practices, stakeholder and Indigenous relations, benchmarking and disclosure, as well as integration into and reporting against achievement of business objectives.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Providers of debt and equity finance rely heavily on externally developed ESG frameworks, standards, and ratings. There are numerous ESG frameworks, such as the UN Sustainable Development Goals, the UN Global Compact, the OECD Guidelines for Multinational Enterprises, Principles for Responsible Investment, and guidelines set out in national Responsible Investment industry associations. While there is a diverse array of external ESG ratings, the three most commonly used standards and frameworks in Canada include the TCFD, GRI, and SASB. All three frameworks may be used by providers of debt and equity finance in combination. The TCFD has greater focus on climate-related financial disclosure, while SASB focuses on investor needs and topics of financial materiality. GRI adds standards on social and governance topics to report on sustainability impacts in a consistent manner.

In 2015, the TCFD developed a framework of 11 recommendations to assist public companies and other organisations to effectively disclose climate-related risks and opportunities leveraging existing reporting processes. The recommendations are based on four areas: governance; strategy; risk management; and metrics and targets. In 2017, the TCFD released climate-related financial disclosure recommendations designed to help companies provide better information to support informed capital allocation.

SASB, established in 2011, developed a set of 77 ESG industry-specific standards applicable around the world. These standards focus on financially material issues reasonably likely to impact the financial condition or operating performance of a company.

GRI first developed standards in 1997 for organisations to report on sustainability impacts in a consistent manner, with a focus on ensuring that organisations are transparent and accountable. GRI sets out universal standards, and topic standards consisting of economic, environmental, or social.

In September 2020, GRI and SASB, together with CDP, the Climate Disclosure Standards Board, and the International Integrated Reporting Council (now merged with SASB), announced a shared vision for a comprehensive corporate reporting system, outlining the ways in which the existing sustainability standards and frameworks can complement generally accepted financial accounting principles. In December 2020, the group published a prototype climate-related financial disclosure standard (SASB, *SASB Standards & Other ESG Frameworks* (2021)).

4.2 Do green bonds or social bonds play a significant role in the market?

Actions to address climate change and greenhouse gas emissions continue to play a critical role in supporting the green bonds market. Investors remain interested in green project initiatives, which include, *inter alia*, renewable energy products, clean technology, and green bond principle-based infrastructure. Domestic investors are the dominant consumers of Canadian-issued green bonds that dedicate funds to specific green projects, which typically are renewable energy projects, clean technology initiatives or low-carbon buildings and developments; however, as green bond funds continue to diversify, investments relating to green transportation and water conservation are gaining popularity.

Canadian-issued green bonds remain a modest presence in the international green bond issuance market in comparison to green bond products emerging from the U.S., Europe, and China (Investment Industry Association of Canada, *Opportunities in the Canadian Green Bond Market v.4.0* (February 2020), https://iiac.ca/wp-content/uploads/Opportunities-in-the-Canadian-Green-Bond-Market-v4.0-Feb-2020.pdf; Reuters, *Canadian green bond market riding high after record quarter* (July 2021)). However, consistent with global trends, ESG bonds are quickly gaining popularity in Canada as companies seek to increase their "green" or sustainability credentials through a focus on renewable energy, pollution reduction, or climate change. For example, sustainable debt issuance in Canada is projected to surpass US$1 trillion this year, which represents a 30% increase from all of 2020 (*Financial Post*, Stefanie Marotta, *The ESG Focus Has Exploded: Sustainability-Linked Bonds Bringing New Issuers to The Table* (July 2021)).

The issuance of Canadian green bonds has been traditionally led by public sector issuers (Responsible Investment Association, *Green Bonds – Fact Sheet for Investors* (2019), https://www.riacanada.ca/content/uploads/2019/02/Green-Bonds-Fact-Sheet.pdf), including ISED and subnational issuers in Ontario and Quebec; however, continued interest in green bond principle-based investments has attracted the attention of a broader spectrum of issuers, including certain Canadian corporations and pension funds.

There are various categories of green bonds. The first, and most commonly used in Canada, are bonds with green use of proceeds. These bonds are like general obligation bonds except that all the funds are directed towards green initiatives and projects. The second are project development bonds. The proceeds from this second type of green bond fund specific purpose entities that own either a single project or many green projects. The third type of green bond are securitisation bonds. These bonds are collateralised by a pool of loans issued to fund numerous green projects.

Sustainability-linked bonds, while relatively new in the ESG investing scene, are becoming increasingly popular because unlike traditional green and social bonds, they do not impose restrictions on how the proceeds can be used. A few notable examples are Telus and Enbridge. Telus was the first Canadian company to issue sustainability-linked bonds, raising CA$750 million in bonds that pay a low interest rate if the company reduces its greenhouse gas emissions. Calgary-based Enbridge was the first North American pipeline company to offer sustainability-linked bonds, whose US$1 billion sale included goals in reducing carbon emissions and bolstering workforce inclusion.

4.3 Do sustainability-linked bonds play a significant role in the market?

The size of the sustainable investment market is still small relative to the larger retail fund market in Canada; however, the sustainable investment market is a growing area as evidenced by the number of new sustainable fund launches over the last few years.

In regard to regulatory action, the OSC approved amendments to the TSX Rule Book to reflect trading of sustainable bonds on the TSX, expanding the types of securities that are able to be traded on the TSX to include sustainable bonds. Sustainable bonds became available for trading on the TSX as of March 1, 2021 (TSX, *TMX Equities Announces Sustainable Bonds Production Launch Details* (n.d.)).

The main goal of the sustainable bond initiative is to increase accessibility and transparency of securities that are already available to Canadian investors.

4.4 What are the major factors impacting the use of these types of financial instruments?

A major factor impacting the use of sustainable bonds, including green and social bonds, is the lack of regulatory verification and standardisation for these types of financial instruments as discussed further in question 4.5. A consequence of a voluntary system for verification is that many bonds arguably lack transparency on which sustainable projects or technologies will be financed. The need for consistency and transparency is heightened in the context of labelling green bonds as "greenwashing" or a reduction in standards, which could shake investor confidence in these valuable financial instruments.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The International Capital Market Association ("**ICMA**") Green Bond Principles are the leading framework and guideline resource for green bond supply in Canada. The ICMA Green Bond Principles are voluntary process guidelines that recommend principles of transparency, disclosure and integrity in the development of green bonds and are intended for broad use by the market, including issuers, various stakeholders, investors, and underwriters.

Canadian green bond programmes can be further bolstered by independent reviews from organisations such as Sustainalytics and the Center for International Climate and Environmental

Research – Oslo ("**CICERO**"). The International Organization for Standardization ("**ISO**") recently published parts of its international green bond standard (the ISO 14030 series) that may also enhance investor appetite for green bonds. In particular, ISO 14030-4:2021 now establishes requirements for verification bodies that review claims of conformity to the ISO 14030 series (ISO, *ISO 14030-4:2021 Environmental performance evaluation – Green debt instruments – Part 4: Verification programme requirements* (September 2021)).

The introduction of sustainable or green bonds into the market is relatively new, but their popularity is growing precipitously. Currently, there are no Canadian regulations established to provide verification of green bonds – only voluntary guidelines. The voluntary approach to green bond verification has resulted so far in a disjointed domestic and global market, creating ambiguity for what constitutes a green bond, and may potentially be hindering the growth of these types of financial instruments.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

COVID-19 has triggered a global health crisis that has disrupted social and corporate networks, constrained local and global communities, and negatively impacted financial and economic markets. For certain companies and industries, COVID-19 has had a significant short-term impact on ESG practices where capital preservation caused by business disruption or uncertainty has been a priority. For most businesses, however, the impact of COVID-19 has underscored the focus on human capital and health and safety matters, as well as compensation governance, digital data, and communications management.

Indeed, many companies facing COVID-related issues were expected to shelve their ESG initiatives and displace their sustainability goals to shift their focus on emergency response plans and recovery strategies; however, a survey conducted by EY revealed the opposite. It was reported that 85% of companies are now more focused on integrating ESG and sustainability goals into their recovery strategies, compared to pre-pandemic periods (EY, Sean Harapko, *How COVID-19 Impacted Supply Chains and What Comes Next* (February 2021)). The severe disruption brought on by the global pandemic highlighted vulnerabilities and underlying problems within companies. Companies were, in turn, propelled to examine and challenge historical policies and practices with the aim of optimising and altering operational, logistic, and labour and employment strategies to become more resilient, collaborative, and connected with customers, suppliers, investors and stakeholders. Generally, these companies were able to rise to the challenge in responding to a multitude of variables, including investor demands for increased ESG performance reporting, increased customer expectations for sustainability, increased regulation from other countries, and employee desire for company engagement in ESG and sustainability initiatives.

With respect to investors, the global impact of COVID-19 has also magnified the importance of incorporating ESG factors into investment decisions in order to support and safeguard long-term investment strategies. Similarly, a survey conducted by ISS ESG of 65 leading global asset managers indicated that social issues are attracting more attention now than before COVID-19 and that governance remains a critical ESG factor in investment analysis. In accordance with the emphasis on social issues, asset managers are expecting to place more emphasis on workplace safety, employee treatment, and diversity and inclusion.

6 Trends

6.1 What are the material trends related to ESG?

As discussed above, the COVID-19 pandemic has accelerated the trend of greater ESG integration by highlighting the role of business in wider societal issues. In particular, ongoing regulatory changes, social pressures and shifting expectations for private enterprise have heightened and will continue to heighten demand for businesses to take responsibility for externalities affecting the environment and society. In fact, a recent survey of institutional investors, consultants and investment professionals conducted by RBC Global Asset Management revealed that the top ESG concerns for investors are corruption, climate change risk and shareholder rights.

Further, there is growing recognition amongst business and investment professionals that ESG issues can have a material impact on company value and management of these risks can preserve and enhance economic value for companies and their shareholders (Harvard Law School Forum on Corporate Governance, Kosmas Papadopoulos *et al.*, *ESG Drivers and the COVID-19 Catalyst* (December 2020)).

In addition to changes resulting from the COVID-19 pandemic, the Canadian corporate environment will likely continue to see an increased focus on diversity and inclusion, including increased pressure on companies to adopt meaningful targets or goals with respect to representation of women on boards and in senior positions, as well as an expansion to address representation of BIPOC communities.

Sustainability and responsible environmental practices will also continue to be in focus, with a transition towards third-party standardisation and frameworks, including verification and benchmarking. With respect to ESG factors generally, investors will likely also continue to push for better disclosure and explanation on how they integrate ESG metrics into key business strategies, and measurement and disclosure of their effects.

By way of example, issuers are increasingly highlighting their focus on relations with Indigenous communities. Millani found that 40% of the S&P/TSX Composite Index constituents with an ESG report provided disclosure on their management and approach of Indigenous relations. There has also been increased attention being paid by corporate issuers to water consumption and wastewater management – in 2020, 60% of ESG reports provided disclosure related to water use, compared to 45% in 2019. Biodiversity is another key risk for companies, with 38% of issuers with ESG reports discussing biodiversity (Millani, *Millani's Annual ESG Disclosure Study: A Canadian Perspective* (September 2021)).

6.2 What will be the longer-term impact of COVID-19 on ESG?

The COVID-19 pandemic has accelerated societal and economic change in an unprecedented way, and its long-term impacts remain uncharted. The forecasted recession and "long ascent" of global economic recovery following COVID-19 will require financial markets to display commitment and decisive action (ISS ESG, *Volatile Transitions Navigating ESG in 2021, Annual Global Outlook* (2021)). As a result of the disruption caused by the COVID-19 pandemic, investors, policymakers and key decision-makers will likely prioritise the evaluation of risk management and mitigation.

ISS ESG also highlights the growing importance of climate change and increasing awareness of biodiversity. Additionally, the survey suggested that the pandemic has raised investor consideration around labour relations, supply chains and diversity (Investment Executive, Langton, J., *Canadian institutional investors have high hopes for ESG portfolios* (2020), https://www.investmentexecutive.com/news/research-and-markets/canadian-institutional-investors-have-high-hopes-for-esg-portfolios/?utm_source=newsletter#038;utm_medium=n; ISS ESG, *Volatile Transitions Navigating ESG in 2021, Annual Global Outlook* (2021); ISS ESG, *Volatile Transitions Navigating ESG in 2021, Americas* (2021)).

While the term "ESG" is broadly accepted in responsible investment markets, the range of issues that responsible investors are called upon to consider daily continues to expand.

Although all ESG factors remain integrated, COVID-19 appears to have shifted a greater emphasis on the social considerations of ESG over the governance and environmental aspects. Asset owners have displayed an increased focus on stewardship activities that hold companies accountable for ESG risks – especially in those sectors weakened by COVID-19. Corporate priorities have been refocused to enhance employee health and safety, to assess factors relating to employee productivity, engagement, and retention, and to consider revising work environment policies and incorporating flexible working arrangements. As a result, many employers will likely review long-term strategies to support modified work environments, enhancement of employee physical and mental health and wellness, employee workplace engagement, training or re-training, work systems, and flexible work arrangements to avoid productivity losses and to address longer-term changes in employee preferences and employment considerations.

The COVID-19 pandemic has also further strained economic disparity in societies, with the exposure of societal inequalities and workforce risks. This strain will likely increase the focus of ESG efforts on community engagement and impact, with a view to more directly facilitating positive community and societal outcomes, including diversity and inclusion, pay equity and equal opportunity.

With respect to governance, the COVID-19 pandemic may have highlighted gaps in director and senior management responses in relation to crisis management and change management, and may encourage a broader view of board and management composition requirements. These areas may include cybersecurity and digital governance, as well as human resource management and employee engagement.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Compared with European and American markets, the development of ESG in China is still in its initial stage. The main substantive laws and regulations related to ESG are as follows:

1. Since the 18th National Congress of the Communist Party of China, China has comprehensively revised its laws and regulations on ecological environment, and established a relatively complete legal system for ecological civilisation. China has established a legal system for environmental protection, with the *Environmental Protection Law* as the core and laws on the prevention and control of water, air, soil, solid waste, noise, nuclear and radiation pollution as the main aspects. Meanwhile, China has comprehensively revised the *Land Management Law*, the *Mineral Resources Law*, the *Water Law*, the *Forest Law*, the *Wildlife Protection Law* and other laws related to resource protection.
2. The *Civil Code* has established the green principle, stipulated the green development obligation of relevant subjects, put forward the behavioural requirements of green development, stipulated the responsibility system of guaranteeing green development, and formed a systematic green principle, system and norm.
3. The *Securities Law*, amended on March 1, 2020, added a special chapter on information disclosure and a special chapter on investor protection, emphasising that listed companies should fully disclose information necessary for investors to make value judgments and investment decisions. The *Green Finance Regulation of Shenzhen Green Special Zone*, China's first regulation on green finance, requires that listed financial companies registered in Shenzhen must disclose environmental information starting in 2022.
4. In recent years, there have been significant developments in supporting policies related to ESG. The China Securities Regulatory Commission (CSRC) has made a series of regulations on environmental information disclosure of listed companies. The Asset Management Association of China (AMAC) officially released the *Research Report on Chinese Listed Companies' ESG* and *Green Investment Guidelines (Trial)*, establishing a core index system to measure the performance of listed companies' ESG. In 2019, the Shanghai Stock Exchange issued the *Listing Rules of the Shanghai Stock Exchange Science and Technology Innovation Board* to clarify the information disclosure requirements of ESG. In April 2021, the People's Bank of China, the National Development and Reform Commission, the CSRC and other authorities jointly issued the *Notice on Printing and Distributing the Catalogue of Projects Supported by Green Bonds (2021 Edition)*, unifying the standards for green bonds in China. In June 2021, the Ministry of Ecology and Environment issued the *Reform Plan for the Legal Disclosure System of Environmental Information*, setting the primary goal of basically establishing a mandatory environmental information disclosure system by 2025.

The Chinese government and regulatory authorities have introduced a series of strategies and policies conducive to the development of ESG, such as putting forward the goal of "carbon neutrality", introducing green finance policies, strengthening the high-quality development of listed companies, and establishing carbon trading mechanisms, which have further improved the ESG system in the domestic market.

1.2 What are the main ESG disclosure regulations?

The *Environmental Protection Law* revised in 2014 added a special chapter on information disclosure and public participation, clarifying the public's rights to know, participate and supervise, requiring key pollutant-discharging units to voluntarily disclose environmental information, and improving the procedures for public participation in environmental impact assessment of construction projects. Since then, the *Air Pollution Prevention and Control Law* and *Water Pollution Prevention and Control Law* and other special laws have been amended to make special provisions on the disclosure of enterprise environmental information.

From a policy perspective, in 2017, the CSRC made requirements on the content and format of annual and semi-annual reports of listed companies. According to relevant regulations, companies or their important subsidiaries that belong to key pollutant-discharging units shall disclose information on environmental pollution and discharge.

The *Guiding Opinions on the Building of a Green Financial System* issued by the People's Bank of China and other departments clearly stated that China should establish a system of mandatory disclosure of environmental information by listed companies step by step. In 2019, the Shanghai Stock Exchange issued a special section on "social responsibility" in the *Listing Rules of the Shanghai Stock Exchange Science and Technology Innovation Board*, requiring listed companies to disclose how they fulfil their social responsibilities, including protecting the environment, ensuring product safety, and safeguarding the legitimate rights and interests of employees and other stakeholders.

Government departments will improve the environmental credit evaluation system for enterprises, establish a blacklist system for polluters, and jointly punish enterprises that violate environmental laws for breaking their trust. At the same time, it is also proposed to establish a mandatory environmental governance information disclosure system for listed companies and bond issuers.

The *Green Finance Regulation of Shenzhen Special Economic Zone* is the first step in China's ESG-related laws and regulations. As a pilot, for the first time, Shenzhen has required enterprises to provide environmental information in the form of regulations.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

At present, most Chinese enterprises still have low requirements for implementing ESG, and the disclosure of ESG data still lacks certain standards. Regulatory authorities are actively formulating ESG-related standards and relatively uniform guidelines and templates for ESG information disclosure. The AMAC issued the *Green Investment Guidelines (Trial)* in November 2018, encouraging all kinds of professional institutional investors to carry out green investment, encouraging qualified institutions to invest in ESG, and requiring fund managers to conduct a self-assessment of green investment once a year.

1.4 Are there significant laws or regulations currently in the proposal process?

In September 2020, the CSRC publicly solicited opinions on the *Provisions on the Management of Rights of Shareholders of Listed Companies (Draft)*, detailing and clarifying information disclosure requirements. In February 2021, the CSRC added relevant ESG content in the revised *Guidelines on Investor Relations Management of Listed Companies (Draft for Comments).*

1.5 What significant private sector initiatives relating to ESG are there?

Private sector initiatives related to ESG focus on ESG disclosure. More and more enterprises are incorporating environmental, social and governance elements into their business development strategies and business decisions, and formulating and publishing corporate sustainability reports. When the carbon emissions trading system starts, companies will make a low-carbon transformation.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Over the past few years, as the capital markets have shifted more attention to more responsible companies, investors and asset managers have increasingly attached importance to ESG, and ESG investments have seen unprecedented growth. ESG investments combine non-financial indicators such as corporate governance, energy efficiency and community relations to measure the current and future development prospects of an enterprise, with low long-term holding risks.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Many non-profit organisations, industry associations, scholars and experts support ESG. They say that ESG practices will enhance the value of enterprises, and that there is a positive correlation between the two. However, due to the late start of ESG investment in China, the requirements of national regulatory authorities on disclosure of ESG are mainly concentrated in listed companies, while small enterprises have not actually carried out ESG work.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In mainland China, the institutions mainly responsible for ESG include: the National Development and Reform Commission; the Ecological Environment Department; the People's Bank of China; the Banking and Insurance Regulatory Commission; the CSRC; stock exchanges; and industry associations, etc. Regulatory authorities have successively issued policies that have played an important role in the process of establishing an ESG market mechanism. Regulators believe that there are still many problems in ESG investment and practice, such as poor operability and implementation of ESG management and information disclosure policies, lack of understanding of investment philosophy, limited scope of data disclosure, insufficient degree of data standardisation, a non-mandatory ESG information disclosure system as a whole, inconsistent evaluation results, etc.

2.4 Have there been material enforcement actions with respect to ESG issues?

Since 2015, China has taken a series of tough environmental protection law enforcement actions, including two rounds of central environmental protection inspections. At the same time, a compensation system for ecological and environmental damage has been established, and claims for ecological and environmental damage have been launched nationwide. In capital market regulation, there is no large-scale enforcement or judicial action on environmental information disclosure and other responsibilities.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

In 2014, the *Environmental Protection Law* established an environmental public interest litigation system, and amendments were made to the *Civil Procedure Law* and the *Administrative Procedure Law*. A compensation system for ecological and environmental damage has been gradually established since 2015, and was incorporated into the *Civil Code* in 2020. A series of litigation systems have been constructed, such as an environmental private interest infringement litigation system, an environmental public interest litigation system, an environmental administrative litigation system, an environmental pollution criminal litigation system and so on.

2.6 What are current key issues of concern for the proponents of ESG?

At present, the key issues for ESG supporters are environmental protection, social responsibility and corporate governance. In addition, the poor quality of ESG reports, irregular ESG ratings, incomplete information disclosure, and the impact of COVID-19 on macroeconomic uncertainties were also highlighted.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

According to Article 42 of the *Environmental Protection Law of the People's Republic of China*, enterprises and institutions that discharge pollutants shall establish an environmental protection responsibility system and clarify the responsibilities of persons in charge of units and relevant personnel.

Pursuant to the *Guidelines for Green Credit* issued by the former China Banking Regulatory Commission in 2012, the board of directors or the council of the financial institutions in the banking industry should be responsible for determining the green credit development strategy, examining and approving the green credit goal formulated by the senior management and the green credit reports submitted by the senior management, and supervising and evaluating the implementation of the green credit development strategy of the institution. The senior management of the financial institutions in the banking industry shall, in accordance with the decisions made by the board of directors or the council, formulate the green credit goal, establish the mechanism and processes, define duties and authority, carry out internal control inspection and appraisal, report to the board of directors or the council on the development status of green credit every year, and promptly report the relevant information to the regulatory authorities. The senior management of the financial institutions in the banking industry shall appoint one senior manager to lead the management department, allocate the corresponding resources, and organise, carry out and centrally manage various works of green credit. Where necessary, a cross-departmental green credit commission may be established to coordinate the relevant work.

On June 28, 2021, the CSRC published the revised versions of the information disclosure rules relating to annual reports and half-year reports for listed companies (the New Disclosure Rules). The New Disclosure Rules contain a revised corporate governance section, which consolidates all provisions relating to corporate governance. The support of the board of directors is now the key factor to ensure the success of the company's ESG governance.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The New Disclosure Rules enhance disclosures on the performance and functions of the board of directors and its special committees of listed companies, as well as information on controlling shareholders and ultimate controlling persons. It is encouraged to integrate ESG into the company's business operations and plans. The board of directors may set up the ESG Committee; for example, certain listed companies have set up their ESG Committees.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

The *Guidelines on Governance of Listed Companies* provide that the performance appraisal of senior management personnel conducted by the listed company should be an important basis for determination of remuneration and other incentives for senior management personnel. Listed companies should actively practise green development, include ecological and environmental protection requirements in development strategies and corporate governance processes, actively participate in the development of ecological civilisation, and play a demonstration and leading role in pollution prevention, resource conservation, ecological protection, etc. The *Green Finance Regulation of Shenzhen Green Special Zone* encourages financial institutions to establish and improve their organisation governance, performance appraisals, incentive policies and internal control systems to promote green financing.

In practice, many companies are still in the preliminary stages of aligning incentives with respect to ESG. ESG is required to be incorporated into the business strategies and operations of companies (especially listed companies); therefore, it would have an adverse impact on performance appraisals and remuneration of the board of directors and management if they fail to satisfy the ESG requirement. On the contrary, positive performance appraisals and remuneration may result from the successful implementation of ESG strategy and the achieved sustainable development of the company.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Many companies and financial institutions have integrated ESG into their daily operations. The *Green Investment Guidelines (Trial)* require fund managers to develop diversified green investment products. For actively managed green investment products, investment targets that do not conform to the green investment philosophy and investment strategy should be included in the negative list. The fund manager is required to conduct a self-assessment of the green investment status once a year, which includes, but is not limited to, the company's green investment philosophy, the establishment of a green investment system, and the achievement of green investment goals.

From the environmental information disclosure perspective, the *Reform Plan for the Legal Disclosure System of Environmental Information* requires certain companies to comply with mandatory disclosure requirements on environmental information, including key pollutants, companies that implement mandatory clean production audits, listed companies that have been held criminally responsible or subject to major administrative penalties for ecological and environmental violations, enterprises who issue bonds, and other enterprises and institutions that are subject to mandatory disclosure of environmental information according to laws and regulations.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

ESG ratings play an increasingly important role in investment and financing. The *Guiding Opinions on the Building of a Green Financial System* emphasise the studying and exploring third-party assessment and rating standards for green bonds. Institutional investors are encouraged to refer to green assessment reports when making investment decisions. Credit rating agencies are encouraged to specifically assess an issuer's green credit records, the green degree of its equity investment projects, the impact of environmental costs on the issuer and the debt credit rating in the credit rating process, and disclose such information separately in the credit rating report.

In respect of investments made by funds, the *Green Investment Guidelines (Trial)* provide that fund managers that carry out green investments could build the environmental evaluation system and environmental evaluation database on target assets by themselves or through a third party. For actively managed green investment products, fund managers should incorporate green factors into the fundamental analysis dimension, and use green factors as risk-return adjustment elements to assist with investment decision-making.

In respect of financing from the banks, the *Guidelines for Green Credit* promulgated by the China Banking Regulatory Commission in 2012 provide that financial institutions in the banking industry should formulate criteria for evaluation of clients' environmental and social risks, conduct dynamic evaluation and classification of clients' environmental and social risks, consider the relevant results as an important basis of clients' ratings, credit access, management and withdrawal, and adopt differential risk management measures in respect of inspections of loans, pricing of loans and allocation of economic capital, etc. Financial institutions in the banking industry should strengthen their ability to construct green credit, establish and improve upon the marking and statistical system of green credit, improve the relevant credit management systems, strengthen training on green credit, and cultivate and introduce the relevant professional talents. Where necessary, the relevant professional services may be obtained through the review of environmental and social risks by qualified and independent third parties or through other effective methods of service outsourcing.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds play a significant role in the Chinese market. Pursuant to the *Guiding Opinions of the China Securities Regulatory Commission on Supporting the Development of Green Bonds*, green bonds refer to the corporate bonds that comply with the requirements of the *Securities Law*, the *Company Law*, the *Administrative Measures for the Issuance and Trading of Corporate Bonds* and other relevant laws and regulations, and follow the requirements of relevant rules of the stock exchange to raise funds that are used to support green industry projects.

According to the *2020 China Green Bond Market Report* released by the China Bond R&D Center, the substantial green bonds issued in China reached 1.25 trillion yuan in 2020. Substantial green bonds herein refer to funds raised in compliance with any of the following four standards: the *Green Bond Support Project Catalog* of the People's Bank of China; the *Green Bond Issuance Guidelines* of the National Development and Reform Commission; the *Green Bond Principles* of the International Capital Market Association; and the *Climate Bonds Taxonomy* of the Climate Bonds Initiative, and funds invested into green projects that account for no less than 50% of the total raised amount.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds are still at the emerging stage in the Chinese market. According to reports, the first batch of seven sustainability-linked bonds were recently successfully issued in May 2021. These projects were all medium- and long-term bonds of two years or more, with an issuance amount of 7.3 billion yuan.

4.4 What are the major factors impacting the use of these types of financial instruments?

Pursuant to the *Guiding Opinions of the China Securities Regulatory Commission on Supporting the Development of Green Bonds*, green bonds should be invested mainly into industries in the *Green Bond Support Project Catalog*, focusing on supporting green industries such as energy conservation, pollution prevention, resource conservation and recycling, clean transportation, clean energy, ecological protection and adaptation to climate change. Funds raised by green bonds shall not be invested into industries with high pollution, high energy consumption, or other industries that violate the guidance of national industrial policies. In addition, how to use funds raised by green bonds will be subject to verification and information disclosure requirements.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Pursuant to the *Green Bond Evaluation and Certification Behavior Guidelines (Interim)*, green bonds are subject to pre-issuance evaluation and interim evaluation.

The main content of the pre-issuance evaluation of green bonds includes, but is not limited to, whether: (1) the green project to be invested is in compliance; (2) the green project selection and decision-making system is complete; (3) the green bond fundraising management system is complete; (4) the green information disclosure and reporting system is complete; and (5) the expected environmental benefits of the green project are reasonable.

The main content of green bond interim evaluation includes, but is not limited to, whether: (1) the green projects that have been invested are in compliance; (2) the green project screening and decision-making system has been effectively implemented; (3) the green bond fundraising management system has been effectively implemented; (4) the green information disclosure and reporting system has been effectively implemented; and (5) the expected environmental benefits of the green project have been achieved.

In respect of green bonds of non-conformity, the green bond mark would be revoked and will not be restored during its term.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

COVID-19 has affected the entire world and made all business people aware of the importance of ESG indicators. Sustainable development and green recovery have become the theme of today's development. The COVID-19 pandemic has made people realise the importance of the ecological environment. According to a survey, the top-five global risks in 2021 are failure of climate action, public health emergencies, man-made environmental damage, biodiversity and extreme weather. With the exception of COVID-19, the other four risks are all environmental risks, and the environmental and social attributes of risks are unusually prominent. Social problems caused by the pandemic have also drawn people's attention.

COVID-19 has exposed many social governance problems, including information transparency and emergency management, and the lack of attention to relevant risk management. The impact of COVID-19 on ESG practice is mainly driving investors to rethink the way they invest.

In addition, in the process of fighting against the pandemic, large domestic enterprises have made full use of science and technology to solve many social problems. For example, online offices, online education and other technologies have been fully used. The number of dispute cases resolved by online mediation has increased significantly.

6 Trends

6.1 What are the material trends related to ESG?

From the perspective of national policies, China's carbon dioxide emissions aim to peak by 2030, and China strives to achieve carbon neutrality by 2060. Driven by the "dual carbon" policy, it will become the main driving force to stimulate ESG investment in the future. According to the *14th Five-Year Plan of the People's Republic of China for National Economic and Social Development and the Outline of the Vision for 2035*, high-quality development will be the theme of economic and social development during the *14th Five-Year Plan* period.

From the perspective of policy mechanism to promote the process, the importance of ESG information disclosure will become increasingly prominent. Information disclosure requirements for the financial industry will be upgraded, environmental disclosure requirements for polluting industries will be upgraded, and standardised management of carbon trading will be put into operation. New green finance evaluation rules for the banking industry will be issued. The annual report and semi-annual report of listed companies should increase the disclosure requirements of environmental and social responsibility information.

From the perspective of ESG market development, investors are gradually increasing their attention to ESG investment. From the perspective of enterprise information disclosure, the requirements of ESG information disclosure are constantly improving, and gradually transitioning from voluntary disclosure to mandatory disclosure.

6.2 What will be the longer-term impact of COVID-19 on ESG?

The COVID-19 pandemic has had a strong impact on global financial cooperation and finance, prompting all parties to take more measures to achieve green and sustainable development. In the long term, China will embrace significant development opportunities in ESG in the context of its own high-quality development and international sustainable development. In addition, the COVID-19 pandemic has promoted the importance of scientific and technological development, and encouraged domestic companies to constantly improve the capability of science and technology on ESG issues.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

There are longstanding laws that establish standards on corporate governance (including relevant ESG-related requirements as discussed below in the Companies Ordinance (Cap 622) ("Companies Ordinance"), the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Listing Rules") and the Corporate Governance Code (Appendix 14 to the Main Board Listing Rules; Appendix 15 to the GEM Listing Rules) ("CG Code")), as well as other areas such as employment and labour relations, health and work safety, anti-discrimination, as well as laws against financial crime (e.g. the Anti-Money Laundering and Counter-Terrorist Financing Ordinance and the Prevention of Bribery Ordinance).

There are also existing laws and regulations in Hong Kong on environmental protection and biodiversity, covering areas such as conservation, air pollution, water pollution and waste disposal, including the Genetically Modified Organisms (Control of Release) Ordinance (Cap 607), which gives effect to the Cartagena Protocol on Biosafety to the Convention on Biological Diversity.

In particular, however, Hong Kong has a strategic role in driving capital and investments towards green or sustainable finance, being among the world's largest stock exchanges by market capitalisation, and as an international financial centre and asset management hub. With significant policy development in relation to green or sustainable finance in recent years, the Securities and Futures Commission ("SFC") and the Hong Kong Monetary Authority ("HKMA") have led the introduction of new or proposed requirements on ESG, green finance and on green and sustainable banking.

With respect to Hong Kong SFC-licensed fund managers, the SFC launched a "Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers" in October 2020, and the consultation conclusions as well as a Circular to licensed corporations on management and disclosure of climate-related risks by fund managers were issued in August 2021 ("Climate-related Risks Circular"). Amendments are made to the Fund Manager Code of Conduct ("FMCC") to require Hong Kong SFC-licensed fund managers to consider climate-related risks in their investment and risk management processes, and to make appropriate disclosures to meet investors' growing demand for climate risk information and to combat greenwashing. The requirements cover four key elements, namely governance, investment management, risk management and disclosure, while the Climate-related Risks Circular sets out the expected standards for complying with the amended FMCC, which include baseline requirements for fund managers managing collective investment schemes and enhanced standards for fund managers with collective investment schemes under management that equal or exceed HK$8 billion in fund assets for any three months in the previous reporting year.

The SFC's requirements are applicable based on the relevance and materiality of climate-related risks to the investment strategies and funds managed by the fund managers as well as their roles. The requirements only apply to fund managers with investment management discretion, although where fund managers delegate the investment management function to sub-managers, they retain the overall responsibility for complying with the SFC's requirements. There is a transition period of 12 months (for "Large Fund Managers") to 15 months (for other fund managers) to comply with the new requirements.

More policy and regulatory initiatives with enhanced requirements on financial institutions and corporations around ESG are expected, especially with respect to climate, and also as Hong Kong further develops its ambition to be the global ESG investment hub of Asia (including recommendations of the Financial Services Development Council ("FSDC") published in July 2020 ("FSDC 2020 Paper"). The Green and Sustainable Finance Cross-Agency Steering Group ("Steering Group") was set up in May 2020 and co-chaired by the HKMA and the SFC, with other members comprising the Environment Bureau, the Financial Services and the Treasury Bureau, Hong Kong Exchanges and Clearing Limited, the Insurance Authority ("IA") and the Mandatory Provident Fund Schemes Authority ("MPFA"). It aims to coordinate the management of climate and environmental risks to the financial sector, accelerate the growth of green and sustainable finance in Hong Kong and support the Hong Kong government's climate strategies. In the Chief Executive of Hong Kong's 2021 policy address in October 2021, the government reiterated its pledge to achieve carbon neutrality by 2050 while Hong Kong's updated Climate Action Plan 2050 sets out more proactive strategies and measures on reducing carbon emissions, and would pursue more aggressive interim decarbonisation targets to reduce Hong Kong's carbon emissions by 50% before 2035 as compared to the 2005 level.

In addition, the Hong Kong government launched the first city-level Biodiversity Strategy and Action Plan ("BSAP") 2016–2021 for Hong Kong in accordance with the principles and guidelines set out in the Convention on Biological Diversity, taking into account local needs and priorities and with a view to step up biodiversity conservation and to support sustainable development. In anticipation of the launch of the second BSAP upon expiry of the BSAP 2016–2021, we may see further substantive regulations enacted to support Hong Kong's efforts on biodiversity conservation and to complement China's national BSAP.

1.2 What are the main ESG disclosure regulations?

The Companies Ordinance mandates all registered companies in Hong Kong (unless exempted) to include, in the business review section of their annual directors' report, "a discussion on the company's environmental policies and performance and the company's compliance with the relevant laws and regulations that have a significant impact on the company" and "an account of the company's key relationships with its employees, customers and suppliers and others that have a significant impact on the company and on which the company's success depends". Another requirement of the business review is to provide "a description of the principal risks and uncertainties facing the company". Companies that meet certain specified criteria may qualify for simplified reporting and be exempted from the said requirement for business review (for example, private companies of a revenue or assets levels below certain thresholds), while the requirements are generally applicable to public companies.

Listed companies

For companies listed on the Stock Exchange of Hong Kong ("HKEx"), in addition to business review disclosure requirements under the Companies Ordinance, they are further subject to disclosure requirements under the Environmental, Social and Governance Reporting Guide (Appendix 27 to the Main Board Listing Rules; Appendix 20 to the GEM Listing Rules) ("ESG Reporting Guide"), which covers the environmental and social aspects, and the CG Code, which covers corporate governance. The ESG Reporting Guide sets out an ESG disclosure framework that, with effect from July 2020, is mandatory in relation to reporting on the board's engagement and oversight on ESG matters and requiring "comply or explain" disclosure in relation to four environmental and eight social aspects.

Under the mandatory disclosure requirements, board directors are expected to provide a statement on the board's oversight of ESG issues, its ESG management approach and strategy, and how the board reviews progress made against ESG-related goals and targets and how these relate to the issuer's businesses. The ESG Report must also disclose how the company addresses materiality in ESG factors, and describe any stakeholder engagement and the significant stakeholders identified, and the process and results of the issuer's stakeholder engagement.

Listed companies are subject to "comply or explain" disclosures on each identified environmental and social aspect set out in the ESG Reporting Guide, as well as disclosing key performance indicators to demonstrate how they have performed. The environmental aspects are:

- emissions;
- use of resources;
- environment and natural resources; and
- climate change.

The social aspects are:

- employment;
- health and safety;
- development and training;
- labour standards;
- supply chain management;
- product responsibility;
- anti-corruption; and
- community investment.

In May 2019, the HKEx also amended its Guidance Letter HKEX-GL86-16 on disclosure in listing documents by new listing applicants, to require additional disclosure on policy of board diversity (including gender) and how gender diversity of the board can be achieved in the case of a single-gender board. To align with obligations under the ESG Reporting Guide, the Guidance Letter also sets out the expected disclosure of ESG matters for new listing applicants, including material information on an applicant's environmental policies, and details of the process used to identify, evaluate and manage significant ESG risks.

The CG Code, first introduced by the HKEx in 2005 and as amended, sets out the principles of good corporate governance with two levels of recommendations: code provisions; and recommended best practices. Code provisions are subject to "comply or explain" requirements, while recommended best practices are subject to voluntary disclosure and are for guidance only. Issuers are encouraged, but not required, to state whether they have complied with the recommended best practices and provide considered reasons for any deviation. In the most recent review of the CG Code and proposed amendments published in April 2021 for market consultation ("CGC Review"), board diversity has been highlighted as one of the key focuses, considered an important driver of a board's effectiveness. The CG Code requires listed companies to adopt a diversity policy and to disclose this policy or a summary of this policy in the issuers' corporate governance reports. In the latest review, among other proposals, it was proposed that diversity is not considered to be achieved for single-gender boards and to require all listed companies to set and disclose numerical targets and timelines for achieving gender diversity at both board level and across the workforce (including senior management).

There have been efforts to align corporate governance and ESG matters; for example, as seen in the requirement under the ESG Reporting Guide for board engagement and assessment of ESG issues for listed companies. It is proposed to include ESG risks in the context of risk management under the CG Code as well as to revise the Listing Rules and the ESG Reporting Guide to align the publication timelines of ESG reports and annual reports. It was made explicit in the CGC Review that the board should be responsible for governance of ESG matters to ensure oversight, as well as assessment and management of material environmental and social risks. The CGC Review also proposes to require a listed company's board to align the company's culture with its purpose, value and strategy. Although it needs to be clarified what is expected in terms of the company's culture, purpose and value, this is a noteworthy development that may encourage listed companies in Hong Kong to better refine and articulate corporate purpose, value and strategy. The final form of the CG Code updates is pending the consultation conclusions.

Green or ESG funds

To facilitate the development of a wide range of green-related investments, the SFC published guidance on enhanced disclosures for SFC-authorised green or ESG funds in April 2019 in its "Circular to management companies of SFC-authorised unit trusts and mutual funds – Green or ESG funds". This will, however, be superseded with effect from 1 January 2022 under a revised circular issued by the SFC in June 2021 ("2021 Circular"). Pursuant to the 2021 Circular, SFC-authorised unit trusts and mutual funds that incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy ("ESG fund(s)") are required to disclose in its offering documents, among other things:

(1) the ESG focus – description of the ESG fund's ESG focus and a list of ESG criteria used to measure the attainment of the ESG focus;

(2) the ESG investment strategy – description of the ESG strategy(ies) of the ESG fund, the binding elements and significance of the strategy(ies) in the investment process and how such strategy(ies) is/are implemented in the investment process on a continuous basis, a summary of the process of considering ESG criteria, and whether an exclusion policy is adopted by the ESG fund and types of exclusion;

(3) asset allocation – the expected or minimum proportion of securities or other investments of the ESG fund (in terms of net asset value) that are commensurate with the ESG focus;

(4) reference benchmark (if applicable, and also the relevance of a designated benchmark to the fund);

(5) indication of additional information references where investors can find out about the ESG fund (e.g. website); and

(6) applicable risks associated with the ESG fund's ESG focus and associated investments strategies (e.g. limitation of methodology and data, lack of standardised taxonomy, subjective judgment in investment selection, reliance on third-party sources, concentration in investments with the particular ESG focus).

In particular, the 2021 Circular provides additional guidance on disclosure for funds with climate-related focus, including examples of climate-related indicators that such funds may consider and guidance where such funds have a designated climate reference benchmark. The Circular further states that an ESG fund should conduct periodic assessment on how the fund has attained its ESG focus and should disclose relevant information about such assessment to its investors.

The 2021 Circular states that ESG factors may include those that are aligned with one or more of the ESG criteria or principles recognised globally or nationally, such as:

- the United Nations Global Compact Principles;
- the United Nations Sustainable Development Goals;
- the Common Principles for Climate Mitigation Finance Tracking;
- the Green Bond Principles of the International Capital Market Association ("ICMA");
- the Climate Bonds Taxonomy of the Climate Bonds Initiative; or
- any other ESG or sustainability criteria or principles or taxonomies.

The manager of ESG funds should regularly monitor and evaluate the underlying investments, with proper procedures in place to make sure it continues to meet the stated ESG focus and requirements set out in the Circular. For new applications to authorise ESG funds submitted on or after 1 January 2022, the manager is required to provide to the SFC either a self-confirmation of compliance or a confirmation on compliance supported by independent third-party certification or fund label. The SFC expects the independent third party or fund labelling agency as part of the certification or labelling process to review, at a minimum, the ESG fund's primary investments to reflect the particular ESG focus that the fund represents, investment selection and ongoing monitoring process.

The SFC recognises that UCITS funds from certain jurisdictions are already subject to the European regulation on sustainability-related disclosures in the financial services sectors ("SFDR"). As such, UCITS ESG funds that meet the disclosure and reporting requirements for Article 8 or Article 9 funds under the SFDR will be deemed to have generally complied in substance with the disclosure requirements set out in the 2021 Circular. However, where appropriate, the SFC may request enhanced disclosure in respect of the fund's specific strategies and risks, and impose or vary the requirements in respect of UCITS ESG funds as it may deem fit at any time.

As noted under question 1.1 above, SFC-licensed fund managers will also be subject to requirements under the FMCC to take climate-related risks into consideration in their investment and risk management processes and make relevant disclosures, including entity-level or product-level disclosures for funds under management where the fund manager is responsible for the overall operation of the fund in question.

Authorised institutions ("AIs") supervised by the HKMA

For green and sustainable banking in Hong Kong, the HKMA adopts a three-phased approach:

- phase I – developing a common framework to assess the "Greenness Baseline" of individual banks;
- phase II – engaging the industry and other relevant stakeholders in a consultation on the supervisory expectation or requirement on green and sustainable banking, with a view to setting tangible deliverables for promoting the green and sustainable developments of the Hong Kong banking industry; and
- phase III – after setting the targets, implement, monitor and evaluate banks' progress in this regard.

To adopt phase I of the three-phased approach, in July 2019, the HKMA formed a Working Group on Green and Sustainable Banking consisting of representatives from 22 AIs to develop the Common Assessment Framework for assessing the "Greenness Baseline" of individual banks or AIs. The HKMA finalised the framework and launched the first round of assessment in May 2020.

The framework collects information surrounding 20 elements grouped under six broad categories covering AIs' stages of development in preparations for managing climate and environmental risks. The six broad categories are governance, corporate planning and tools, risk management process, business policies, products and services, performance and resources, and disclosure and communication. AIs are required to conduct this self-assessment exercise focusing on the financial risks (e.g. credit risk and market risk) associated with climate and environmental issues, and to report their level of development in relation to each element under each broad category. AIs are also required to answer all assessment questions and some additional quantitative questions to demonstrate their progress in certain elements. In its quarterly bulletin published in September 2020, the HKMA emphasised that this assessment is not a pass or fail test, but rather a process to facilitate AIs to formulate their strategies and approaches to address climate and environmental risks, and also to inform its design of the supervisory expectations and approach under the second phase of its three-phased approach. It is now in its second phase, which involves the development of climate risk management-related supervisory requirements for AIs – the HKMA released an industry consultation on the draft Supervisory Policy Manual GS-1 on climate risk management in July 2021, the details of which are set out in question 1.4 below.

Insurers

It is noted by the FSDC 2020 Paper that although the IA has promulgated guidelines on the Corporate Governance of Authorised Insurers and Enterprise Risk Management, respectively, there is not yet a dedicated set of guidelines or regulation that covers the entire scope of ESG to encourage or require insurance firms to disclose their policies on the consideration or management of ESG risks in their asset allocation process. In this regard, the FSDC recommends the IA to encourage authorised insurers to (i) publish and explain their policies on the consideration of ESG risks in their investments, and (ii) provide their boards with information on their exposure to financial risks arisen from climate change.

Significantly, as part of the "Strategic Plan to Strengthen Hong Kong's Financial Ecosystem to Support a Greener and More Sustainable Future" ("Strategic Plan") launched by the Steering Group in December 2020 (further discussed in question 6.1 below), the Steering Group has agreed to take active steps to enhance climate-related disclosures of financial institutions and confirmed that mandatory climate-related disclosures (aligned with the Task Force on Climate-related Financial Disclosures ("TCFD") recommendations across relevant sectors, referred to in question 1.3 below) shall be expected by no later than 2025, and coverage of mandatory disclosure would be increased as soon as practicable.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

In its 2019 public consultation on the review of the ESG Reporting Guide and related Listing Rules, while noting that some respondents called for aligning the ESG Reporting Guide with international disclosure standards, the HKEx said that prescribing specific standards would go beyond the scope of the ESG Reporting Guide, but instead encouraged issuers to voluntarily refer to or adopt international ESG reporting standards or guidelines for their relevant industries or sectors, and provided a list of selected resources on the HKEx ESG webpage. This list currently includes the CDP's Climate Change Questionnaire and Water Security Questionnaire, Climate Disclosure Standards Board's Climate Change Reporting Framework, Corporate Sustainability Assessment for inclusion in the Dow Jones Sustainability Indices, Global Reporting Initiative's ("GRI") Sustainability Reporting Standards, International Integrated Reporting Council's International Integrated Reporting Framework, ISO 26000 Guidance on Social Responsibility, OECD's Guidance for Multinational Enterprises and Principles of Corporate Governance, Sustainability Accounting Standards Board's ("SASB") Materiality Map, the Financial Stability Board's TCFD recommendations, and the United Nations Sustainable Development Goals. There are also "Reference Materials on Specific Topics", and "ESG Resource Providers/Initiatives", which included the United Nations Global Compact Principles and the United Nations Principles for Responsible Investment ("UNPRI").

The SFC, HKEx and HKMA regularly reference and support adopting TCFD recommendations, indicating intention to gradually align their policies with the TCFD framework. This intention is reflected in the SFC's Strategic Framework for Green Finance (September 2018), and the HKMA white paper on green and sustainable banking (June 2020) clearly encouraged TCFD as a core reference for disclosure, while the new addition of an aspect on climate change in the ESG Reporting Guide is a clear effort by the HKEx to align with TCFD. In the Consultation Paper on review of the CG Code issued in April 2021, the HKEx also encourages listed companies to consider adopting TCFD recommendations when disclosing climate-related information in compliance with the ESG Reporting Guide, and states that it will provide further guidance in this regard. Similarly, in the draft GS-1, the HKMA also names TCFD recommendations as a desirable framework for AIs to rely upon for disclosure, at least at the initial stage, and requires that AIs should make climate-related disclosures aligned with TCFD recommendations as a minimum. Further, under the draft GS-1, the HKMA would expect AIs to take actions to prepare climate-related disclosures in accordance with TCFD recommendations as soon as practicable, and make their first disclosures no later than mid-2023, with the intention to align disclosures of AIs with the TCFD framework no later than 2025.

More significantly, as discussed in question 1.2 above, as part of its Strategic Plan, the Steering Group has agreed to take active steps to enhance climate-related disclosures and confirmed that mandatory climate-related disclosures aligned with TCFD recommendations shall be expected by no later than 2025, and coverage of mandatory disclosure would be increased as soon as practicable.

The SFC has also introduced enhanced requirements on Hong Kong investment managers on the management and disclosure of climate-related risks that are intended to be aligned with TCFD (see question 1.1 above).

Separately, the SFC Principles of Responsible Ownership ("PRO") adopted in 2016 involve a voluntary disclosure framework for institutional investors on shareholder engagement. Investors are encouraged to adopt the PRO by disclosing to their stakeholders that they have done so, but may either apply the PRO in their entirety and disclose how they have done so, or explain why aspects of the PRO do not, or cannot, apply to them. There is a total of seven PROs, where investors are reminded that, to discharge their ownership responsibilities, they should engage with investee companies to promote the long-term success of these companies, and should:

- establish and report to their stakeholders their policies for discharging their ownership responsibilities;
- monitor and engage their investee companies;
- establish clear policies on when to escalate their engagement activities;
- have clear policies on voting;
- be willing to act collectively with other investors when appropriate;
- report to their stakeholders on how they have discharged their ownership responsibilities; and
- when investing on behalf of clients, have policies on managing conflicts of interests.

In a Circular issued in November 2018 and further reiterated in its 2019–2020 annual report, MPFA stated that it is "good practice for pension funds to disclose their approach to ESG factors in their investment policies" and it "highly encourages" Mandatory Provident Fund ("MPF") (the mandatory retirement scheme in Hong Kong) trustees and their investment managers to consider taking into account the relevant international ESG standards in their decision-making process and disclosing their approach to ESG factors to scheme members. It also further encourages MPF trustees to discuss with their investment managers the possible inclusion of green bonds in their MPF portfolio holdings.

1.4 Are there significant laws or regulations currently in the proposal process?

Green and sustainable banking

Phase II of the three-phased approach by the HKMA to support and promote Hong Kong's green finance development is to engage the banking industry and other relevant stakeholders in consultation on supervisory expectation or requirement on green and sustainable banking. A white paper was published in June 2020 outlining the HKMA's thinking on its supervisory approach to addressing climate-related issues, and to a lesser extent, broader sustainability issues, as summarised in nine guiding principles in the areas of governance, strategy, risk management and disclosure.

Given the diversity among AIs, the HKMA aims to adopt a proportionate approach, such that the supervisory requirements are appropriate to AIs regardless of size and scale. The development of the supervisory requirements will take into account the "greenness assessment" results from the Common Assessment Framework, the feedback on its engagement with the industry and international developments.

In July 2021, the HKMA issued a consultation letter to the banking industry on its draft GS-1, which sets out the HKMA's latest supervisory policies and practices and the minimum standards that banks are expected to attain, in relation to climate risk management. The proposed requirements are in relation to AIs' governance, strategy, risk management and disclosure in building climate resilience. In particular, it is highlighted in the paper that the Banking Ordinance requires AIs to conduct their business with integrity, prudence and professional competence and in a manner that is not detrimental to the interests of depositors or potential depositors, and in this connection, the HKMA will take account of, among other things, AIs' approach to managing climate-related financial risks and building climate resilience.

Under the draft GS-1, AIs should embed climate considerations throughout the current strategy formulation process, from strategic assessment to action plan development. To conduct a comprehensive strategic assessment, the draft GS-1 suggests stakeholder engagement, to enable the AI to better understand the key concerns and expectations of various stakeholders (including regulators, the government, investors, depositors, clients, counterparties, industry associations, standard-setting bodies, suppliers, employees and the general public), and also to inform them about how the AI is positioning itself in light of climate-related risks and opportunities.

Adoption of the Common Ground Taxonomy

One of the action points in the Strategic Plan is to aim to adopt the Common Ground Taxonomy, which is being developed by the International Platform on Sustainable Finance ("IPSF") Working Group on Taxonomies co-led by China and the EU. The Working Group's objectives are to comprehensively compare existing taxonomies for environmentally sustainable investments published by public authorities of IPSF member countries, identify commonalities and differences in their respective approaches, criteria and outcomes, so as to develop and publish the Common Ground Taxonomy, which highlights such commonalities. The Working Group published its first report in November 2021, covering a comparison between some features of the EU and China's green taxonomies. This first publication covers the initial phase of work, which will be expanded over time. The current scope of the report covers substantial contribution criteria for climate change mitigation, whilst other environmental objectives have not been covered at this stage. Other eligibility features such as "Do No Significant Harm" were also not covered within the scope of the first phase.

The Common Ground Taxonomy aims to provide transparency to investors and companies by providing a common reference point for the definition of investments that are considered environmentally sustainable across relevant IPSF jurisdictions. The development of the Common Ground Taxonomy aims to contribute to reducing transaction costs and, ultimately, to facilitate cross-border green capital flows.

IFRS Foundation's prototype for climate disclosure standard

The Steering Group has stated that it welcomes the publication of the prototype climate and general disclosure requirements by the IFRS Foundation (see question 6.1 below), and the SFC and HKEx will maintain close collaboration with stakeholders including the Financial Reporting Council and the Hong Kong Institute of Certified Public Accountants with a view to evaluating and potentially developing a roadmap to adopt this standard.

Mandatory Provident Funds

In October 2019, the International Organisation of Pension Supervisors ("IOPS") issued supervisory guidelines to encourage supervisory authorities to require pension funds to integrate ESG factors in their investment and risk management process. As a member of IOPS, MPFA stated in its 2019–2020 Annual Report that it will consider how to adopt such guidelines.

Biodiversity

Given that the BSAP 2016–2021 is due to expire in 2021, an updated BSAP (or a public consultation for formulating such an update) is expected to be launched imminently.

1.5 What significant private sector initiatives relating to ESG are there?

The private sector initiatives relating to ESG include the use of voluntary international reporting standards and frameworks to report on ESG in investments, education for ESG intellectual capacity building and an increasing push for a unified or standardised reporting framework. For the investment industry, the efforts and adoption of the UNPRI has been key, and the number of Hong Kong UNPRI signatories has been increasing steadily, while investors and asset owners are increasingly expecting more ESG focus in investing, decision-making and stewardship.

In addition, the government-backed non-profit Hong Kong Green Finance Association ("HKGFA") was established in 2018 with the aim of developing Hong Kong as a green finance hub and facilitating public-private sector dialogue, among other initiatives. The HKGFA has established seven working groups in driving HKGFA strategies and deliverables with its members, including working groups on green bonds, green banking and ESG disclosure and integration. At the HKGFA 2nd Annual Forum held on 5 November 2020, the HKGFA launched a new report on climate transition finance, which proposed a principles-based framework and focus on China and Hong Kong's respective alignment with the Paris Agreement, calling for more action on Hong Kong's adoption of a net-zero target.

"Hong Kong 2050 is Now" is a prominent private sector initiative that involves the joint efforts of the Civic Exchange, World Resources Institute, RS Group and ADM Capital Foundation to galvanise collective action towards Hong Kong net-zero by 2050, aiming to engage partners across relevant sectors to shed light on Hong Kong's pathway to climate neutrality. Efforts include research, policy and other recommendations in key sectors, including energy, mobility, building efficiency, nature-based solutions, lifestyle considerations and carbon pricing.

Our Hong Kong Foundation is also a key private sector policy think tank that has been covering a broad spectrum, from policy research on ESG, green bonds, social innovation, pay-for-success, to social impact assessment.

ReThink HK has developed as an annual conference and solutions showcase expo on sustainable development designed for Hong Kong business leaders, sustainability practitioners and those responsible for researching and resourcing new sustainable strategies. ReThink HK 2021, which was held in October 2021, was co-organised with the Business Environment Council, a body advocating for sustainable strategies, environmental protection and contributing to the transition to a low-carbon economy.

Separately, the B Corp movement is gaining traction both globally and in Hong Kong. B Corp certification involves measuring a company's entire social and environmental performance, and as part of the certification process, the B Impact Assessment ("BIA") evaluates how a company's operations and business model impact its main stakeholder groups, including its workers, community, environment, and customers, covering a wide range of ESG issues. Separate from being an assessment tool for certification to become a B Corp, the BIA may also serve as a useful metric for companies to plan and assess its performance in ESG issues. B Lab (Hong Kong & Macau) is active in growing the community of B Corps in Hong Kong, and B Lab has introduced the "Legal Requirement" for Hong Kong B Corps, as a mission-lock in relation to governance, one of the key pillars in the B Corp certification process, with effect from January 2021.

While globally the CFA Institute has introduced a Certificate in ESG Investing, Friends of the Earth Hong Kong established a "Green Finance Education System" in its Certified Environmental, Social, Governance Analyst (CESGA®) certification programme at the end of 2020, among other ongoing efforts of this charitable organisation to advocate and promote sustainable and environmental public policies, business practices and community in Hong Kong.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

As observed in the FSDC 2020 Paper, asset owners in public and private sectors, including pension funds and sovereign wealth funds, are increasingly integrating ESG strategies in their investment portfolios. Asset and wealth managers and product owners uncover opportunities, identify risks, and generate returns for asset owners and other clients through incorporating ESG factors into their investment strategies and ongoing engagement with investee companies.

In 2019, the SFC conducted the "Survey on Integrating Environmental, Social and Governance Factors and Climate Risks, in Asset Management", which focused on the sustainable investment practices (including their commitment, investment processes, post-investment ownership practices and ESG disclosures) of asset managers and asset owners. The survey results, published by the SFC in December 2019, indicated that while most asset managers generally considered ESG factors, they did not take a consistent approach to integrating these factors into their investment and risk management processes and disclosing them. In addition, only a few asset managers had processes in place to manage the potential financial effects associated with climate-related risks. These practices fell short of the expectations of asset owners and the latest international developments in this area. In response, as noted in question 1.1 above, the SFC has introduced requirements for Hong Kong SFC-licensed fund managers to consider climate-related risks in their investment and risk management processes, and to make appropriate disclosures to meet investors' growing demand for climate risk information and to combat greenwashing. Taxonomies is another area in which market actors are calling for policy guidance, and it may be particularly relevant as the HKMA is looking at supervisory requirements for green and sustainable banking. It should be noted that part of the Strategic Plan and near-term action points include efforts to explore the development of a local taxonomy for use across financial sectors in Hong Kong taking into account both global experience and local circumstances and the aim to adopt the Common Ground Taxonomy that is being developed by IPSF.

Considering the growing international trend on expanding fiduciary duty of investors to cover ESG considerations, regulations in relation to investors is another area to develop in Hong Kong. There have been calls by market actors for the PRO to be aligned with principles such as the UNPRI, or for PRO disclosure to be strengthened from voluntary to "comply or explain". The HKMA took the lead in May 2019 in requiring external managers of Hong Kong equities and China active equities portfolios of the Exchange Fund under its management to comply with the PRO on a "comply or explain" basis and requiring external managers of developed market equities portfolios to adhere to generally accepted international ESG standards. The HKMA has also included ESG factors in the selection, appointment and monitoring of external managers of the Exchange Fund.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

In the FSDC 2020 Paper, it is observed that enhanced ESG disclosure/reporting is becoming commonplace among companies of different sizes, partly due to new regulatory requirements but also enhanced risk-adjusted returns, lower funding costs and new sources of capital. However, it also identified that some smaller companies, including some small- to mid-cap listed companies, are struggling to understand the essence of ESG reporting, partly because of confusion with the overwhelming number and lack of standardisation of international standards and principles.

The Asian Corporate Governance Association expressed that one of the biggest challenges for fund managers and institutional investors to engage with investee companies listed in Hong Kong on climate risk issues lies in the different standards that listed firms and fund managers are subjected to, being the separate rules imposed by the HKEx and SFC. In particular, the HKEx, which sets out rules for the underlying listed companies that fund managers invest in, does not attach the same level of importance to TCFD as the SFC and HKMA. As such, there is potential divergence in reporting standards, and asset managers are finding it difficult to have their investee firms fully cooperate for their own compliance with SFC rules.

Apparently, the Hong Kong government has placed great focus on green or sustainable finance, highlighting Hong Kong's role as a green or sustainable finance hub, and at the same time introducing specific requirements on banks and fund managers for the management of climate-related risks, and also disclosure requirements of fund managers or investment funds that are intended to provide better transparency on green investments and combat greenwashing. However, there are limited mandatory requirements for businesses on managing climate-related risks, other than the ESG reporting requirements for Hong Kong listed companies, which are disclosure requirements. Globally, it is increasingly recognised that to meet the goals of the 2015 Paris Agreement for limiting global temperature rise, concrete actions and commitments to target carbon reduction are necessary. Hong Kong and Hong Kong businesses will need a more specific roadmap for energy transition, towards a low-carbon economy for achieving carbon neutrality. As an example, it is worth mentioning that the Hong Kong Green Building Council has developed a set of green certification standards, BEAM Plus, which offers independent assessment of building sustainability performance. More than 1,600 buildings and development projects in Hong Kong have been awarded this certification. However, there are critics that doubt the standard's credentials, which highlights that in the absence of unified standards or reporting requirements, there are growing greenwashing concerns globally. Greenwashing affects market confidence on the credibility of ESG labels and, more importantly, raises concerns that companies are not taking the required action for climate or not creating the positive impact on the environment and society that they claim to be creating.

The SFC itself highlighted issues regarding the fragmented regulatory landscape characterised by a variety of regimes and voluntary sustainability reporting frameworks, which brought about sustainability reporting that is incomplete and inconsistent across jurisdictions, industries and companies. It is also noted by the SFC that the fragmentation in sustainability reporting and the lack of credible ESG data raise concerns around mispricing of assets, misallocation of capital and the increasing risk of greenwashing. To address this, the SFC stresses the importance of the development of climate disclosure standards by the International Sustainability Standards Board ("ISSB") and it is potentially developing a roadmap to adopt this standard together with the HKEx (see question 6.1).

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In Hong Kong, the principal regulators with respect to ESG issues include the Registrar of Companies, SFC, HKEx, HKMA, the Environment Bureau, the Financial Services and the Treasury Bureau, MPFA and the IA, the majority of which constitute the Steering Group. One of the main issues being pressed by these regulators is to promote the flow of climate-related information, for example, through enhancing ESG reporting.

Climate is a primary focus of the Hong Kong government and the various regulators. In October 2020, the SFC released the Consultation Paper to enhance climate-related disclosures by Hong Kong SFC-licensed fund managers, the conclusions of which were published in August 2021 (further detailed in question 1.1 above). The Consultation Paper was issued in furtherance of the objectives set out in the SFC's Strategic Framework for Green Finance issued in September 2018, and forms part of its initiative to encourage the consideration of ESG factors in the investment and risk management processes and enhance reporting of environmental and climate-related information. It takes into account the latest international developments, including growing regulatory focus on managing climate risks, the increasing adoption of TCFD, and the SFC's regulatory objectives and intention to align with international standards and its aims to collaborate with international and Hong Kong local financial regulators and the industry in meeting those objectives. The SFC acknowledges the importance of promoting sustainable development, in both ESG or sustainability factors, and climate change or environmental factors. However, the SFC proposed to focus initially on climate-related risks relevant to each investment strategy and fund due to various factors, including the irreversible impact of climate change and urgency to take action to address the threat of climate change.

In October 2021, the Hong Kong government released Hong Kong's Climate Action Plan 2050, setting out the vision of "Zero-carbon Emissions Liveable City Sustainable Development", and outlining the strategies and targets for combatting climate change and achieving carbon neutrality. The four major decarbonisation strategies and measures outlined in the updated plan are net-zero electricity generation, energy saving and green buildings, green transport and waste reduction. The Chief Executive of Hong Kong also committed to a medium-term target to reduce total carbon emissions in Hong Kong by half against the 2005 level before 2035, and allocated HK$240 billion in the next 15 to 20 years to support actions to combat climate change.

The government also recognises the importance of conserving biodiversity and the ecosystem while developing sustainably. The BSAP 2016–2021 has been formulated in an effort to step up biodiversity conservation and support sustainable development. The main areas of focus in the BSAP are:

- conservation: continue to implement and enhance existing conservation measures;
- mainstreaming: incorporate biodiversity considerations into planning and decision-making to achieve sustainable development;
- knowledge: conduct biodiversity surveys and studies to fill knowledge gaps; and
- community involvement: promote public awareness and knowledge of biodiversity among stakeholders and the public.

As mentioned above, an updated BSAP (or a public consultation for formulating such an update) is expected to be launched imminently.

2.4 Have there been material enforcement actions with respect to ESG issues?

Breach of a mandatory requirement of the ESG Reporting Guide or of the Listing Rules may result in disciplinary consequences from the SFC, but so far there have been no ESG-related actions from the regulator.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

ESG litigation is currently not common in Hong Kong and causes for shareholder activism in Hong Kong have typically been financial-related concerns.

2.6 What are current key issues of concern for the proponents of ESG?

For companies that seek to meet international best practices, they need to follow international ESG reporting standards. However, there are currently many different reporting frameworks and standards that companies may choose to adopt, including GRI, TCFD and SASB, and they may also choose to adopt one or more different frameworks for different sectors, asset classes or business areas. There are also numerous ESG rating agencies, with varying indicators, methodologies, and weightings for ESG scores, while some organisations are focused on specific industries or particular ESG issues. The absence of a unified ESG market standard presents difficulties for investors and asset managers in terms of evaluating the ESG performance of companies and for companies and issuers to effectively gauge their own ESG performance, attract investors, and align their operations to international best practices. This is clearly recognised by regulators as a key issue as two of the five action points agreed upon by the Steering Group for the near term surround the need to align climate-related disclosures with TCFD recommendations and to support the alignment of global reporting standards.

In the FSDC 2020 Paper, ESG intellectual capacity building is one of the key issues identified as a crucial factor to help drive the continued development of sustainable finance and investment in Hong Kong. Similarly, in MPFA's 2020–2021 annual report, pursuant to a survey carried out in July 2020 to understand MPF trustees' views and practices of integrating ESG factors into the MPF funds' investment and risk management processes and disclosing the integration to MPF scheme members, there is a need for MPFA to support capacity building and training of trustees on sustainable investing and raise MPF scheme members' awareness of the subject. There is an ESG talent gap in Hong Kong, where larger companies have generally better resources to carry out ESG reporting than small to medium-sized companies. It is suggested in the FSDC 2020 Paper that companies should be equipped with the resources, knowledge and skills to produce ESG disclosures that are of good quality, so that investors can perform meaningful analysis and make informed decisions with their expertise accordingly. Investors also expect to be provided with sufficient resources and information to deliver on their ESG-related goals. One of the key focus areas identified in the Strategic Plan is to enhance capacity building for the financial services industry and to raise public awareness. In July 2021, the Steering Group also launched the Centre for Green and Sustainable Finance, a cross-sector platform that coordinates the efforts of financial regulators, government agencies, industry stakeholders and academia in capacity building, thought leadership and policy development. The Centre has established working groups to develop strategies and roadmaps to promote capacity building and develop data repository and analytics capability.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The board of directors is collectively responsible for the management and operations of the company, including to address any ESG issues and discharge any disclosure obligations the company may have. For listed companies, this is made explicit in the Guidance Letter HKEX-GL86-16 updated in July 2020, where the HKEx emphasises the importance for listing applicants to put in place mechanisms that enable them to meet the HKEx's requirements on corporate governance and ESG well in advance so that they are in compliance upon listing. Further, as the board of directors of an applicant is collectively responsible for its management and operations, including the establishment of such mechanisms, directors are expected to be involved in the formulation of such mechanisms and related policies.

For an investment fund or collective investment scheme, the manager of the fund will have the principal responsibility for addressing any ESG issues, including new obligations introduced under the amended FMCC, for fund managers to identify climate-related risks that are relevant to their investment strategies and the funds they manage, and assess impact and materiality in the investment management process. For the purpose of complying with the requirements under the FMCC, the board or board committees of the Hong Kong licensed manager has overall oversight of climate-related issues, whilst management should, among other things, supervise and monitor the efforts to manage climate-related risks, as well as set goals for addressing and developing action plans for managing climate-related risks.

For AIs supervised by the HKMA, under the draft GS-1, the board has primary responsibility for an AI's climate resilience and the senior management is responsible for the proper functioning of the AI's risk management framework and for driving necessary changes in addressing climate-related issues. The board should play an active role in overseeing the development and implementation of the AI's climate strategy and is responsible for setting the AI's overall risk appetite.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

A company's internal governance mechanism to supervise management of ESG issues may vary and there is no standard practice. However, under the ESG Reporting Guide, a listed company is required to disclose the company's ESG governance structure to allow investors and stakeholders to assess the company's commitment to and effort in ESG matters and the quality of its ESG governance. This includes a statement from the board on the board's oversight of ESG issues, the process used to identify, evaluate and manage material ESG-related issues and how the board reviews progress made against ESG-related goals and targets.

Further, as elaborated in the HKEx's "Leadership Role and Accountability in ESG – Guide for Board and Directors" published in March 2020, the board of directors of a company should take leadership over and accountability in:

- overseeing the assessment of the company's environmental and social impacts;
- understanding the potential impact and related risks of ESG issues on the company's operating model;
- aligning with what investors and regulators expect and require;
- enforcing a materiality assessment and reporting process to ensure actions are well followed through and implemented; and
- promoting a culture from the top down to ensure ESG considerations are part of the business decision-making process.

The board should consider whether it needs the help of a board committee, for example, by establishing a new ESG committee (such as a dedicated sustainability committee), or expanding the roles of an existing committee in order to integrate ESG issues into key governance processes (such as the audit and risks committee being responsible for ensuring that data in the group's sustainability reports are appropriate).

For Hong Kong licensed fund managers, for the purpose of complying with the requirements under the FMCC, the board or the board committees of the manager has overall oversight of climate-related issues, whilst management should, among other things, supervise and monitor the efforts to manage climate-related risks, as well as set goals for addressing and developing action plans for managing climate-related risks.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

There is currently no legal requirement in Hong Kong to align incentives to ESG outcomes.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

For investment managers, investors or asset owners, ESG integration may include incorporating ESG issues into investment analysis and decision-making processes, incorporating ESG issues into stewardship policies and practices, and active engagement with investee companies; while at the corporate level, integration may include adopting policies such as responsible recruitment and human resources practices, board diversity policies, environmental or climate policies, personal data protection and other compliance policies, as well as data collection of

ESG issues for required ESG performance metrics and disclosures as applicable. More concrete actions should be expected following the new ESG Reporting Guide for listed companies effective for reporting from July 2020, the HKMA initiatives in recent years on green and sustainable banking, as well as the SFC's requirements on Hong Kong fund managers in relation to climate-related risks and ESG funds, besides increasing expectation of investors and asset owners on ESG.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Generally speaking, externally developed ESG ratings, such as those offered by MSCI, Bloomberg, S&P, ISS ESG, Sustainalytics, Refinitiv (to name a few more commonly referenced), tend to be used by providers of debt and equity finance in Hong Kong.

In Hong Kong, the Hang Seng Corporate Sustainability Index Series aims to gauge the performance of companies with outstanding sustainability practice in Hong Kong and Mainland China markets. Separately, the Hong Kong Quality Assurance Agency ("HKQAA") provides a CSR Index Series, as well as Sustainability Rating and Research services and, of increasing importance, Green Finance Certification for green bonds and ESG and green funds.

The Hong Kong Green Organisation Certification ("HKGOC"), led by the Environmental Campaign Committee and the Environmental Protection Department, aims to benchmark green organisations with substantial achievement in green management, to encourage participants to adopt environmental practices in different aspects and to recognise their efforts and commitments to the environment. HKGOC consists of four certificates, namely the "Wastewi$e Certificate", "Energywi$e Certificate", "IAQwi$e Certificate" and "Carbon Reduction Certificate". The recognised green organisations under HKGOC will receive the title of "Hong Kong Green Organisation".

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds are playing an increasingly important role in the market, with the government taking a lead role. In May 2019, the Hong Kong government issued the largest sovereign green bond at the time at US$1 billion, which was four times oversubscribed and triggered a rapid growth in green bond issuance in Hong Kong. The second batch of government green bonds totalling US$2.5 billion were offered in January 2021, among which the 30-year tranche is the longest tenor bond issued by the government and the longest tenor US$-denominated government bond in Asia to date. According to a research report conducted by the Hong Kong Institute for Monetary and Financial Research ("HKIMR") published in November 2020 ("Green Bond Report"), the cumulative volume of green bonds arranged and issued in Hong Kong reached US$26 billion by the end of 2019. Mainland entities were the largest issuer group by origin, with a total issuance amount of US$18 billion by the end of 2019 (more than 70% of the total market). There are a wide range of green bond issuers in the market, including real estate companies, energy firms and financial institutions, and notably multilateral development banks. As a means to develop Hong Kong's position as a green finance hub regionally and internationally, the Financial Secretary of Hong Kong announced in his 2020–2021 Budget the plan to issue green bonds totalling HK$66 billion (about US$8.5 billion) in the next five years. The Financial Secretary further proposed to double the borrowing ceiling of the green bond programme to HK$200 billion to allow for further issuance of green bonds totalling HK$175.5 billion within the next five years, having regard to the market situation, indicating the government's commitment to Hong Kong's net-zero goals.

In Hong Kong, green bonds remain the dominant type of sustainable financing tool but there has been an increasing demand for social bonds riding on the back of COVID-19. Transition bonds and sustainability-linked bonds have also gained momentum for companies that are trying to transition or would like to articulate their transition commitments and strategies. The development of social bonds such as social impact bonds or pay-for-success is at a nascent stage of development, with hopes for more through the efforts of the Social Innovation and Entrepreneurship Development Fund ("SIE Fund"), a government initiative established to catalyse and develop social innovation. The first pay-for-success project, namely "Start from the Beginning – Chinese Supporting Scheme for Non-Chinese Speaking Students in Kindergarten", was launched in Hong Kong in September 2020 by Oxfam Hong Kong and for which the SIE Fund has taken up the role of Commissioner. Investors have undertaken to provide upfront capital for structuring and implementing the project, while the SIE Fund, as the Commissioner, will pay the investors based on the fulfilment of target performance to be validated by an independent impact auditor.

To facilitate the pilot development of the pay-for-success model in Hong Kong, the SIE Fund welcomes proposals for the SIE Fund to act as the Commissioner of structured pay-for-success projects, or applications for grants from the SIE Fund to fund the structuring cost of potential pay-for-success projects.

4.3 Do sustainability-linked bonds play a significant role in the market?

While sustainability-linked loans have been widely used and Hong Kong is home to more than half of the region's such loans, there is also increasing interest in sustainability-linked bonds as a sustainable finance instrument due to the flexibility in the use of proceeds. As at 1 November 2021, there are three sustainability-linked bonds listed on HKEx's Sustainable and Green Exchange ("STAGE").

4.4 What are the major factors impacting the use of these types of financial instruments?

The HKMA has been leading the way on green bonds. The HKMA has launched several schemes to attract local and overseas issuers to issue bonds in Hong Kong since May 2018. The HKMA launched the Green and Sustainable Finance Grant Scheme ("Grant Scheme") to provide eligible green and sustainable bond issuers with subsidy to cover expenses of bond issuance and external review services from HKMA-recognised external reviewers. The Grant Scheme is available for the next three years for first-time issuers of green and sustainable bonds (with no such issue in the five years prior to the bond's pricing date), for issuance size of at least HK$1.5 billion (or equivalent in foreign currency), and being, at issuance, issued in Hong Kong to 10 or more persons or if issued to less than 10 persons none of whom is an associate of the issuer. The Hong Kong government also became the first Asian signatory to the Green Bond

Pledge in May 2019, demonstrating its commitment to greening infrastructures with the aim to reinforce the goals of the Paris Agreement.

According to the Green Bond Report, in 2019, more than half (55%) of the green bond issuers in Hong Kong were first-time issuers, reflecting the strong appeal of Hong Kong to new issuers due to supportive government policies, strong expertise, robust green bond infrastructure and broad investor base. From a survey commissioned by the HKIMR "Developing Hong Kong into a global green bond hub" conducted from June to August 2020 ("Green Bond Survey"), it was found that the major considerations for the issuance of green bonds are brand development needs, issuance costs, and the size and availability of international investors. Participants of the Green Bond Survey rated the large number of international investors, availability of government subsidies and support, and low legal and marketing expenses as important advantages of the Hong Kong green bond market. Meanwhile, existing investors cite investment returns as a main consideration for investing in green bonds and over 40% of existing investor participants of the survey are motivated by socially responsible issuers and transparent ESG information disclosure to make green bond investments in Hong Kong. At the same time, potential and existing issuers have reflected that one of the key challenges in the green bond market in Hong Kong is the verification and certification procedures, which involve financial and time costs, despite the availability of incentive schemes provided by the HKMA.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The assurance and certification process for green bonds is not regulated by any regulators in Hong Kong. Supported by the Hong Kong government, HKQAA has developed and launched the Green and Sustainable Finance Certification Scheme ("GSFCS") to provide third-party conformity assessments and certification for green and sustainable finance issuers. Compared to its predecessor, the Green Finance Certification Scheme, the GSFCS emphasises the importance of impact assessment, stakeholder engagement and transparency and its scope further covers green and sustainable subjects including sustainability-linked or green and climate transition requirements. The Hong Kong government also launched the Grant Scheme (outlined in question 4.4 above) to subsidise eligible green and sustainable bond issuers for costs of external review by a recognised external reviewer. HKQAA is one of the recognised external reviewers.

HKQAA has developed the GSFCS with reference to a number of widely recognised national and international standards and principles on green and sustainable finance, including:

- ICMA – Green Bond Principles.
- ICMA – Social Bond Principles.
- ICMA – Sustainability Bond Guidelines.
- ICMA – Sustainability-linked Bond Principles.
- ICMA – Climate Transition Finance Handbook.
- Loan Market Association ("LMA"), Asia Pacific Loan Market Association ("APLMA"), Loan Syndications and Trading Association ("LSTA") – Green Loan Principles.
- LMA, APLMA, LSTA – Sustainability-linked Loan Principles.
- ISO/DIS 14030 Environmental performance evaluation – Green debt instruments (Parts 1–4).
- EU Technical Expert Group's Recommendations for an EU Green Bond Standard.
- 中國人民銀行、中國證券監督管理委員會公告(2017) 第20號——綠色債券評估認證行為指引(暫行) (Announcement No. 20 [2017] of the People's Bank of China and the China Securities Regulatory Commission – Guidelines for the Assessment and Certification of Green Bonds (Interim)).

HKQAA certification can be issued at stages of pre-issuance and post-issuance and the certified green and sustainable finance instruments are displayed on HKQAA's website on green finance.

The green bonds issued by the Hong Kong government in May 2019 and February 2021 have received the Green Finance Certificate (Post-issuance Stage) from HKQAA. According to the Green Bond Report, all green bonds issued in Hong Kong benefitted from at least one type of external review in 2019. In 2019, 100% of green bond issuance in Hong Kong by volume had external review, and 81% had post-issuance reporting. It was observed that a key factor leading to the high rate of pre-issuance external review (compared to 86% globally) is the development and support of the use of the GSFCS.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

According to observations by the FSDC, following the outbreak of the pandemic, market participants believe that investors will further prioritise investments with conscience, placing sustainability at the front and centre of their investment approaches. Despite being part of due diligence in the past, ESG is now receiving far more attention and the shift has been given an extra push by COVID-19.

6 Trends

6.1 What are the material trends related to ESG?

There are increasing attempts to accelerate the growth of green and sustainable finance as well as ESG policymaking in Hong Kong through cross-agency collaborations and efforts.

In November 2020, the HKMA signed a partnership with the International Finance Corporation ("IFC"), a member of the World Bank Group, in an effort to encourage commercial banks in Asia to adopt strategies and targets to become greener. As the founding member and first regional anchor for the Asia chapter of the Alliance for Green Commercial Banks (a new initiative launched by IFC to help develop green commercial banks and encourage more green finance to address climate change), the HKMA will serve as the hub for green finance among commercial banks in Asia. Under the agreement, the HKMA and IFC will jointly launch targeted initiatives and campaigns to undertake green finance research, provide unique market insight, tailor capacity building/training support, and provide practical guidance for banks to develop their own roadmaps to mainstream green finance as their core business and revamp existing green financial products and services. Recently, IFC announced at COP26 that it will partner with the HKMA and another institutional investor to create a new US$3 billion global platform for climate-smart investment aligned with the Paris Agreement. The new programme, Managed Co-Lending Portfolio Program (MCPP) One Planet, combines institutional investor contributions with IFC's own funds to scale up climate-responsible financing for private companies in emerging markets.

The Steering Group, mentioned in question 1.1, aims to coordinate the management of climate and environmental risks to the financial sector, accelerate the growth of green and sustainable finance in Hong Kong and support the Hong Kong government's climate strategies.

In December 2020, the Steering Group announced its green and sustainable finance strategy for Hong Kong and six key long-term focus areas in its Strategic Plan as well as five key near-term action points. The six key focus areas are:

(1) strengthening climate-related financial risk management;

(2) promoting the flow of climate-related information at all levels to facilitate risk management, capital allocation and investor protection;

(3) enhancing capacity building for the financial services industry and raising public awareness;

(4) encouraging innovation and exploring initiatives to facilitate capital flows towards green and sustainable causes;

(5) capitalising on Mainland opportunities to develop Hong Kong into a green finance centre in the Guangdong-Hong Kong-Macao Greater Bay Area; and

(6) strengthening regional and international collaboration.

The five near-term action points are:

(1) Climate-related disclosures aligned with TCFD recommendations will be mandatory across relevant sectors no later than 2025, and active steps will be taken to enhance climate-related disclosures of financial institutions including banks, asset managers, insurance companies and pension trustees and to increase the coverage of mandatory disclosure as soon as practicable, so that more information on how companies and assets will be impacted by climate change is available in the financial markets to support informed capital allocation and promote market discipline.

(2) Aim to adopt the Common Ground Taxonomy, which is being developed by IPSF's Working Group on Taxonomies co-led by China and the EU.

(3) Support the IFRS Foundation's proposal to establish a new Sustainability Standards Board for developing and maintaining a global, uniform set of sustainability reporting standards.

(4) Promote climate-focused scenario analysis to assess the impacts on financial institutions under different climate pathways, such as through the pilot climate risk stress testing exercise for banks and insurers, and the use of scenario analysis by large asset managers.

(5) Establish a platform to act as a focal point for financial regulators, government agencies, industry stakeholders and academia to coordinate cross-sectoral capacity building, thought leadership and as a cross-sectoral repository of green and sustainable finance resources in addition to STAGE.

Considering feedback from market participants and the key near-term action points agreed to be implemented by the Steering Group, composed of and led by the major regulators in Hong Kong, we anticipate that there will be stronger coordinated efforts to develop and maintain a uniform set of reporting standards that will facilitate effective and meaningful disclosure to generate data that are of better comparability and materiality.

In July 2021, the Steering Group announced the next steps in its strategy towards bolstering Hong Kong's position as a leader in green and sustainable finance and help transition the financial ecosystem towards carbon neutrality. In particular, the Steering Group will support the efforts by the ISSB under the IFRS Foundation to develop a new reporting standard built on the TCFD framework. In connection with this, the SFC and HKEx will collaborate with the Financial Reporting Council and the Hong Kong Institute of Certified Public Accountants to work on a roadmap to evaluate and potentially adopt the new standard.

It is also worth mentioning Hong Kong's expected role as China continues its strong efforts in green finance, such as in connection with the Guangdong-Hong Kong-Macau Greater Bay Area Green Finance Alliance, including initiatives to develop an integrated carbon market. In light of the significant growth expected in the global and regional carbon markets, the Steering Group has set up a Carbon Market Work Stream ("CMWS") co-chaired by the SFC and HKEx to assess the feasibility of developing Hong Kong as a regional carbon trading centre to strengthen collaboration in the said area. The CMWS will actively explore opportunities presented by both the cap-and-trade carbon market and the voluntary carbon market in China and overseas.

As anticipated in the near-term action points above and as recently announced over the period of COP26, a new ISSB was formed in November 2021 to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs. Further, the Technical Readiness Working Group (chaired by the IFRS Foundation and including participants from the Climate Disclosure Standards Board, TCFD, IASB, Value Reporting Foundation, and World Economic Forum) published prototype climate and general disclosure requirements, to provide recommendations to the ISSB for consideration. Following these global developments, the Steering Group has stated that it welcomes the publication of the prototype, and the SFC and HKEx will maintain close collaboration with stakeholders including the Financial Reporting Council and the Hong Kong Institute of Certified Public Accountants with a view to evaluating and potentially developing a roadmap to adopt this standard.

6.2 What will be the longer-term impact of COVID-19 on ESG?

While the pandemic in Hong Kong (and the rest of the world) rages on and is unlikely to be over any time soon, it is difficult to foresee the scale and long-term impacts of COVID-19 on ESG. It is clear that the public and private sectors are continuing to push hard for ESG to be widely incorporated into investment decisions and operations, among other things, in order to mitigate material risks and create sustainable strategies. Due to the impact of the pandemic, it is likely that there will continue to be an increased focus on the "social" element of ESG, in particular with respect to employees' health and safety and more broadly on the corporate responsibility of businesses to employees and community.

Vivien Teu is a partner and head of Asset Management & ESG at Dentons Hong Kong. She has more than 20 years' experience with a deep and broad focus in the areas of asset management, diverse forms of investment funds across asset classes and structures, retail funds and privately placed funds, investments in public markets, private equity, real estate and alternative investments. In recent years, Vivien has been market-leading in having developed a unique focus in her practice on corporate and regulatory issues around environmental, social, and corporate governance (ESG), sustainable finance, responsible investment, impact investing and social finance.

Vivien has received commendations by *Asialaw* profiles for three consecutive years (2018 to 2020) as a leading lawyer for the practice areas of investment funds and corporate M&A, and is listed by *China Business Law Journal* in the 2020 A-List Elite 100 foreign lawyers for China practice.

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Jojo has also accumulated knowledge and experience working on matters relating to charities, social enterprises, impact organisations and B Corps. In particular, she has assisted on the establishment of a social finance arrangement in Hong Kong, as well as advising charitable organisations on setting up and governance matters, donation agreements and giving and receiving donations, and dealing with the Inland Revenue Department and Companies Registry in relation to obtaining tax-exempt status in Hong Kong.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

The regulatory framework related to ESG is not in any one legislation but under various pieces of legislation, including the Factories Act, 1948, Environment Protection Act, 1986, Air (Prevention and Control of Pollution) Act, 1981, Water (Prevention and Control of Pollution) Act, 1974, Hazardous Waste (Management, Handling and Transboundary Movement) Rules, 2016, Companies Act, 2013 (**Companies Act**), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (**Listing Regulations**), Prevention of Money Laundering Act, 2002, Prevention of Corruption Act, 1988, and laws with respect to the payment of minimum wages, bonus, gratuity, welfare activities, health and safety, etc. Various aspects of ESG are covered under these pieces of legislation in a fragmented manner. For instance:

- Section 134(3)(m) of the Companies Act requires the board's report to contain details on conservation of energy including any steps taken or impact on conservation of energy, steps taken to utilise alternate sources of energy, capital investment in energy conservation equipment, efforts towards technology absorption, etc.
- Section 166 of the Companies Act casts duty on a director of a company to act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment.
- Section 135 of the Companies Act read with the Companies (Corporate Social Responsibility Policy) Rules, 2014 makes it mandatory for companies with specified net worth, turnover or net profit to constitute a Corporate Social Responsibility (**CSR**) committee to oversee the CSR policy and activities. Eligible companies are required to annually spend at least 2% of their average net profits of the last three financial years on CSR. The board's report shall disclose the composition of the CSR committee, content of the CSR policy, an explanation for any unspent amount, etc.
- Regulation 17(1)(b) of the Listing Regulations stipulates that one-third of the board of a listed entity shall be composed of independent directors in case the chairperson is a non-executive director and not a promoter or related to a promoter or a person occupying a management position; otherwise, at least half of the board should be composed of independent directors.
- The Companies Act has stipulation for having female directors for certain classes of companies. Additionally, Regulation 17(1)(a) of the Listing Regulations requires the top 1,000 listed entities to have an independent, female director on their boards.
- Regulation 17(1)(b) of the Listing Regulations provides that, with effect from 1 April 2022, the chairperson of the board of the top 500 listed entities (except those that do not have any identifiable promoters) shall be a non-executive director and not related to the managing director or chief executive officer.
- Section 177 of the Companies Act requires the board of every listed company and certain classes of public companies to constitute an audit committee consisting of a minimum of three directors, with independent directors forming a majority. Additionally, Regulation 18 of the Listing Regulations requires that at least two-thirds of a listed entity's audit committee members are independent directors; however, in case of a listed entity having outstanding SR equity shares, all members must be independent directors. It also requires that the chairperson of the audit committee shall be an independent director.
- Section 178 of the Companies Act requires the board of every listed company and certain classes of public companies to constitute a nomination and remuneration committee (**NRC**) consisting of three or more non-executive directors, of which not less than one-half shall be independent directors. The chairperson of the company (whether executive or non-executive) may be appointed as a member of the NRC but shall not chair the NRC. Additionally, Regulation 19 of the Listing Regulations requires that in case of a listed entity having outstanding SR equity shares, two-thirds of the NRC shall be composed of independent directors. It also requires that the chairperson of the NRC shall be an independent director.
- While the Securities and Exchange Board of India (**SEBI**), i.e. the capital markets regulator, made it mandatory for the top 100 listed companies by market capitalisation to file a business responsibility report (**BRR**) capturing their non-financial performance across ESG factors back in 2012, SEBI has recently, in May 2021, expanded the BRR and replaced it with a new business responsibility and sustainability report (**BRSR**). SEBI *vide* Regulation 34(2)(f) of the Listing Regulations and its circular dated 10 May 2021 on '*Business responsibility and sustainability reporting by listed entities*' (**BRSR Circular**) made it mandatory for the top 1,000 listed entities by market capitalisation to include, in their annual report, a BRR describing the initiatives taken by the listed entity from an ESG perspective. The requirement of submitting a BRR shall be discontinued

after FY 2021–22 and be replaced thereafter by BRSR with effect from FY 2022–23. While the existing BRR filing is mandatory for FY 2021–22, listed entities have been given the option to voluntarily file the new BRSR for the present financial year *in lieu* of the BRR. The remaining listed entities may voluntarily submit such reports.

1.2 What are the main ESG disclosure regulations?

The main form of ESG reporting in India is the BRR/BRSR. As mentioned in question 1.1 above, the Listing Regulations mandate the top 1,000 listed entities to disclose a BRR in their annual report. The annual report is shared with the shareholders, submitted to the stock exchange, and published on the company's website.

The new BRSR seeks disclosure from listed entities of their performance against the nine principles of the '*National Guidelines on Responsible Business Conduct*' (**NGRBC**), which were issued by the Ministry of Corporate Affairs, Government of India (**MCA**) in the background of emerging global concerns, the Sustainable Development Goals (**SDGs**), and the United Nations Guiding Principles on Business and Human Rights. These principles require that businesses should:

i) conduct and govern themselves with integrity, and in a manner that is ethical, transparent and accountable;
ii) provide goods and services in a manner that is sustainable and safe;
iii) respect and promote the well-being of all employees, including those in their value chains;
iv) respect the interests of and be responsive to all stakeholders;
v) respect and promote human rights;
vi) respect and make efforts to protect and restore the environment;
vii) when engaging in influencing public and regulatory policy, do so in a manner that is responsible and transparent;
viii) promote inclusive growth and equitable development; and
ix) engage with and provide value to their consumers in a responsible manner.

Reporting under the BRSR format is divided into three parts: general disclosures; management and process disclosures; and, principle-wise, performance disclosures. Reporting under each principle is divided into essential indicators and leadership indicators. The essential indicators are expected to be mandatorily disclosed while leadership indicators may be voluntarily disclosed. Some of the disclosures sought in the BRSR are:

i) An overview of the entity's material ESG risks and opportunities, and the approach to mitigate or adapt to the risks along with financial implications of the same.
ii) Sustainability-related goals and targets, and performance against the same.
iii) Environment-related disclosures covering aspects such as resource usage (water and energy), greenhouse gas emissions, air pollutant emissions, biodiversity, waste generated, waste management practices, etc.
iv) Social-related disclosures covering the workforce, value chain, consumers and communities including: (a) employees/workers – disclosures on gender diversity, social diversity including measures for differently abled persons, wages, turnover rates, welfare benefits, training, occupational health and safety, etc.; (b) consumers – disclosures on product recall, product labelling, complaints by consumers regarding cyber security, data privacy, etc.; and (c) communities – disclosures on social impact assessments, CSR, rehabilitation and resettlement, etc.
v) Governance-related disclosures covering aspects such as training and awareness programmes, anti-corruption or anti-bribery policies, fines and penalties imposed on the entity, directors or key management personnel, complaints with respect to conflicts of interest, affiliations with trade and industry associations, any corrective actions taken by authorities on issues related to anti-competitive conduct, etc.

The BRSR also provides for inter-operability of reporting, i.e. entities that prepare sustainability reports based on internationally accepted reporting frameworks (such as the Global Reporting Initiative (**GRI**), Sustainability Accounting Standards Board (**SASB**), Task Force on Climate-Related Financial Disclosures (**TCFD**), International Integrated Reporting Council (**IIRC**)) may cross-reference the disclosures made under such frameworks to the disclosures sought under the BRSR.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Beyond what is described above, ESG reporting largely remains voluntary in India, depending on the initiative of a business (except for the top 1,000 listed entities). Generally, disclosures are based on well-accepted global sustainability frameworks and standards, such as GRI, SASB, TCFD, IIRC, etc. Moreover, SEBI's BRSR Circular also permits inter-operability of reporting.

In 2018, the Bombay Stock Exchange published a guidance document for all corporates listed on it, to provide a comprehensive set of voluntary ESG reporting recommendations along with 33 key performance indicators.

Separately, under SEBI's new BRSR, leadership indicators are to be disclosed on a voluntary basis.

1.4 Are there significant laws or regulations currently in the proposal process?

The Government has codified 29 labour laws into four codes, namely: the Code on Social Security, 2020; the Industrial Relations Code, 2020; the Code on Wages, 2019; and the Occupational Safety, Health and Working Conditions Code, 2020. These codes are intended to consolidate and update the morass of previous statutes and amendments that previously covered these areas. These codes provide for the right to minimum wages, social security, right of security to workers in all situations, among others. Although the codes have been notified, their implementation has been deferred until the time that some major industrial states frame the requisite rules under said codes.

Customer data and privacy has become a material aspect in the operations of companies, and new laws are being formulated in this regard. The Personal Data Protection Bill was first proposed by the Government in 2018 and has since undergone several changes. The Bill imposes obligations on entities/individuals deciding means and purpose of processing personal data to undertake certain transparency and accountability measures, sets out certain rights of individuals and grounds of processing personal data, sets up a data protection authority to protect interests of individuals and prevent misuse of personal data, among others. The Bill is currently being considered by a Joint Parliamentary Committee and is yet to be finalised.

On 26 October 2021, SEBI floated a '*Consultation paper on introducing disclosure norms for ESG Mutual Fund schemes*' proposing a series of measures to ensure that ESG schemes remain true to label, which should reflect consistency in its name, its stated objective, its documented investment policy and strategy, and its investments. It also proposes that, with effect from 1 October

2022, asset management companies shall only invest in securities that have BRSR disclosures. Stakeholders are invited to provide their comments and inputs on this consultation paper.

In November 2018, MCA constituted a Committee on Business Responsibility Reporting for finalising business responsibility reporting formats for listed and unlisted companies, based on the framework of the NGRBC. The report of the committee was released on 11 August 2020. The new BRSR format introduced by the BRSR Circular (as discussed in question 1.2 above) has its foundation in this committee report. The report makes certain other recommendations, such as that the reporting requirement may be extended by MCA to unlisted companies above specified thresholds of turnover and/or paid-up capital, and that smaller unlisted companies below this threshold may adopt a lite version of the format. It is yet to be seen whether any regulatory changes will be brought by the Government and regulators based on such recommendations.

1.5 What significant private sector initiatives relating to ESG are there?

In 2020, the National Stock Exchange (**NSE**) carried out a comprehensive study on the disclosure and performance of India Inc. on non-financial ESG parameters. The study was the first of its kind on ESG disclosures and performance. The sample was restricted to 50 listed companies that have disclosed either their sustainability report or integrated report voluntarily and are within the top 10 companies of their sectors and within the top 100 companies as per their market capitalisation. This study provides a broader picture of ESG footprint and will further enable gap analysis and drive companies to achieve better performance and leadership status. Additionally, it will give institutional investors a ready-made tool to benchmark companies.

Various corporates in India are taking initiatives relating to ESG. For instance:

- Blue-chip stocks such as Reliance Industries and Tata Consultancy Services (**TCS**) announced their roadmaps towards reduction in greenhouse gas emissions towards zero.
- TVS Motor's focus on reduction of direct emission and usage of renewable energy, such as wind and air energy, resulted in a CO_2 emission reduction of approximately 58,812 tons during 2020–21.
- P&G introduced Fairy Ocean Plastic bottles made of 10% ocean plastic and 90% recycled plastic.
- UltraTech Cement integrated a low-carbon strategy to address climate change goals based on COP21 of the United Nations Framework Convention on Climate Change with initiatives such as cooler upgradation, calciner modification, etc. across its manufacturing plants to improve the company's energy productivity.
- PI Industries, by using scientific advancements in the field of agriculture across their manufacturing locations, changed the direct seeding of rice technique across 675,000 hectares of land that resulted in conserving 355 billion gallons of water and saving 25–30% irrigation and energy costs.
- Hindustan Unilever Limited started the Suvidha Centre in Mumbai to cater to issues of lack of personal hygiene, non-availability of safe drinking water and poor sanitation in slums.
- Dabur India launched 'Sundesh', a non-governmental organisation for developing rural areas.
- Infosys Limited, in October 2020, launched its ESG Vision & Ambition for 2030 with a focus on the areas of climate change, technology, diversity and inclusion, energising local communities, ethics and transparency, data privacy, and information management. Its board also constituted an ESG committee in April 2021 to discharge its oversight responsibility on ESG matters including initiatives, priorities, and leading practices.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

A survey conducted by CRISIL indicates that over 80% of issuers and institutional investors intend to integrate ESG in their decision-making. In fact, the United Nations Principles for Responsible Investment has some India-based entities, including asset managers, as signatories.

Investors and asset managers are increasingly relying on ESG performance to guide their investment decisions, and there are rising expectations for ESG performance, appropriate ESG disclosures and transparency on boards' oversight on important ESG matters. A number of sustainability indices have also been launched by stock exchanges in India. For instance, the S&P BSE 100 ESG Index is designed to measure exposure to securities that meet sustainability investing criteria while maintaining a risk and performance profile similar to S&P BSE 100, its benchmark index.

There are various indicators showing greater transparency in businesses and investments as well as steps towards improving investors' confidence. There has been a surge in the number of ESG funds in India, from a mere two at the end of 2019 to 10 funds with aggregate assets under management of INR 12,403 crore (USD 1.66 billion). Despite ESG reporting being mandatory for only the top 1,000 listed companies, four out of five companies on Nifty 50 are reported to have voluntarily released disclosures on ESG practices. In the stock indices, too, ESG index companies on average have performed better compared to other index companies. Spending in CSR activities by Indian companies has also crossed the milestone of INR 1 lakh crore (USD 13.4 billion).

Foreign investors have been a significant factor in influencing the market preference for companies with strong ESG practices. For instance, Norges Bank Investment Management, Norway's USD 1 trillion wealth fund, excluded Page Industries from its portfolio for alleged human rights violations. Similarly, an increasing number of global pension funds and other such institutions have ceased to finance coal projects. To date, over 100 globally significant asset managers/owners, banks and insurers/reinsurers have announced their divestment from coal mining and/or coal-fired power plants.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

The U.S. Trust Insights on Wealth and Worth 2018 survey indicated that 87% of high-net-worth millennials considered a company's ESG track record as an important consideration in their investment decisions. Furthermore, a 2019 Morgan Stanley Institute for Sustainable Investing survey of high-net-worth investors found that 95% of millennials were interested in sustainable investing.

However, this trend is yet to develop in India, given that the participation of millennials in the markets is yet to scale up. Similarly, India is yet to see the trend of employees being major drivers of ESG trends in large companies.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In India, the principal regulators with respect to ESG are MCA, which supervises corporates incorporated under the Companies Act, and SEBI, which supervises publicly listed companies as well as asset managers. SEBI's BRR goes the furthest in promoting ESG disclosures on a mandatory basis. Separately, MCA has imposed mandatory reporting on CSR under the Companies Act. In addition, enforcement authorities under labour laws and environmental laws (including the Ministry of Environment, Forest and Climate Change and the Central and State Pollution Control Boards) play a meaningful role in ESG compliance in their respective spheres. The Ministry of New and Renewable Energy plays an important role in establishing goals and benchmarks for the renewable energy business in India.

In 2021, the Reserve Bank of India (**RBI**) highlighted in a paper that 'green finance' is emerging as a priority for public policy, and that reduction in the asymmetric information regarding green projects through information management systems and enhanced coordination between stakeholders could pave the way towards sustainable economic growth. Furthermore, SEBI has also made the new BRSR format mandatory from 2022–23.

This discussion would not be complete without reference to the important role that courts play in India with respect to environmental issues. The Supreme Court of India pioneered public interest litigation (**PIL**), making access to courts easier through the well-settled principle of *locus standi*. PIL enables public-spirited citizens or social action organisations to mobilise a judicial concern before the Supreme Court and High Courts on behalf of vulnerable sections of the community or to raise matters of common concern. The ambit and extent of PIL has significantly expanded over the years and has been used as a major device for resolving disputes around protection of the environment. There is also a constitutional basis for the courts to look into environmental issues, in particular, Article 21 of the Constitution of India providing for 'protection of life and personal liberty' as a fundamental right. Article 21 has been expanded by judicial interpretation over the years to include the right to a healthy and pollution-free environment, amongst others.

Moreover, in 2010, the Government established a specialised body, i.e. the National Green Tribunal, a quasi-judicial body, for effective and expeditious disposal of cases relating to environmental protection and conservation of forests and other natural resources including enforcement of any legal right relating to the environment and giving relief and compensation for damages to persons and property.

2.4 Have there been material enforcement actions with respect to ESG issues?

There have been a number of relatively high-profile enforcement actions by the authorities in connection with alleged failures to comply with ESG laws. For instance:

- In 2009, a public listed company, Satyam Computers, became the subject of various legal proceedings because of fraud committed by its promoter-shareholders involving large-scale falsification of books, misstatement of finances, fundraising and trading in shares while in possession of unpublished, price-sensitive information. The persons responsible for the fraud faced severe regulatory action including disgorgement and debarment from the securities market for a certain time period.
- In 2013, the Supreme Court of India ordered Sterlite Industries (India) Ltd. (now Vedanta Limited) to pay compensation of INR 100 crore (USD 13.42 million) for having polluted the environment and for operating its copper smelting plant in Tamil Nadu without a valid permit renewal for a certain time period. The quantum of compensation was decided based on the financial strength of the company to create a deterrent effect. In 2018, the Government of Tamil Nadu and Tamil Nadu Pollution Control Board ordered the closure of the plant, and in 2020, the Madras High Court upheld the validity of these orders. Presently, an appeal is pending before the Supreme Court against the judgment of the Madras High Court.
- State Pollution Control Boards are active in environmental sustainability and take action against defaulters by way of fines, closure of plants and seizure of materials, among others. For example, the Maharashtra Pollution Control Board has completely banned certain plastic products such as carrier bags, single-use disposable cups, straws, etc., issued closure directions to 103 plastic and thermocol manufacturing industries, collected fines of INR 2.44 crore, and seized around 297 tonnes of banned plastic items.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Environmental issues represent the most notable litigation risk. The courts in India have been very active in entertaining litigation, which alleges improper environmental clearances, encroachment into environmentally sensitive areas or that businesses are operating without obtaining necessary clearances. Since certain courts in India exercise 'public interest' jurisdiction and consider the right to a clean environment as a fundamental right, there is sometimes scope for environmental litigation even if the relevance licences have been obtained or do not apply.

2.6 What are current key issues of concern for the proponents of ESG?

The environment is an important area of concern due to the disturbing levels of air pollution in Indian cities and is therefore likely be an area of major legal and policy development in the future. The Government has already taken steps such as adoption of Bharat Stage VI with respect to emission norms of vehicles, the national air quality index and the introduction of FAME II to promote manufacturing and purchase of electric vehicles.

Diversity on boards and leadership of companies is another area on which proponents of ESG are focused. In terms of ESG disclosures, while SEBI's new BRSR format has addressed certain misses in the earlier BRR format and is intended to be a useful standardised disclosure, certain challenges continue to remain. However, it is likely that the level of disclosure on ESG issues will ramp up in the coming years to meet the demands of domestic and international investors.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Government and policymakers are equally aware of ESG issues as corporate leaders. Policies and laws in relation to sustainable business practices play important roles in addressing ESG issues. A recent NSE study on ESG disclosures of 50 listed entities also gives credence to this. The study indicated that the companies largely scored better on policy disclosures followed by governance factors, compared to environmental and social factors, which can be attributed to the fact that in the last two decades, governance reforms have transformed into laws and many policies have been mandated to be prepared by the regulatory authorities.

In a company, there are several factors that make ESG a board agenda and not only a remit of executive management. A board's fiduciary duty towards ESG is implicitly enshrined under the provisions of the Companies Act; for instance, Section 166(2) mandates a director of a company to act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment, while Section 166(3) requires a director to exercise his duties with due and reasonable care, skill and diligence and exercise independent judgment, and Schedule IV on the code for independent directors also makes reference to '*balance the conflicting interest of the stakeholders*'.

There are several other factors that put ESG into the mainstream agenda, such as demand from investors, the link between ESG and the valuation of a company and cost of capital, 'E' and 'S' factors impacting business models, growing regulatory push for ESG disclosures, litigation risks, etc.

Policy and strategy decisions by the board of directors are key for setting the tone and changing the strategy of the corporate entity with respect to ESG issues. Company management that operate in today's dynamic ecosystem are expected to have a 'triple-bottom line' approach, i.e. concern for the company, the community as well as the environment, to steer the funds of a corporation.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The role of the board is discussed in question 3.1 above. As such, duties of a director cannot be assigned, as the director is considered a delegate of the members of a company, and therefore in line with the principle of *delegatus non potest delegare*. The punishment for violation of fiduciary duties of a director is severe to deter any wrongdoing; for instance, if a director violates Section 166 of the Companies Act, such violation shall be punishable with a fine of up to INR 500,000 (USD 6,700).

There is no one-size-fits-all governance mechanism for ESG issues. With emerging prominence of ESG considerations, some companies, both globally and in India, have adopted various models for board oversight of ESG matters, such as complete board oversight with inducting required knowledge and skills, if needed, requiring an existing committee to support the board, setting up a separate board committee for ESG, setting up external advisor councils to assist the board with suggestions on ESG, and setting up stakeholder councils with representation from various stakeholders to obtain their perspective.

In India, another important aspect is that some elements of ESG are already considered by various committees of the boards, such as the risk management committee, audit committee, stakeholder relationship committee, NRC, and CSR committee. For effective oversight of ESG issues, some interlinkage of these committees may be required.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Many leading companies in India have started to include ESG targets as a part of their key result areas (**KRAs**) for top management when computing their variable pay.

As per a study by Refinitiv in 2020 comparing disclosures of 160 Indian companies, approximately 8% had a policy on ESG-related executive compensation.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Many Indian companies are adapting to ESG requirements, with boards dedicating significant time to discussing ESG issues. Companies are adopting various policies and strategies such as reducing their carbon footprint, using renewable energy, voluntary CSR, setting up medical and education establishments, firms making variable pay as well as ESG a part of the KRAs for top management, amongst others, thereby making efforts towards establishing a sustainable ecosystem. Below are some of the leading examples:

- ITC Limited has become India's first company to commit to its target for 2035 to certify all of its factories and hotels operating in areas of high water stress to the Water Stewardship Standard (**AWS Standard**), the global benchmark for water stewardship.
- Blue-chip stocks Reliance Industries and TCS announced roadmaps towards reduction in greenhouse gas emissions towards zero.
- Marico, a consumer goods maker, has made ESG part of its top management KRAs for determining compensation.
- Welspun, a textile major, has also embarked on a journey to enable a sustainable approach in all its operations including sourcing of raw materials, manufacturing, supply chain and waste recycling.
- Vedanta, a global natural resources company, is currently transforming to embed ESG into every aspect of its decision-making and performance evaluation process.
- Tata Group entities consider sustainability as one of the business objectives for the organisation.
- Snapdeal, an e-commerce unicorn, has aligned its outlook with India's Nationally Determined Contributions of lowering emissions intensity of its GDP by 33–35% by 2030 compared to 2005 levels and has opted for a facility for its data centres that follows green building standards as per the certification issued by the Indian Green Building Council and uses water-cooling techniques and evaporative cooling for reduced energy consumption.
- There is interest to support start-ups that actively facilitate ESG goals by early-stage venture capital investors.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

To the extent that debt and equity finance providers rely on ESG ratings and scores, the same tend to be developed externally.

Globally, some of the biggest ESG rating providers are MSCI, Sustainalytics, Bloomberg, and Refinitiv, and credit rating agencies such as S&P, Moody's, and Fitch. From 2020, various agencies have made their ESG ratings public. Development in the ESG market has also resulted in the emergence of new ESG and credit rating agencies providing bespoke ESG research solutions.

Recent publications of Edelweiss ESG Scorecard & Ratings of 100 Indian companies and CRISIL ESG scores for 225 Indian companies allude to increasing relevance of ESG ratings. Furthermore, in October 2021, a full-service broking and investment platform, Sharekhan, by BNP Paribas, partnered with Morningstar India to roll out ESG ratings for companies under coverage, to help its traders and investors assess companies holistically and compare them across industries in the process of investment decision-making.

There are still certain drawbacks that pose questions on reliability of ESG ratings, such as lack of consistency and set standards between rating providers for measuring ESG practices, which may be attributed to individual methodologies and weightage adopted, lack of data, which may result in use of proxies, non-comparability for cross-industry analysis, disclosure quality and standardisation. It is expected that increasing regulatory steps around disclosure may address these issues to some extent.

4.2 Do green bonds or social bonds play a significant role in the market?

Green finance in India is still in its nascent stage. Most green bonds are issued by public sector entities and corporates with better financial health. A report by RBI dated January 2021 suggests that green bonds have constituted 0.7% of total bond issuance since 2018, and bank lending to the non-conventional energy sector constituted 7.9% of outstanding bank credit to the power sector, as in March 2020.

Although the value of green bond issuances contributed to a small portion of all bonds issued in India, among emerging markets, India has consistently been the second-largest issuer after China and has the second-largest volume of outstanding green bonds (USD 10.8 billion as in 2020).

Based on data from Refinitiv, up until July 2021, 10 Indian companies have raised USD 4.64 billion via sustainable bonds issued in overseas markets, which is five times the amount raised in 2020 by just two companies. Out of these 10 issuances, seven were green bond issuances, two were social bond issuances and one was a sustainability-linked bond.

The demand for green bonds increased during the pandemic, particularly in the renewable sector. USD 3.5 billion worth of green bonds were issued by India's renewable energy producers in the first half of 2021, breaking the earlier one-year record. The issuances attracted a lot of interest with a significant percentage of oversubscription on average. This year also witnessed India's very first green bond issuance by a municipal corporation (namely, Ghaziabad Municipal Corporation) in April 2021.

Social bonds are also gaining attention. Recently, Pimpri Chinchwad Municipal Corporation and United Nations Development Programme India signed a memorandum of understanding to create the first social impact bond of India.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds (**SLBs**) are also gradually gaining traction among Indian issuers. This year, UltraTech Cement raised USD 400 million by issuance of senior unsecured USD denominated notes in the form of SLBs, thereby becoming the first company in India and second in Asia to issue SLBs. The bonds are listed on the Singapore Stock Exchange. JSW Steel and Adani Electricity Mumbai Ltd. have also issued SLBs this year.

4.4 What are the major factors impacting the use of these types of financial instruments?

These instruments offer investors a diversified portfolio, increase coupon, lower risk, and help investors contribute to the SDGs. These factors also help issuers in improving their reputation in the market and in demonstrating their commitment towards sustainable development.

The ability of larger Indian corporates to tap into sustainable financing is also attributed to necessary processes being put in place over the last few years, including improvement in ESG quotient, ESG-related information being disclosed in their annual disclosures, and commitment towards sustainable development. This is supplemented by the Government's commitment towards sustainable development as reflected in the constantly improving ESG-related regulatory landscape.

Having said that, there are certain challenges associated with such instruments, such as higher borrowing costs, asymmetric information, maturity mismatches, greenwashing, etc.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The assurance and verification process is guided by voluntary guidelines, such as the Green Bond Principles issued by the International Capital Market Association and voluntary standards and certification scheme by Climate Bonds Initiative.

In 2017, to push green bond issuances in India, SEBI issued a circular on green bonds including listing of green bonds on the Indian stock exchanges. The 2017 circular was repealed and currently, SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021 read with SEBI's circular dated 10 August 2021 govern the issue and listing of green bonds.

The regulations define 'green debt securities' to mean a debt security issued for raising funds that are to be utilised for projects and/or assets falling under any of the specified categories, i.e. renewable and sustainable energy, clean transportation, climate change adaptation, energy efficiency, sustainable waste and water management, sustainable land use including sustainable forestry and agriculture, biodiversity conservation or any other category as may be specified by SEBI, from time to time. The circular, *inter alia*, provides the following:

i) The offer document will consist of a statement on environmental objectives of the issue, brief details of the decision-making process followed/proposed for determining the eligibility of projects or assets for which the proceeds are being raised, details of the system/procedures to be employed for tracking the deployment of the proceeds, etc.

ii) The issuer may, at its discretion, appoint an independent third-party reviewer/certifier, for reviewing/certifying the processes including project evaluation and selection criteria, project categories eligible for financing by green debt securities, etc. Any such appointment shall be disclosed in the offer document. In other words, SEBI has not mandated a third-party reviewer/certifier; however, disclosure is mandated upon such appointment (if any).

iii) As part of the continuous disclosure requirement, an issuer who has listed its green debt securities shall provide, along with its annual report and financial results, disclosures on utilisation of the proceeds of the issue, as per the tracking carried out by the issuer using the internal process as disclosed in the offer document, and details of unutilised proceeds. Utilisation of the proceeds shall be verified by the report of an external auditor, to verify the internal tracking method and allocation of funds towards the project or asset, from the proceeds of green debt securities.

iv) As part of the continuous disclosure requirement, the following additional disclosures are required to be provided along with the annual report:

   a) A list and brief description of the projects or assets to which proceeds of the green debt securities have been allocated/invested and the amounts disbursed. If details of any project or asset cannot be shared owing to confidentiality agreements, details of the areas in which such project or asset falls should be provided.

   b) Qualitative performance indicators and, where feasible, quantitative performance measures of the environmental impact of the project or asset.

   c) Methods and the key underlying assumptions used in preparation of the performance indicators and metrics.

v) An issuer of green debt securities or any agent appointed by the issuer complying with globally accepted standards for the issuance of green debt securities including measurement of environmental impact, identification of the project or asset, utilisation of proceeds, etc., shall disclose the same in the offer document and/or as part of continuous disclosures.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

The COVID-19 pandemic has accelerated the relevance of ESG considerations to investors and other stakeholders, and carved a path for the 'new normal' in ESG management for both companies and investors. There is an increase in awareness of ESG issues and recognition of mere pontification of ESG, and with intense scrutiny, companies need to show concrete evidence for their ESG consciousness. Investor engagement is not limited to financial performance; they are also focusing attention on managing risks, oversight mechanisms, policy gaps, and performance metrics. Public participation in the ESG debate has also intensified due to social media platforms, and a shift towards sustainable investing has been noted. This is also reflected by the surge in new launches of ESG-themed mutual fund schemes and growth in underlying assets during this period. Disruption caused by the unprecedented pandemic has prompted companies to address the issues raised during this period, such as a need for workplace health and safety procedures, executive pay being under scrutiny in the context of employee lay-off, job losses and salary cuts, supply chain resilience, etc. Regulatory focus on the ESG reporting framework is a consequence of the need for rebuilding a better business ecosystem and increased resilience going forward.

6 Trends

6.1 What are the material trends related to ESG?

There has been a surge in new launches of ESG-themed mutual fund schemes and growth in underlying assets this year. This trend is likely to continue.

Transparency and ESG integration are going to become more profound. Surface-level implementation of ESG is becoming outdated, and companies are expected to ensure that ESG compliance is less superficial and more goal-oriented. Integration of sustainability risks in the portfolio is key, while management of environmental and social risks is likely to emerge as a new standard for comprehensive corporate governance practices.

Investors will seek specific and standardised ESG disclosures, and the regulator has also stressed increased transparency and standardisation by introducing the BRSR. The MCA report that recommended BRSR states that it will serve as '*a single comprehensive source of non-financial sustainability information relevant to all business stakeholders – investors, shareholders, regulators, and public at large*'. It is yet to be seen whether the BRSR will be accepted as a singular source of information for companies reporting in India.

The COVID-19 pandemic has significantly impacted CSR practices. The 'S' element in ESG is likely to gain more traction as the pandemic continues to reveal the social issues and need for responsibility towards workforce and communities.

Sustainability instruments are also expected to attract more interest, and there is increasing pressure to act on climate change. This is likely to be the dominant theme for the Government, regulators, investors, corporates, and other stakeholders.

As ESG considerations gain prominence, more companies are likely to link executive incentives to ESG-related metrics, and with digitalisation, cyber security and data privacy will be at the forefront of stakeholders' agenda.

6.2 What will be the longer-term impact of COVID-19 on ESG?

The ongoing COVID-19 pandemic has had a deep-rooted impact on economies globally. The focus now seems to be on building sustainable and resilient business models in order to survive in the long run.

The pandemic and associated lockdowns have affected business continuity and accelerated trends such as digitalisation, e-commerce, agile working, automation, among others, which have brought to light concerns around data privacy and security, workforce management, supply chain resilience, contingency planning, risk governance, etc. The way in which businesses adapt to these trends will be a determining factor of their performance in the long run. There is renewed focus on sustainability and, in addition to strategy and management of ESG issues, stakeholders will seek increased transparency and accountability.

Other issues that have emerged are exposure of workforce risk and social inequalities. Many employees and workers have experienced lay-offs, and 'essential workers' have been the most exposed to the risk of COVID-19 in their workplaces. This has brought the 'S' element of ESG to the centre of discussion, and we foresee a demand for measures around workplace safety, employee health, and support for vulnerable communities going forward.

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We frequently advise our clients on elements of Indian corporate laws and the legal and regulatory issues that impact their day-to-day business. We offer services broadly as per the following practices: Corporate; Mergers and Acquisitions/JVs; Competition; Energy and Infrastructure; Restructuring and Insolvency; Private Equity; Banking and Finance; Capital Markets; Asset Management and Funds; Financial Services Regulatory; Governance and Enforcement; Tax; Real Estate; Dispute Resolution/ Litigation; White Collar Crimes and Investigation; Labour and Employment; and Technology, Media and Telecom.

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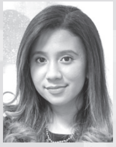
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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

ESG-related matters are addressed across a variety of laws and regulations in Indonesia. These include:

Environmental

Law No. 32 of 2009 on Environmental Protection and Management and its amendment cover the basic rules that shall be applied by everyone in order to protect the environment. It regulates the obligation to manage environmental sustainability and forbids anyone to pollute the environment, dispose of toxic hazardous waste into the environment, and conduct land clearing by burning.

Social

Provisions regarding social matters are regulated in various regulations, depending on the social aspect to be addressed.

Employment is regulated under Law No. 13 of 2003 on Manpower as amended by Law No. 11 of 2020 on Job Creation. It protects employees from discriminative acts from employers and ensures that employees obtain work safety, timely payment and other rights to which they are entitled based on the laws and regulations.

Indonesia also protects consumers. Consumer protection is specifically regulated under Law No. 8 of 1999 on Consumer Protection. It regulates consumers' rights, such as, among others, the right to: (i) choose goods and/or services; and (ii) be heard, in the event that they have opinions or complaints related to such goods and/or services.

Corporate governance

Law No. 40 of 2007 on Limited Liability Companies ("**Company Law**") is the main corporate law that regulates governance matters, including the duty of the Board of Directors ("**BoD**") and Board of Commissioners ("**BoC**"), and the obligation of annual general meeting shareholders and of the company to notify and obtain approval from the Ministry of Law and Human Rights related to amendment of the company's Articles of Association.

Further, the Financial Services Authority (*Otoritas Jasa Keuangan* or "**OJK**") supports ESG implementation in the Indonesian economy by publishing several roadmaps and regulations, such as the Integration of Social Environment and Governance for Banks (Guide to Starting Implementation 2015), the Sustainable Finance Roadmap (2015–2019) and the Indonesia Corporate Governance Roadmap in 2014, the Sustainable Finance Roadmap Part II (2021–2025), and OJK Regulation No. 60/POJK.04/2017 on the Issuance and Requirements of Green Bonds as well as OJK Regulation No. 51/POJK.03/2017 concerning the Implementation of Sustainable Finance in Financial Services Institutions, Issuers, and Public Companies.

1.2 What are the main ESG disclosure regulations?

Principally, disclosure is made in a company's annual report by the BoD to the shareholders in the annual general meeting of shareholders after the annual report is reviewed by the BoC. The Company Law regulates the minimum information that shall be disclosed in the annual report, such as the implementation of social and environmental responsibility by the company, any issues that arose during the financial year that affected the company's business activities, and a report on the supervisory duties that have been carried out by the BoC during the last financial year.

The annual report of public companies shall be in accordance with OJK Regulation No. 29/POJK.04/2016 on Annual Report of Public Companies. Such annual report shall contain, among other things: the BoD and BoC report; management analysis and discussion; governance of the company; and social and environmental responsibility of the company.

In addition, public companies are also required to submit a report on material information or facts to OJK and publish such information or facts to the public. Material information or facts include, among others: (i) changes in members of the BoD and/or the BoC; (ii) labour disputes that can disrupt the company's operations; and (iii) legal cases that have a material impact on the company.

Furthermore, according to OJK Regulation No. 51/POJK.03/2017, sustainability reporting is required for financial services institutions, issuers, and public companies. The sustainability report could be rendered as part of the annual report or separately and shall contain, among others:

a. an explanation of the sustainability strategy;
b. an overview of sustainability aspects (economic, social and environmental);
c. an explanation of the BoD;
d. sustainability governance; and
e. sustainability performance.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Although requirements for private companies are different from those for public companies, which are required to provide a sustainability report, several private companies in Indonesia voluntarily disclose their ESG matters in their sustainability reports made in accordance with international standards, such as the Global Reporting Initiative and Sustainability Accounting Standards Board. The reports are made by the company itself or by an appointed third party.

1.4 Are there significant laws or regulations currently in the proposal process?

Given that ESG aspects are spread across multiple laws and regulations, there are several proposed changes and new laws and regulations that are currently in process. The Indonesian government is currently working on laws and regulations that specifically regulate new and renewable energy. The new and renewable energy laws are being drafted in accordance with Indonesia's efforts in and commitment to overcoming the impact of climate change due to the increase in the earth's temperature so as to create clean and environmentally friendly energy.

Other regulations also in the discussion stage in the House of Representatives of the Republic of Indonesia, among others, are the Second Amendment of Law No. 18 of 2013 on Prevention and Eradication of Forest Destruction, the Amendment of Law No. 32 of 2009 on Protection and Management of Environment, the Law on Utilization of Solar Power, the Law on Social Responsibility of a Company, and the Amendment of Law No. 8 of 1999 on Consumer Protection.

1.5 What significant private sector initiatives relating to ESG are there?

Big and reputable companies, especially companies whose business activities have an impact on the environment, are making environmental or sustainability programmes and strategies as well as publishing a voluntary sustainability report or other reports that address ESG matters.

A decacorn company that engages in the ride-hailing industry, PT Aplikasi Karya Anak Bangsa (known as Gojek), published its first sustainability report in 2020. The company stated that the report discloses its performance on material ESG topics to all of its stakeholders. Several key ESG highlights performed by the company are: (i) the launch of a strategy and framework for achieving diversity, equity and inclusion in the market; (ii) the launch of an employee assistance programme in 2019; and (iii) becoming a signatory of the UN's Women's Empowerment Principles for advancing gender equality in 2020, among others.

Another example can be seen in multinational fast-moving consumer goods company, PT Unilever Indonesia Tbk, which makes real effort to preserve the environment by using environmentally friendly packaging for its products. It has also conducted several other concrete actions, such as: (i) positioning a woman at Director level; and (ii) utilising post-consumer recycled plastic as alternative refuse-derived fuel.

Many webinars on ESG have also been held to raise awareness on the importance of ESG to companies in particular and to economy sustainability in general. The webinars are usually held in collaboration with the government.

The existence of awards and ratings held by several parties could also be a trigger to raise ESG awareness in Indonesia. For example, in 2020, the ESG Awards were held virtually by *Investor Magazine* in collaboration with the Global Carbon Foundation. The ESG Awards are intended to motivate companies to be more concerned with environmental, social, and good corporate governance matters.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

A number of investors and asset managers realise that there is a growing awareness of ESG investing. Actual philosophies in integrating ESG considerations into the business decisions of those investors and asset managers are mainly to align themselves to global sustainability initiatives, especially in accordance with the UN Principles for Responsible Investing. Not only has ESG investment proven to provide risk-adjusted returns, but also better investment sustainability in the long term.

Even though there is no known set of certain ESG reporting that is endorsed by those investors and asset managers, criteria that includes environmental protection, rights and obligations of employees, and transparency in corporate governance of a company are key considerations for investors and asset managers.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Other stakeholders, such as the Indonesian Chamber of Commerce and Industry ("**KADIN**"), support and want to have more involvement in the growing number of green projects initiated by the government to achieve the Nationally Determined Contribution in reducing greenhouse gas emissions.

Furthermore, environmental activists, such as the Indonesian Center for Environmental Law ("**ICEL**") and Wahana Lingkungan Hidup Indonesia ("**WALHI**"), actively give their opinions, responses, and criticisms on the environmental condition in Indonesia as well as on government and private actions related to the environment through books, policy papers, press releases or newsletters.

The Indonesian Biodiversity Foundation ("**KEHATI**"), a non-profit organisation, has introduced a Sustainable and Responsible Investment Equity Index ("**SRI-KEHATI**") that benchmarks the sustainable practices of companies in the Indonesian stock market and picks the top 25 to be included in the Index. With company selection standards that apply the principle of Sustainable Responsible Investment ("**SRI**"), as well as ESG principles, the SRI-KEHATI Index is now one of the references for investment principles that emphasise ESG issues in the Indonesian capital markets.

Another relevant stakeholder applying pressure is the Indonesian Stock Exchange ("**IDX**"). In 2020, it launched the ESG Leaders Index, which measures price performance of stocks that become leaders in ESG ratings and do not have significant controversies selected from stocks with high trading liquidity and good financial performance. The ESG rating and controversy analysis is developed by *Sustainalytics*.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

There is no one principal regulator responsible for enforcing ESG issues. Nevertheless, OJK has played an important role with respect to ESG through the issuance of several roadmaps and regulations listed above at question 1.1.

In addition, the National Committee on Good Governance formed by the Coordinating Ministry for Economic Affairs is responsible for the implementation of good corporate governance in the public sector as well as corporations in Indonesia. This Committee has published relevant guidelines that are widely use in national practice, such as the Good Corporate Governance Guidelines for Corporates and for Banking Corporations, the Good Public Governance Guidelines, the Good Governance Guidelines for Syariah Business, as well as the Whistleblowing System Guideline.

2.4 Have there been material enforcement actions with respect to ESG issues?

The enforcement actions in Indonesia (other than litigation enforcement) are mainly centred around disclosure obligations and environmental issues. OJK has imposed administrative sanctions on companies that have violated the laws and regulations of the capital market sector, such as failure to submit an annual report to OJK as obliged by the law. The administrative sanctions have been in the form of fines and written warnings.

The Ministry of Environment and Forestry, on the other hand, has imposed several administrative sanctions on companies that have considered harming the environment. Between 2015 to 2021, there were 1,958 administrative sanctions enacted by said Ministry in the form of licence revocation, licence suspension, written warnings, and government coercion.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Litigation is one of the ways of resolving disputes related to ESG, especially the environmental and labour aspects. Regarding the environmental aspect, cases are arising from commercial activities that impact the environment, such as: (i) disputes related to environmental protection; (ii) disputes related to the use of natural resources; and (iii) disputes arising from pollution and/or environmental destruction.

One distinguished case related to the environment is the Lapindo Mudflow in Sidoarjo, East Java. The hot mudflow at a drilling site owned by PT Lapindo Brantas that began on May 29, 2006 has forced many villages to flee the area. The centre of the hot mud eruption is located in the Porong District, about 12 kilometres south of Sidoarjo. This residential area is densely populated and one of the main industrial areas in East Java. Several highways, toll roads, and railway lines have also been affected. Huge losses are inevitable, and tens of thousands of residents have had to evacuate and start a new life elsewhere.

The cause of the mudflow is still a matter of debate, and two theories have been put forward by PT Lapindo: first, that the mudflow occurred due to a procedural error during drilling; and second, that the hot mud erupted by chance during drilling, but the cause is unknown. As there are so many parties impacted by the mudflow, the lawsuit against PT Lapindo came from several parties, demanding that the company take responsibility for the losses suffered.

In 2014, the Constitutional Court decided that PT Lapindo shall pay compensation to the victims. However, the issuance of such compensation has yet to be completed.

In addition to environmental issues, labour issues are usually also settled through court. Such issues involved in disputes are generally related to: (i) termination of an employee; (ii) rights disputes between an employer and an employee; (iii) disputes of interest between a labour organisation and an employer; and (iv) employment law crimes.

2.6 What are current key issues of concern for the proponents of ESG?

The current key issues are mainly environmental and social issues. Regarding the environment, with rainforests and verdant greenery accenting its landscape, Indonesia is sometimes referred to as the "Emerald of the Equator". While the country's abundant natural resources enable it to maintain energy independency, it has also negatively affected public health. Coal, which produces significantly more carbon emissions that other fossil fuels, provided over half of Indonesia's power generation in 2016 alone.

Further, farmers have also created pollution by "slashing and burning" to clear harvested crops from lands before replanting. In 2015, these practices resulted in the "haze crisis" that plagued the entire Southeast Asia region. Recognising the severity and urgency of the situation, Indonesia pledged to reduce its greenhouse gas emissions by 29% between 2015 and 2030, in part through diversification of renewables and reduction in deforestation.

Regarding social issues, the main problem is the social gap created by income inequality. There is huge inequality between the citizens of Jakarta and other cities in Indonesia. Even between the citizens of Jakarta themselves, the social gap is tremendously pronounced between rich and poor. The poverty rate in Jakarta in 2020 was 4.53%, while in other, more remote cities, such as Jayapura, it was 12.44%, Bandung 6.91%, and Semarang 7.51%.

As with many developing countries, corruption is also particularly problematic in Indonesia. The country ranks 89th out of 180 according to Transparency International. The crime has slowly decreased due in large part to prosecutorial efforts by the Corruption Eradication Commission (*Komisi Pemberantasan Korupsi*, "**KPK**"). Since its inception, KPK has achieved an almost 100% conviction rate, resulting in the sentencing of 122 parliamentarians, 25 ministers, 17 governors, and 51 regents and mayors. These efforts have reduced political corruption, but it remains endemic. Bureaucratic corruption also continues to be an issue despite the country's efforts to enforce and streamline regulatory processes.

Further, legal uncertainty is also an obstacle that hinders the implementation of ESG in Indonesia. As mentioned in question 1.4, there are several laws in the discussion process in the House of Representatives that shall aim to accelerate the process and create legal basis and certainty.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The BoD has principal responsibility for addressing ESG issues and formulating the strategy of the company. In accordance with the Company Law, the BoD will be supervised by the BoC.

The BoD addresses ESG issues through the annual report, other public reports that are required by the laws and regulations, and/or a voluntary report. In practice, the BoD could delegate some of its ESG-related roles to the management of the company or a special committee established to formulate strategy and manage and evaluate the implementation of ESG matters in the company. However, the BoD shall maintain its ultimate responsibility.

The committee (if any) shall give a report to the BoD on the strategy that it would like to apply. The BoD will then review, approve or reject such strategy.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The mechanism to supervise the management of ESG issues shall be in accordance with internal policy designated to it or any other standard operating procedures made by the company (if any). If there are no particular regulations in the company, then the supervision shall be conducted in accordance with its Articles of Association as well as the Company Law in which the BoD will be supervised by the BoC.

The role of the BoD or the special committee relating to ESG issues includes, among others:

a. Environmental: establishing policy and strategy that ensures that the company supports environmental protection and sustainability (utilisation of recycled products, waste management, emissions reduction by improving operational efficiency, etc).

b. Social: establishing a healthy working environment, providing training and skill development, increasing income opportunities, etc.

c. Governance: ensuring that the company operates ethically and with integrity, establishing a code of conduct and standard operational procedure and ensuring the company's compliance with laws and regulations.

For public companies, it is required that they have an audit committee to supervise the company. The audit committee is a committee formed by and responsible to the BoC in order to help carry out its duties and functions. Such audit committee may have a role in supervising the management of ESG issues.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Compensation or remuneration is commonly given to the company's management and employees. Nowadays, compensation or remuneration is often calculated based on the ESG compliance factor of the company or an individual within the company. For example, in PT Wijaya Karya (Persero) Tbk, an Indonesian state-owned enterprise engaged in the construction sector, the remuneration of the BoD is determined based on the target for achieving profit as well as the ability to maintain business sustainability and development. Further, in one of the biggest mining companies in Indonesia, employees are entitled to a performance-based achievement bonus in the event that no work incident has occurred on site.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

There is no uniform approach that could ultimately show that a company has integrated ESG into its operations. Each company could conduct different actions that are suitable to the current condition of the company.

Integration of ESG into day-to-day operations could be evident by:

- Formation of a special committee.
- Incorporation of ESG experts in the business unit.
- Demonstration of a real commitment to ESG in sustainability/ESG reports.
- Publishing of information to explain that ESG is considered in the company's investment process.
- Providing evidence that the company is trying to address ESG issues (transition to renewable energy, ensuring women's involvement on the board, etc).

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Generally, investors use an ESG score in their investment strategy to see the consequences of a poor rating on a company and how significant it will be for their decision. For example, a bad rating would mean that the company's stock may be considered an unsustainable asset.

PT Bank CIMB Niaga Tbk stated in its Sustainability Report 2020 that the company periodically reviews a debtor's credit facilities following the Bank's Principal Credit Policy and Commercial Credit Policy. A review is also applied to the lending process by taking into account the debtor's commitment and background in complying with ESG aspects.

Another example comes from a state-owned bank, PT Bank Rakyat Indonesia (Persero) Tbk. In its Sustainability Report 2020, the Bank stated that its loans approval procedure is carried out by taking into account ESG risks. The company also has a risk and credit management committee that gives consideration to environmental risks, including climate change. In addition, the company has specifically formulated an ESG risk management policy relating to palm oil.

In practice, financiers for public companies could rely on the available ESG-related IDX Indices, such as SRI-KEHATI and ESG Leaders, to determine the ESG performance of a company.

For private companies, investors rely more on the annual reports of a company. As the voluntary report is also becoming a trend, investors could also include such report in its consideration. In some cases, like if the investment is coming from a special government vehicle, such as PT Indonesia Infrastructure Finance, the investor will require its debtor to comply with their own set of environment and social standards and principles.

4.2 Do green bonds or social bonds play a significant role in the market?

In 2018, PT Sarana Multi Infrastruktur became the first party to issue a green bond in Indonesia. In the same year, PT Jasa Marga (Persero) Tbk also issued its green bond, known as the Komodo Bond, which is listed on the London Stock Exchange. Slowly but surely, green bonds are developing. However, this development is relatively slow in Indonesia, with a total of USD 3.8 trillion compared to global issuance. One of the causes of such slow development is the lack of interest in environmental issues and bonds. Like the green bond, social bonds also have a relatively small role in the Indonesian market.

In addition to green bonds, Indonesia also recognises the green sukuk, which is a Sharia-compliant bond. The green sukuk has played a significant role in the Indonesian market having issued USD 3 million, one of the highest in the world. In July 2021, due to keen investors and strong bookbuilding sessions, the number of orders for the green sukuk was recorded at USD 10.3 billion, more than three times the government's target of USD 3 billion.

4.3 Do sustainability-linked bonds play a significant role in the market?

The first sustainability-linked bond in Indonesia was issued recently in 2021 by a leading agrifood company, PT Japfa Comfeed Indonesia. The bond itself is listed on the Singapore Stock Exchange. It is still unknown whether sustainability-linked bonds will play a significant role in the market, with green bonds being more common.

4.4 What are the major factors impacting the use of these types of financial instruments?

The government's commitment to combatting climate change through the Paris Agreement 2016 highlighted the priority actions listed in the National Medium-Term Development Plan to also focus on the implementation of low carbon and zero transmission. The government has been developing a Green Bond and Green Sukuk Framework under which it plans to finance and or refinance eligible green projects via issuance of such bonds. Some eligible green projects have even planned to be exclusively financed or refinanced with such bonds. Eligible green projects as projected by the Ministry of Finance are in the sectors of renewable energy, energy efficiency, resilience to climate change for highly vulnerable areas and sectors/disaster risk reduction, sustainable transport, waste to energy and waste management, sustainable management of natural resources, green tourism, green buildings, and sustainable agriculture.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Currently, the assurance and verification process for green bonds is handled by the Ministry of Finance via the issuance of the Green Bond and Green Sukuk Framework. The involvement of OJK also plays a vital role since OJK has issued a regulation (OJK Regulation 60/2017) on the issuance and requirement of green bonds, which mentions the environmentally friendly business activities permitted to use green bonds, requirements for the issuance of green bonds, as well as sanctions for non-compliance. Also, to provide assurance on its annual green bond and green sukuk report provided by the Ministry of Finance, the government will engage an independent third party to make sure such report and the compliance of each green bond and green sukuk is issued within the Green Bond and Green Sukuk Framework.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

The COVID-19 pandemic has impacted each of the aspects that represent ESG in Indonesia.

From the social aspect, unemployment in both the formal and informal sectors is increasing. In October 2020, a survey on unemployment was conducted and the results show that 63% of the respondents lost their jobs during the pandemic. Furthermore, food insecurity has also become a parallel problem as a result of such unemployment.

From the environmental aspect, COVID-19 has caused significant disruption in the food supply chain, and has accelerated waste and medical waste problems, air pollution, water shortages, and the increasing intensity and severity of climate-related disasters.

OJK highlighted that the current condition is a great reminder for businesses to pay their utmost attention to sustainability issues for future generations.

6 Trends

6.1 What are the material trends related to ESG?

ESG is predicted to be, if not already, the main trend in industry and investment. Some trends related to ESG implementation are as follows:

a. Sustainability report: Even though it is not yet an obligation, many companies in Indonesia, from public to private, as well as state-owned, are starting to publish sustainability reports to display their support for and commitment to the implementation of the Sustainable Development Goals.

b. Making corporate strategies related to ESG and achieving sustainability: Indonesian companies are competing to create corporate strategies related to ESG and sustainability, for example: (i) the three pillars (GoForward, GoGreener, and GoTogether) created by Gojek to achieve its ambitious goal of the Three Zeroes (Zero Emissions, Zero Waste, and Zero Barriers); and (ii) the strategic triple-p roadmap (portfolio roadmap, people roadmap, and public contribution roadmap) created by PT Astra International Tbk. Such strategy aims to increase shareholder value, to build the company's human resources and to provide benefits to the community. With this strategy, the company balances its business growth with human resource development and contribution to society.

c. Investors require debtors to comply with ESG requirements: Investors tend to be more interested in companies that pay attention to ESG matters; some are even requiring their debtors to comply with environmental and social standards and principles made by the investors.

d. Making programmes in line with ESG: One reputable securities company in Indonesia believes that the opportunity for the development of ESG in Indonesia is high, in line with government programmes and authorities in terms of sustainability. A project that is predicted to be developed is the production of electronic vehicles, expected to reach 2 million units by 2025, or equivalent to 20% of the national production target. By 2030, production is expected to increase to 3.05 million units.

6.2 What will be the longer-term impact of COVID-19 on ESG?

As a result of COVID-19, Indonesia has faced challenges in achieving its development goals. Statistically, between March and September 2020, there was an increase in the national poverty rate from 9.78% to 10.19%. Furthermore, COVID-19 also brings awareness to companies and employees on the importance of healthcare and a healthy work environment as well as the sustainability of companies in order to survive an unpredictable future event, such as a global pandemic.

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Before establishing Bahar, he was a lecturer at Padjadjaran University and Trisakti University, Jakarta on various subjects, including air and space law, telecommunications law and international law. He also actively attends various international training programmes, colloquia and seminars on corporate finance, capital markets, trade and environmental law. In addition, Wahyuni is entrusted by many domestic and international organisations to act as a speaker in various seminars/workshops, in the fields of capital markets, securities, cross-border M&A, investment, Islamic financing, telecommunications, and aviation, among others.

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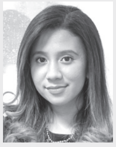

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Since joining Bahar in 2018, Fresa has been focusing on investment, M&A, capital markets, restructuring, and good corporate governance. She is experienced in conducting legal due diligence as well as providing legal advice for a range of sectors such as land and property, automotive, construction, and investment in general. Assisting the Managing Partner, Fresa was also involved in the KADIN Omnibus Law Task Force between 2019 and 2020.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

The main substantive ESG-related regulations are (i) the Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088), (ii) the Taxonomy Regulation (Regulation (EU) 2020/852), (iii) the Low Carbon Benchmark Regulation (Regulation (EU) 2019/2089), and (iv) the European Union (Disclosure of Non-Financial and Diversity Information by certain large undertakings and groups) Regulations 2017 as amended, which transposed into Irish law the Non-Financial Reporting Directive (Directive 2014/95/EU).

1.2 What are the main ESG disclosure regulations?

The main ESG disclosure regulations are the Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088), the Taxonomy Regulation (Regulation (EU) 2020/852) (including the regulatory technical standards), and the Low Carbon Benchmark Regulation (Regulation (EU) 2019/2089).

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Voluntary disclosures beyond those required by law or regulation include the consideration of principal adverse impacts of investment decisions on sustainability factors. The voluntary regimes that are currently in existence with respect to ESG include the Global Reporting Initiative, the Financial Stability Board's Task Force on Climate-related Financial Disclosures, and the Sustainability Accounting Standards Board. In order to improve disclosure in respect of ESG matters, companies are increasingly looking to issue sustainability reports prepared in accordance with the Global Reporting Initiative's Sustainability Reporting Standards. In addition, certain ESG-related regulations have introduced voluntary disclosures; for example, the Low Carbon Benchmark Regulation has introduced two new categories of low-carbon benchmarks, namely: (i) a climate-transition benchmark; and (ii) a specialised benchmark that brings investment portfolios in line with the Paris Climate Agreement regarding the goal to limit the global temperature increase. The categories are voluntary labels designed to assist investors who are looking to adopt a climate-conscious investment strategy.

1.4 Are there significant laws or regulations currently in the proposal process?

In addition to the ESG disclosure regulations noted above, there are several other legislative proposals in various stages of the EU's legislative process, including the regulatory technical standards for the Taxonomy Regulation, the regulatory technical standards for the Sustainable Finance Disclosure Regulation, the Corporate Sustainability Reporting Directive (the "CSRD"), which will amend and enhance the existing reporting requirements of the Non-Financial Reporting Directive, a delegated regulation supplementing Article 8 of the Taxonomy Regulation (specifying the content methodology and presentation of information to be disclosed), the EU Green Bond Standard (the "EU GBS"), the EU Ecolabel, guidelines on credit ratings, and guidelines on loan origination and monitoring.

1.5 What significant private sector initiatives relating to ESG are there?

There are a number of significant private sector initiatives relating to ESG. In Ireland, the prominent private sector initiative is the Sustainable and Responsible Investment Forum ("SIF Ireland"). SIF Ireland is a national platform to advance responsible investment practices across all asset classes, and it aims to raise awareness of responsible investment nationally, bringing together policymakers, asset owners, asset managers and other investment intermediaries to stimulate and advance the growth of responsible investment practices in Ireland. SIF Ireland also aims to grow the market by increasing understanding, acceptance and demand for sustainable investments.

The Industrial Development Authority (the "IDA") is also working with the financial sector associations on promotion of Ireland as a location for sustainable finance and environmental sustainability and partnering with multinational corporations on green economy initiatives and opportunities. These initiatives and partnerships are a key pillar of the IDA's new strategy "*Driving Recovery and Sustainable Growth 2021–2024*". The Banking and Payments Federation Ireland has also endorsed the UN Principles for Responsible Banking. In addition, Irish Funds announced the launch of "The Green Team Network", an industry initiative that aims to provide a central forum to facilitate knowledge sharing and collaboration in the field of sustainability across the Irish funds industry.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors are increasingly looking to align their investment decisions with their personal priorities. Investors are now not only focused on financial returns but also on non-financial outcomes. Investors are seeking to invest in companies that have the capabilities to both achieve and maintain strong financial and ESG performance. Asset managers are embracing ESG in order to align stakeholders' interests and avoid short-term investments and results, in return for long-term incentives aligning investment practices with social responsibilities and principles in order to meet investor demands. Investors are also recognising the potential for ESG factors to affect the valuation and performance of companies they invest in, and this has resulted in investors pressurising companies to increase the amount of information disclosed to investors on ESG-related matters.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

ESG and sustainable finance is an area that is continuously evolving and growing to meet the expectations of a wide number of stakeholders, including shareholders, policymakers, regulators and central banks. Within the EU and Ireland, new regulatory frameworks are being introduced to address and support the European Commission's revised Action Plan on Sustainable Finance and the Renewed Sustainable Finance Strategy. This includes a number of regulations outlined above, including the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation, the Low Carbon Benchmark Regulation and also the supporting secondary legislation with regard to the implementation of delegated acts. There are also a number of matters in progress, including the development of the EU GBS, the EU Ecolabel for financial products, and updating corporate financial reporting under the Non-Financial Reporting Directive (by the CSRD as outlined above). This is in addition to the European Green Deal, the European Commission's plan to make the EU's economy sustainable, which sets out an action plan to boost the efficient use of resources by moving to a clean, circular economy, restoring biodiversity and cutting pollution with the aim of the EU being climate neutral in 2050 with the proposed European Climate Law, which turns the political commitment into a legal obligation. Furthermore, shareholders have placed increasing pressure on companies with respect to social and governance issues, including gender and racial diversity on boards, requiring companies to adopt policies, and enhanced disclosure with respect to ESG matters.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The principal financial regulator in Ireland is the Central Bank of Ireland. The Office of the Director of Corporate Enforcement (the "ODCE"), whose mission is to improve the compliance environment for corporate activity in the Irish economy by encouraging adherence to the requirements of the Companies Acts, and bring to account those who disregard the law, is also a key regulatory body in addition to the Irish Auditing and Accounting Supervisory Authority. More broadly within the EU, bodies including the European Commission and bodies such as the European Securities and Markets Authority ("ESMA"), the European Banking Authority, the European Insurance and Occupational Pensions Authority (the Joint Committee of the European Supervisory Authorities), and the Technical Expert Group (the "TEG") are the principal regulators with respect to ESG issues. The key issues being pressed by these bodies are the action plan on financing sustainable growth, which includes the following: (i) developing an EU classification system for environmentally sustainable economic activities; (ii) developing EU standards (such as the EU GBS) and labels for sustainable financial products (via Ecolabel) to protect the integrity and trust of the sustainable finance market; (iii) fostering investment in sustainable projects; (iv) incorporating sustainability in financial advice; (v) developing sustainability benchmarks; (vi) sustainability in research and ratings; (vii) disclosures by financial market participants; and (viii) sustainability in prudential requirements, strengthening sustainability disclosures by corporates, and fostering sustainable corporate governance and promoting long-termism. This is in addition to the Renewed Sustainable Finance Strategy, which includes six proposed actions, namely to (i) develop a more comprehensive framework and help the financing of intermediary steps towards sustainability, (ii) improve the inclusiveness of sustainable finance, (iii) enhance economic and financial resilience to sustainability risks, (iv) increase the contribution of the financial sector to sustainability, (v) monitor an orderly transition and ensure the integrity of the EU financial system, and (vi) set a high level of ambition in developing international sustainable finance initiatives and standards and to support EU partner countries.

2.4 Have there been material enforcement actions with respect to ESG issues?

At the broader European level, there have been a number of material enforcement actions with respect to ESG issues regarding issuers whose securities are admitted to trading on a regulated market. Investors are also increasingly demanding reliable and relevant disclosure on ESG factors. ESMA, the EU securities markets regulator, published its 2020 annual report on 26 April 2021 on enforcement of corporate disclosure. The report presents the 2020 activities of ESMA and of European accounting enforcers when examining compliance of financial and non-financial statements provided by European issuers. In light of the increased importance of companies' ESG disclosures, European enforcers continued their enforcement activities on non-financial information in 2020, leading to examinations of 737 non-financial statements or 37% of the total number of issuers required to publish a non-financial statement. Related enforcement actions taken by ESMA represented an action rate of 5%.

Unusually within the EU context, the European enforcer in Ireland under the Transparency Directive (Directive 2004/109/EC) and the Accounting Directive (Directive 2013/34/EU), namely the Irish Auditing and Accounting Supervisory Authority, does not have powers relating to non-financial statements. Rather, the implementing legislation in Ireland (S.I. No. 360/2017) in respect of Article 19a (non-financial statement) and Article 29a (consolidated non-financial statement) of the Accounting Directive designates the ODCE as having such powers of enforcement. To date, there have been no reported enforcement actions by the ODCE in this regard.

Finally, with the implementation of the new ESG regulatory framework, the Central Bank of Ireland has already warned against the risk of investors being misled into buying financial products that do not meet the represented environmental standards, a practice known as "greenwashing". The Central Bank of Ireland regards ESG issues as a strategic priority, so material enforcement action against firms in this area can be expected going forward.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The principal litigation risks arise from shareholder activism and related investor claims against companies and their directors, particularly in relation to materially false or misleading ESG disclosures or representations made in prospectuses or investor reports. This could give rise to claims in contract (breach of contract and misrepresentation), tort (negligence, negligent misstatement and fraud) as well as under statute (for example, section 1349 of the Companies Act 2014 provides for civil liability for loss and damage relating to misstatements in prospectuses). The Central Bank (Supervision and Enforcement) Act 2013 has created a broad statutory cause of action for damages suffered by any customer of a regulated financial service provider as a result of a failure to comply with any obligation under financial services legislation.

To date, there have been limited reported decisions by the Irish courts in relation to ESG issues. Further, while Ireland has a number of active environmental non-governmental organisations ("NGOs"), climate-related claims by such NGOs have tended to be in the area of planning and environmental law. Nonetheless, the trend of ESG-related litigation, which has arisen elsewhere, is likely to surface to some degree in Ireland in the near future. The prevalence of such claims by groups of investors or consumers in Ireland may be tempered somewhat as, unlike other jurisdictions that have seen a rise in such litigation, especially the U.S., Ireland does not currently have a formal class action procedure. While in certain circumstances it may be open to a party to bring a test case, whereby there are multiple claims arising from the same circumstances and a select claimant's case is heard, or a representative action, whereby a claimant brings a case on behalf of a group that shares the same interest, these procedures are restrictive and do not facilitate group claims as efficiently as the class action system that exists in the U.S. Such barriers should be significantly alleviated for consumers by the EU Collective Redress Directive, which was published on 4 December 2020. EU Member States are required to adopt implementing measures for the Directive by 25 December 2022 and to apply such measures by no later than 25 June 2023. When operational, this will provide for a more accessible and cost-efficient framework for consumer class actions in Ireland and across the EU in relation to breaches of EU law.

A further factor that has likely contributed to the increase in such litigation in other jurisdictions is the availability of litigation funding. However, the funding of litigation by third parties without any *bona fide* interest in the litigation remains prohibited in Ireland.

The Irish courts are likely to be receptive to claims concerning ESG issues, particularly in relation to environmental aspects. This is evident from the Irish Supreme Court's landmark decision in August 2020 in *Friends of the Irish Environment CLG v The Government of Ireland & Ors* where it quashed the Irish Government's National Mitigation Plan, its statutory plan for tackling climate change. This plan was quashed on the basis that it did not contain the requisite specificity required under the Low Carbon Development Act 2015, which provided for the approval of plans by the Irish Government to address climate change. The Supreme Court observed that climate change was undoubtedly one of the greatest challenges facing all states and that it was already having a profound environmental and societal impact in Ireland.

2.6 What are current key issues of concern for the proponents of ESG?

The key issues for the proponents of ESG are a lack of transparency and reporting standards as well as a series of delays with respect to the implementation dates of regulations. For example, the proposed implementation date for the regulatory technical standards to supplement the Sustainable Finance Disclosure Regulation has now been postponed until 1 July 2022; however, the Taxonomy Regulation in respect of the climate change mitigation and adaptation objectives is expected to apply from 1 January 2022, which may cause implementation challenges for asset managers. In addition, the lack of comparable ESG data is a concern for proponents of ESG. Robust, comparable and reliable ESG data is key to identifying and assessing sustainability risks and to steer financial market participants and their products towards the objectives of the Paris Climate Agreement and the European Green Deal. The availability of quality, comparable, reliable and public ESG data is currently limited. It is also often expensive, leading to unnecessary costs and competition concerns. The availability of raw, harmonised ESG data would allow for better comparability, increase transparency, lower barriers and costs, generate efficiency, reduce complexity and attract new players.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Senior management has an essential role in addressing an organisation's ESG issues and for assessing the potential impact of such ESG issues on the organisation's operating model. The key issue for management bodies is to identify ESG themes that are emerging as industry drivers ahead of their competitors in order to gain competitive advantage. This requires management bodies to identify the various stakeholders, their incentives and the matters that may bring about change with respect to ESG, including obtaining insight in respect of the companies' social or environmental impact. By connecting business goals with the demands of investors with respect to ESG issues and differentiating from competitors, companies can increase revenue and gain competitive advantage. In order to set and change the strategy of a corporate entity with respect to ESG matters, management bodies should adopt strategic practices to establish accountability structures for ESG, identify and create a corporate purpose and culture, and enhance investor transparency. Management bodies play a key role and are responsible for ensuring that a company's mission is achieved.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The structures and processes in place to supervise management of ESG issues depends on the nature and scale of the company. Boards play an important role in driving ESG development within their companies, and board oversight on ESG issues can help businesses better manage their ESG-related risks and opportunities. This includes a board's oversight responsibilities. Boards also play an essential role in assessing an organisation's environmental and social impacts and understanding the impact of ESG issues on the organisation's operating model. Boards have a crucial role to ensure that companies are aware of, and are able to navigate, the ever-changing landscape and exercise oversight in this respect; such oversight should be informed, strategic and aligned with the company's business model to create long-term value. The board will also play a role in identifying the issues as well as evaluating and recommending steps to be taken with respect to ESG issues.

Investors are increasingly turning towards the boards of companies for accountability. Key performance indicators ("KPIs") are also in place to supervise the management of ESG issues, used as a tangible measurement to quantify the extent to which a company is achieving its goals. Investors expect board members to be competent in the area of ESG matters.

With regard to providing oversight and supervision in this area, consideration should be given to allocating oversight responsibilities to consider (i) which activities should be overseen by the board and those that should be delegated to a committee, for example, a sustainability committee, which could include providing guidance to management, (ii) disclosure of information with regard to information that should be shared between the board and management, including, for example, KPIs and metrics in order to understand the importance of certain ESG issues, and (iii) ESG as part of the board's oversight and strategy by incorporating ESG initiatives into the overall company strategy, and establishing metrics to include ESG initiatives to assess these performance indicators against the overall company strategy and ensuring oversight of ESG integration.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Compensation or remuneration incentives can be used to align executive compensation with shareholder interests with respect to ESG; examples of such policies include paying bonuses only when shareholder return targets are reached for a number of years in succession. The desired outcome being that the company will increase transparency for shareholders and create more responsible standards for achieving company growth over executive pay. One approach used to align incentives with respect to ESG is to have bonuses depend largely, or solely, on executives' success in respect of strategic opportunities related to sustainability, while continuing to monitor and disclose aspects of ESG performance, and insisting on seeing ESG metrics to ensure executives act responsibly, mitigate risk and comply with regulations. Compensation committees can use their discretion to adjust pay after the facts for sustainability performance in these areas. In order to integrate ESG issues into executive pay, companies should firstly adopt a clear process for identifying appropriate ESG metrics that relate to sustainable shareholder returns and company strategy. Linking ESG metrics to a reward system in a manner that forms a substantial component of the overall remuneration framework, and integrating ESG targets within a particular time frame that corresponds with the business strategy, will ensure that such ESG factors are used to incentivise high performance.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

ESG is fast becoming an inextricable part of how companies do business. The individual elements of environmental, social and governance are interconnected. A common example of how companies have integrated ESG into their day-to-day operations includes building reward systems that link performance with ESG metrics and tying this in with employee compensation. This in turn may lead to the attraction of, and retention of, talent. In addition, with regard to social issues such as insufficient diversity of talent and gender inequality, companies have addressed this through their recruitment process, putting in place committees and policies to ensure there is sufficient diversity. Environmental matters have also been integrated into the day-to-day operations of companies by reducing the amount of energy and resources used by companies.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Issuers of debt and equity finance rely on both internally and externally developed ESG ratings and not just financial data in order to add value by both improving performance and reducing volatility returns. In the past decade, there has been a significant increase in the use of ESG information in the investment process, with providers of debt and equity finance and investors alike recognising that ESG ratings have real value in driving investment performance. ESG ratings can complement existing factors such as liquidity, volatility and performance. Investors are increasingly considering a company's ESG rating when making investment decisions. Companies that produce low ESG ratings can be subject to criticism, whereas companies that produce high ESG ratings may see an increase in investor demand and investment flows.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds play a significant role in the marketplace. They tend to be used for financing or refinancing only green projects or assets and are structured to increase sustainable investing for investors created to fund projects that have positive environmental and/or climate benefits. Green bonds provide transparency for investors on the green projects that are being financed or refinanced and provide investors with an opportunity to be engaged in corporate environmental strategies, while providing bond markets with the opportunity to have an impact on green finance, in particular climate change mitigation finance.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-Linked Bonds ("SLBs") play a significant role in the market as they are designed to drive the provision of information needed to increase capital allocation to such financial products. SLBs aim to further develop the key role that debt markets can play in funding and encouraging companies that contribute to sustainability. SLBs are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives. Issuers of SLBs commit explicitly to future improvements in sustainability outcome(s) within a predefined timeline.

4.4 What are the major factors impacting the use of these types of financial instruments?

The Sustainability-Linked Bond Principles (the "SLBPs") provide guidelines relating to SLBs, including disclosure and reporting guidelines, and are a major factor impacting the use of these financial instruments. The SLBPs are applicable to all types of issuers and any type of financial capital market instruments. The SLBPs are voluntary for issuers and their advisors in structuring, disclosing and reporting on SLBs that outline best practices to incorporate forward-looking ESG outcomes and promote integrity in the development of the SLB market, as well as providing issuers with guidance on the key components involved in SLBs. The SLBPs emphasise the recommended and necessary transparency, accuracy and integrity of information that will be disclosed and reported by issuers to stakeholders. The SLBPs have five core components: selection of KPIs; calibration of sustainability performance targets; bond characteristics; reporting; and verification.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Industry-accepted Green Bond Principles developed by the International Capital Market Association (the "ICMA") ensure that such "green bonds" or "sustainable bonds" meet the rules of the respective principles formulated by the ICMA. There are also standards such as the Climate Bonds Standard and Certification Scheme, an investor-focused organisation that seeks to mobilise investors, industry and government to catalyse green investments at the speed and scale required to avoid dangerous climate change and meet the goals of the Paris Climate Agreement. The Certification Scheme allows investors, governments and other stakeholders to identify and prioritise "low-carbon and climate-resilient" investments and avoid "greenwashing". In addition, following the establishment of the TEG on sustainable finance in 2018 by the European Commission, the TEG has made recommendations to establish the EU GBS and the European Commission has proposed the new regulation on the EU GBS. The TEG has proposed that any type of listed or unlisted bond or capital market debt instrument issued by a European or international issuer that is aligned with the EU GBS should qualify as an EU Green Bond. The TEG has also published the "EU Green Bond Standard Usability Guide" (the "Guide"), which offers recommendations from the TEG on the practical application of the EU GBS. The Guide aims to support potential issuers, verifiers and investors of EU Green Bonds. The TEG proposes that the use of the EU GBS remains voluntary, and builds on market best practices such as the Green Bond Principles developed by the ICMA. At present, issuers having an EU Green Bond voluntarily verified by an external verifier has become common practice. Guidance on voluntary verification has been available thanks to ICMA's Guidelines for External Reviews. The EU GBS builds on these foundations while formalising it and requiring additional processes. It institutes mandatory prior verification of the alignment of green bond issues and will be open to all issuers of green bonds, including both private, public and sovereign issuers, and includes issuers located outside of the EU. The TEG has also recommended that oversight and regulatory supervision of external review providers eventually be conducted via a centralised system organised by ESMA.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

COVID-19 has had a significant impact on ESG practices. It has been the first test of whether investors and asset managers alike are truly dedicated to sustainable investments and ESG, or if ESG is just another case of greenwashing or PR spin. COVID-19 has increased investor focus in ESG, highlighting the role that good businesses and practices play in society and emphasising the direct link between social responsibility and investing. ESG practices have aided companies throughout the crisis, and investors are increasingly looking towards sustainable investment strategies when making investment decisions. Companies that focus on ESG practices are more likely to be resilient in the face of a crisis such as COVID-19 if they are managed for the long term in line with societal megatrends. In addition, COVID-19 is likely to increase the efforts of boards with regard to governance and disclosures, and how companies address governance factors is likely to impact businesses going forward.

6 Trends

6.1 What are the material trends related to ESG?

The inflows in ESG products are increasing with the launch of new funds, as well as the repurposing of non-ESG funds, and this has continued despite the impact of COVID-19. In the fixed income market, green bonds are the fastest-growing market. Asset managers are increasingly looking to integrate ESG factors in portfolio selection. In addition, socially responsible and ESG exchange-traded funds have become an increasingly popular area of focus for investors and asset managers alike. Following COVID-19, new opportunities may arise for categories of impact funds such as health and wellbeing as key areas of the response to the pandemic. COVID-19 seems to be further widening the scope of strategies.

6.2 What will be the longer-term impact of COVID-19 on ESG?

Early indicators show that COVID-19 is accelerating the demand for sustainable investing, introducing a renewed focus on climate change and requiring both asset managers and investors to focus on a sustainable approach to investing. As a result of the impact of COVID-19 on the global economy, policymakers and investors are looking at alternative investments, including those relating to climate change. COVID-19 may be pivotal for ESG investing alongside traditional financial investing in the long term. Recent studies have highlighted the fact that investors see COVID-19 as increasing investor awareness in other areas such as climate change, which should have a positive impact on ESG, particularly in the long term. The COVID-19 crisis is likely to increase the measures taken by boards and markets to factor in systematic risk, including disclosures related to ESG. COVID-19 has led to enhanced scrutiny from investors in respect of ESG metrics. ESG products have performed strongly relative to non-ESG products during the market downturn, and it is expected that investors will add these relative performance metrics to their asset selection preference. To date, with respect to investment funds, much of the focus has been on the environmental products, but the impact of COVID-19 on society is likely to see growth in social impact funds.

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Peter is a recognised legal expert in the ESG and sustainable investment space and works with some of the world's largest managers and financial institutions to implement their internal policies as well as external standards such as UN PRI and the EU's Sustainable Finance Action Plan.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

While there is no separate set of ESG-related regulations, the Italian legal framework includes several pieces of major legislation that relate to ESG sustainability and to Benefit Corporations. There is a long legal tradition in Italy on ESG issues arising from the 1948 Constitution that has a strong civic and human rights component. In 2016, Italy adopted the Italian National Action Plan on Business and Human Rights for 2016–2021, undertaking the implementation of the 17 Sustainable Development Goals ("SDGs") and encouraging companies to realise the goal of decent work for all, as set out in SDG 8 (Decent Work and Economic Growth) and to enhance the use of indicators of quality, sustainable development, equality and gender.

Environmental sustainability	Social sustainability	Governance
Italian law implementing EU Directive 2004/35/CE on environmental liability	Obligation for companies to recruit disabled workers if certain conditions are met	Prohibition for directors to act in conflict of interest with the company (Article 2391 of the Italian Civil Code)
Civil liability for pollution damage (Article 2043 of the Italian Civil Code)	Protection of workers' health and safety in the workplace (Legislative Decree 81/2008)	Requirement for companies owned or controlled by the Italian State to adopt anti-corruption models (Law 190/2012)
Legislative Decree 231/2001 ("Decree 231/2001") on the criminal liability of legal entities for crimes committed by directors and employees	Provisions on countering undeclared labour, labour exploitation in agriculture and wage rebalance in the agricultural sector (Law 199/2016)	EU Reg. 2088/2019 ("SFDR") on the establishment of a framework to facilitate sustainable investment and which is directly applicable to Italian market operators
Green procurement: Law 221/2015 on environmental provisions to promote green economy measures and to contain excessive use of natural resources. Article 34 of Legislative Decree 50/2016 and Ministry of Environment Decree dated 11 January 2017 on minimum environmental criteria in public procurement	National Action Plan Against Trafficking in and Serious Exploitation of Human Beings adopted pursuant to Legislative Decree 24/2014 (implementing EU Directive 2011/36)	EU Delegated Regs 2021/1253, 2021/1255, 2021/1256, 2021/1257 and EU Delegated Directives 2021/1269 and 2021/1270
Law Decree 111/2019 on air quality implementing Directive 2008/50/CE	–	Law Decree 1/2012 on a Legal Compliance Rating (*Rating di Legalità*) issued by the Italian Antitrust Authority
Law 120 of 11 September 2020, which empowers SACE, the export credit agency, to grant guarantees (SACE Green Guarantees) that support projects that aim to facilitate the transition to a clean and circular economy and to sustainable and intelligent mobility	–	–

Environmental sustainability	Social sustainability	Governance
Law Decree 111/2019 (Climate Decree), then transformed by Parliament in Law 141/2019, on urgent measures concerning all sectors potentially vulnerable to climate change, which has introduced measures to encourage environmentally virtuous behaviours and actions. Among these: the transformation of the Inter-ministerial Committee for Economic Planning ("CIPE") into the Inter-ministerial Committee for Economic Planning and Sustainable Development ("CIPESS"), in order to enhance environmental aspects in economic and financial policy decisions and the establishment of "Environmental Economic Zones"	–	–

Benefit Corporations

Law 208/2015 introduced to the Italian legislative framework the *Società Benefit* as a new legal status for Italian companies. *Società Benefit* are for-profit businesses that include common benefits both for society and the environment in their mission, pursue one or more aims of common benefit, and operate in a responsible, sustainable and transparent manner towards communities, territories and the environment, as well as cultural and social assets and activities, bodies and associations and other stakeholders. *Società Benefit* are subject to ESG mandatory disclosures and enjoy some beneficial fiscal treatment. In Italy, there are more than 1,000 registered *Società Benefit*, of which 120 have achieved an official certification from B Lab.

1.2 What are the main ESG disclosure regulations?

EU law, such as the SFDR on the establishment of a framework to facilitate sustainable investment, is directly applicable to Italian market operators. Further ESG disclosure regulations especially addressed to banks are expected to be enacted at European level in the coming years.

The national legislative provisions on ESG disclosure listed below apply to corporate entities (financial and non-financial), pension funds and asset managers.

1) Legislative Decree 254/2016 ("Decree 254/2016") on the disclosure of non-financial information, which requires public-interest entities ("PIEs") to disclose sustainability information into the reporting cycle. This Legislative Decree implemented EU Directive 2014/95 in Italy; the criteria to define PIEs (as listed and defined under Article 16 of Legislative Decree 39/2010) are entities that have, on an individual or consolidated basis, during the financial year, an average number of employees greater than 500 and that, at the end of the financial year, have exceeded (with respect to individual or consolidated data) at least one of the following limits: (a) total net asset value: €20 million; and (b) total net income from sales and services: €40 million. Article 16 of Legislative Decree 39/2010, as amended by Legislative Decree 135/2016, defines PIEs as: (a) Italian companies issuing securities admitted to trading on regulated Italian and European markets; (b) banks; (c) insurance companies; and (d) reinsurance companies, with registered office in Italy.

   The Decree sets out the requirement for PIEs to draw up an annual, non-financial statement ("NFS") containing information regarding the entity's development, performance, position, and the impact of the entity's operations on environmental, social, employment, human rights, anti-corruption, and bribery matters relevant to the nature and operations of the entity. A description of the compliance programme implemented pursuant to Decree 231/2001 should also be included alongside the relevant outcome and risk areas. The NFS may be included in the directors' management report of the annual financial statements or may be filed with the Companies' Register as a stand-alone report ancillary to the annual financial statements.

   A PIE's directors, members of the supervisory board and auditors may be fined, depending on their role and the circumstances, from €20,000 to €150,000 if the NFS (i) is not filed, (ii) does not comply with Decree 254/2016's provisions, or (iii) provides untrue or incomplete information (unless the conduct is criminally relevant). Decree 254/2016 was implemented by Regulation issued by CONSOB, the Italian financial markets regulator, with Resolution 20276 of 18 January 2018. In order to address the risk of greenwashing, CONSOB issued further guidance on the requirements of disclosure of non-financial information in Resolution 21850 of 19 May 2021.
2) Legislative Decree 147/2018 on the activity and supervision of pension funds. This Legislative Decree implemented the European Pensions Directive (IORP II – EU 2016/2341) in Italy and highlights that sustainability issues are important for the investment policy and risk management of pension funds. Therefore, these funds are required to declare whether they take ESG criteria into account in their investment choices and how they integrate them into risk management. In particular, the law refers to the reporting of ESG issues in the areas of governance, investment policies, risk assessment and management and information to members and potential members based on the "comply or explain" principle.
3) Legislative Decree 49/2019 Italian laws implementing the Shareholder Rights Directive (2007/36/EC) and the Shareholder Rights Directive II (EU/2017/828). The Shareholder Rights Directive has the objective of encouraging an approach to and greater activism on the part of institutional investors in the exercise of voting rights associated with participation in the share capital of the invested companies. The expected effect is to foster dialogue between investors and issuers on company policies that are part of medium- to long-term objectives.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Pursuant to Law Decree 1/2012, Italian companies can apply, on a voluntary basis, to obtain a Legal Compliance Rating (*Rating di Legalità*) issued by the Italian Antitrust Authority, which requires that the applicant notify the Authority of certain violations of primary and secondary legislation. The level of the actual rating is also contingent upon adoption by the applicant company of voluntary governance and consumer codes and of internal codes addressing corporate social responsibility, anti-corruption issues, criminal liability under Decree 231/2001 and the risk of dealing with counterparties linked to criminal organisations.

Among the voluntary disclosures more frequently introduced by Italian non-financial corporates are the climate-related financial disclosures by the Task Force on Climate-related Financial Disclosures ("TCFD") and the Carbon Disclosure Project ("CDP") generally published within the annual Sustainability Report. For asset managers, investment companies and service providers, the most common voluntary disclosure is the Transparency Report required by the Principles for Responsible Investment ("PRI") framework.

A voluntary disclosure is also the Green Framework, a document introduced by the Green, Social and Sustainability-linked ("GSS") Bonds Principles published by the International Capital Market Association ("ICMA") for companies approaching the bond or loan market with a sustainability-related debt instrument. Once the disclosure is adopted, the content and structure of the document shall be in line with the Green Bond Principles ("GBPs").

1.4 Are there significant laws or regulations currently in the proposal process?

To date, a large part of the ESG legislation applicable in Italy has been derived from EU law. This trend is expected to continue, due to the European Green Deal. The applicability of the "Do No Significant Harm" test for all projects funded by NextGenerationEU will trigger a collective effort by public and private entities to disclose and report ESG risks and factors identified by the EU Taxonomy (Italy being the biggest recipient of funds among the EU Member States). However, a number of initiatives are currently being considered at governmental level to boost Energy Efficiency Mortgage Loans, to develop social housing, to allow considerable investment in research and development for circular economy activities, to name a few. These initiatives are part of the draft Sustainable Finance Action Plan for Italy that was presented to the stakeholders on 8 November 2021.

Recently, the Constitutional Affairs Committee approved new drafts of Articles 9 and 41 of the Italian Constitution introducing, respectively, the principle of protection of "environment, biodiversity and of ecosystems, also in the interest of new generations" (Article 9), and a general prohibition for entrepreneurial activities to be carried out in a manner that could hinder "health and the environment" (Article 41). The amendment to Article 9 also introduces the concept of animal protection, providing that law will regulate the matter. The Constitutional Affairs Committee substantially approved the wording of Article 9 originally debated in 2008 and failed to recognise the evolution of the international and EU concept of sustainable development, falling short of referring to "sustainable development". Furthermore, this amendment does not extend to the establishment of a fundamental right to "a healthy environment" or to "a fundamental right to sustainable development"; it simply sets a policy, albeit of constitutional ranking. Although one could well argue that this proposed constitutional amendment does not go far enough, it represents a significant policy step. In addition, given that the protection afforded by the Constitutional Court in this area remains broad, the absence of a fundamental right in the Constitution has limited impact in practice.

The EU Climate Law, once adopted, will have an important impact on domestic decarbonisation policies; however, what is still lacking is the enactment of legislation requiring public and private entities to carry out a carbon assessment and to define a carbon budget, which would trigger a pathway to decarbonisation, aligned with "Fit for 55" and net zero targets.

1.5 What significant private sector initiatives relating to ESG are there?

The most prominent local private initiatives for the promotion of ESG issues are linked to global or European initiatives such as the Forum for Sustainable Finance and the Global Compact Network Italy Foundation ("GCNI"). The Forum for Sustainable Finance is a non-profit association with a multi-stakeholder membership base, including financial operators and other organisations interested in the environmental and social impact of investments. The Forum's mission is to promote knowledge and practice of sustainable investment, with the aim of spreading the integration of ESG criteria into financial products and processes. The Forum is a member of Eurosif, the leading European association for the promotion and advancement of sustainable and responsible investment across Europe, for the benefit of its members. The GCNI has been active since 2002 and became legally established as the GCNI in 2013. It was created with the primary aim of contributing to the development in Italy of the United Nations Global Compact, an initiative for the promotion of the culture of corporate citizenship promoted and managed on a global scale by the United Nations.

Since 2015, other local initiatives have been established whose promoters include not only private but also public institutions. The most notable of these initiatives is the *Alleanza Italiana per lo Sviluppo Sostenibile* ("ASviS"), created in 2016 to raise awareness of the importance of the 2030 Agenda for sustainable development and to mobilise people to achieve the SDGs.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Italian institutional investors and asset managers have generally adopted UN PRI guidelines and have been actively involved in various soft law initiatives. Generali, Eurizon and Amundi, the largest asset investors and managers in the Italian market, are committed to applying ESG and UN PRI to their management funds and regularly contribute to the UN Environment Programme Finance Initiative and other initiatives. Generali is the only Italian investor that has joined the Net-Zero Asset Owner Alliance and the only Italian insurance company that is a member of the Net-Zero Insurance Alliance. More recently, Intesa Sanpaolo, UniCredit and Banca Ifis joined the Net-Zero Banking Alliance.

In 2021, Generali set the target of €8.5–9.5 billion new green and sustainable investments by 2025, with year-end 2020 as the baseline. On the underwriting side, Generali committed to no longer underwrite risks associated with the exploration and production of fossil fuels from tar sands or shale deposits (oil and gas) or extracted in the Arctic Zone, both onshore and offshore.

According to the recent "Reaching Net Zero by 2050" report by Accenture, only 23% of Italian listed companies have pledged to net zero and they aim to reach it, on average, by 2041.

Assogestioni, the association of Italian asset managers, adopted in 2013 its stewardship principles, which refer to those set by the Code for External Governance approved by the European Fund and Asset Management Association. Even before the adoption of the European Pensions Directive (IORP II – EU 2016/2341), the largest Italian pension funds have been applying sustainability criteria when considering investments since the UN PRI were launched, and the Cometa pension fund paves the way in this respect.

While stewardship is a concept generally understood by the investor community, this has not led to investee companies adopting a clear statement of purpose or a strategy pursuing such purpose. According to CONSOB, in 2020, only seven companies (five in 2019), still all in the energy/oil and gas industry, fully addressed in their NFS their strategy issues that generate value in the short and long term and describe the connections between financial and non-financial matters. Among these companies, just one company mentioned materiality analysis as a pillar of its strategic plan. The latest Stewardship Report by Assogestioni also indicates that several non-fossil fuel investee companies after several interactions are just beginning to accept the need to adopt carbon emissions science-based targets and that they are willing to engage in ESG matters. Assogestioni recently launched the Shareholder Director Exchange principles, which set out best practice for engagement with directors. Investors appear to be quite attentive to compliance with disclosure requirements by corporates. There is less evidence of investors exerting actual influence on corporates' management in order to ensure their engagement with other stakeholders. This is also confirmed by a recent report prepared by CONSOB, which indicates that, in 2020, only 83 (70 in 2019) of the 151 listed companies that have filed an NFS have actually engaged with other stakeholders.

As of 1 November 2021, 34 Italian companies have joined the Science Based Targets initiative ("SBTi") (one in 2019 and 11 in 2020), which shows that the need for a carbon budget is rapidly gaining traction, but this is still limited to large corporates.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

A number of public institutions such as CONSOB and the Bank of Italy have created teams of experts focused on the analysis of non-financial risks and especially of climate change. Their regular technical reports on the Italian banking and financial system's response to these issues represent a key point of reference for market participants and they exercise an important moral suasion. The Ministry of Economy, *Cassa Depositi e Prestiti* and SACE are actively working on defining a national Sustainable Finance Action Plan that would boost NextGenerationEU funding.

Private individuals in Italy have been historically concerned about air and sea pollution and about the impact caused by climate change on Italy's biodiversity, which is quite unique in the Northern Hemisphere. Stakeholders tend to exert influence mainly through NGOs such as *Legambiente* and Greenpeace and through associations such as ASviS, *Forum per la Finanza Sostenibile*, and WWF Italia.

Legambiente is a non-profit association of citizens who care about the protection of the environment in all its forms, the quality of life, a fairer, more just and more supportive society. *Legambiente*'s mission is based on scientific environmentalism. The association is also very active in training and educational projects.

The *Forum per lo Sviluppo Sostenibile* is a shared working space where the subjects from civil society and practices of sustainability can emerge, bringing together public policies and social energies. The objective of the Forum is to accompany the implementation of the National Sustainable Development Strategy and the 2030 Agenda through the active participation of actors promoting actions and policies in favour of sustainability.

In 2020, WWF launched the Leaders Pledge for Nature programme that committed to reverse biodiversity loss by 2030 for sustainable development, which was also endorsed by Italy. WWF Italia has had a longstanding tradition of activity in the country since 1966. In 2005, the WWF Foundation was established with the scope to disseminate the culture of environmental protection and put pressure on political leaders and governments on biodiversity.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

CONSOB is responsible for investigating and sanctioning infringements of the non-financial disclosure regulation of corporates (financial and non-financial). The European supervisory authorities (the European Banking Authority ("EBA"), the European Securities and Markets Authority ("ESMA") and the European Insurance and Occupational Pensions Authority ("EIOPA")) have recently introduced sustainability as an integral part of their mandate to promote the integrity and stability of financial markets and ensure investor protection. EBA and EIOPA will be supported by the national supervisory authorities (the Bank of Italy for less significant financial institutions and the Institute for the Supervision of Insurance ("IVASS") for insurance companies). They highlight the need for transparency and oversight of ESG-related aspects, the role of ESG ratings, ESG benchmarks and ecolabels as crucial aspects to mainstreaming sustainable finance.

The Ministry for Ecological Transition (former Ministry of the Environment and Protection of Land and Sea) has the primary competence in environmental regulation. Scientific agencies with a regulatory role include the National Institute for Environmental Protection and Research (*Istituto Superiore per la Protezione e la Ricerca Ambientale*).

2.4 Have there been material enforcement actions with respect to ESG issues?

In January 2020, Eni, the Italian oil giant, which is incidentally very focused on ESG issues and on transition towards decarbonisation, was fined €5 million by the Italian Competition Authority for having launched a misleading marketing campaign for its *Diesel+* fuel. The Authority held that Eni was deceiving customers by causing confusion between a *Diesel+* component (Hydrotreated Vegetable Oil ("HVO") made of crude palm oil and derivatives), which Eni called *Green Diesel*, and the *Diesel+* fuel itself, as it had induced customers to assume that *Diesel+* as a whole (rather than just the HVO component) had a positive carbon emissions benefit. The Authority indicated that transport diesel is, "by its nature", highly polluting and cannot be considered "green". This was the first case of reported greenwashing in Italy. Eni announced initially that it would challenge the decision before the Administrative Court, but then, in April 2020, paid its fine.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The main ESG-related litigation risk relates to greenwashing that may lead to breach of disclosure and of fiduciary duties by the company's directors, which would allow, under certain circumstances, for shareholders and creditors to bring a derivative or a direct action against the directors. Greenwashing could also trigger extra contractual and fiduciary liability attributable to the issuer (and its directors) to the extent that it falsely alleges ESG credentials in its offering prospectuses to the market.

Incidentally, EU Prospectus Regulation 2017/1129 does not require issuers to specify a green use of proceeds or their green credentials or to continue to apply ESG standards; however, it is expected that, as part of the EU Taxonomy, specific mandatory requirements will be set in this respect for issuers when publishing their prospectuses. CONSOB invites issuers to disclose, based on IOSCO Principle 16, when ESG matters are considered material, the impact or potential impact on their financial performance and value creation, as well as to provide insight into the governance and oversight of ESG-related material risks.

The other potential risk for corporates could arise in connection with their omission to file and with the filing of an incorrect or misleading NFS required following the implementation of Directive 2014/95/EU by Decree 254/2016. In 2020, all 151 Italian companies with ordinary shares listed on the Italian Stock Exchange, including three firms that could potentially benefit from a size-related exemption, published an NFS. According to CONSOB, in line with previous years, most of the firms published only the report required by Decree 254/2016, also in the form of a Sustainability Report (137 cases). Eleven firms (nine in 2018) integrated financial and non-financial information either in an Integrated Report or by releasing an Integrated Report together with an NFS or by publishing an Integrated Report alongside a Sustainability Report (two firms). In addition, three issuers circulated both an NFS and a Sustainability Report.

Obviously, other litigation risks could arise from non-compliance with environmental, governance and employment legislation in force.

In 2021, the first lawsuit against the Italian State for "climate inaction" was launched by more than 200 plaintiffs. The lawsuit, initiated as part of the *Giudizio Universale* Campaign (The Last Judgement), is one of many climate cases initiated by civil society in more than 40 countries around the world. The lawsuit was filed with the Civil Court of Rome against the State (represented by the Presidency of the Council of Ministers). The legal action is being promoted as part of an awareness-raising campaign to underline the global scope of the climate challenge and the need for urgent action. The plaintiffs were assisted by a legal team composed of lawyers and university professors, founders of the *Rete Legalità per il Clima*. The general objective of the legal initiative is to ask the Court to declare that the Italian State is responsible for failing to tackle the climate emergency and that the efforts made are insufficient to meet the long-term temperature goal set by the Paris Agreement, resulting in the violation of numerous fundamental rights. Among the arguments of the lawsuit, the following elements are crucial: the relationship between human rights and climate change; and the need to recognise a human right to a stable and secure climate.

The specific requests made by the plaintiffs to the judge are:

- Declaring that the Italian State is responsible for failing to tackle the climate change emergency.
- Ordering the State to reduce greenhouse gas emissions by 92% by 2030 compared to 1990 levels, applying the principle of equity and the principle of common but differentiated responsibilities (Fair Share), i.e., taking into account Italy's historical responsibilities in greenhouse gas emissions and its current technological and financial capabilities.

2.6 What are current key issues of concern for the proponents of ESG?

The first key issue is that ESG could be perceived by some companies as a mere compliance exercise to please investors and that corporate governance may not be fit for purpose. Out of 151 companies that filed their NFS in 2020, there was induction of management on ESG issues in 32 cases, while 73 had Sustainability Committees in office. Only 39 of them integrated ESG principles in their Board of Director's guidelines and just 37 applied ESG principles when making their decisions. About half of the companies failed to refer to SDGs in their NFS, although they all adopted the framework of the Global Reporting Initiative Sustainability Reporting Standards. It is likely that these numbers will significantly increase by the end of 2021 after Borsa Italiana's new Code of Corporate Governance has entered into force.

Significantly, all 151 reports include a materiality analysis. Material topics were represented through a materiality matrix in 121 cases, while in the remaining 30 reports, firms provided either a list or a table.

Also, promotion of ESG is inevitably linked to finance. The number of green, blue, social and sustainability-linked bonds and loans by Italian issuers and borrowers is still on the low side when compared with other major European countries.

Another issue relates to the actual prospects of effective engagement with stakeholders and especially with young generations. This is because corporates' efforts to involve youth in the ESG debate remain limited. Italy has one of the highest number of NEETs ("Not in Education, Employment, or Training") in the EU and some of its young generations tend to be slightly disenchanted and less empowered than those of other European countries. However, the issue is recognised, and actions are being taken to address it. Since September 2020, sustainable development is mandatorily taught in Italian schools that follow an SDG-led educational methodology. Universities are increasingly offering green and sustainable finance courses to undergraduates and post-graduates. The recent involvement of Italian public and private institutions in the 2021 "Pre-COP26" conferences, which included meetings with young generations and the new Italian Government's commitment to fight climate change in the interest of new generations, is an important step; however, no legislation or policies have yet been adopted on the participation of civic society in climate change issues, unlike citizens' assemblies in the UK or France.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The scope of directors' fiduciary duties covers the carrying out of (i) any management activity (both under ordinary and extraordinary administration) in accordance with the law and the company's by-laws, (ii) the functioning of the company's organisation, and (iii) the activities necessary to achieve the "corporate object" of the company, i.e., the carrying out of a specific business. Directors' decisions fall within the remit of business judgment rule, and they cannot be challenged before the courts unless such decisions are found to be clearly unreasonable or irrational.

While courts and doctrine, when considering the scope of directors' fiduciary duties, in some instances have integrated the corporate object concept with a higher concept of "interest" or "benefit", this approach has been mainly applied to the potential liability of directors arising in the context of intra-group transactions rather than to the attainment of a corporate aim to tackle ESG issues.

The principal responsibility for disclosing ESG issues lies with the directors in companies that have adopted the monistic system (which is the prevailing governance system applied in Italy). There is no separate set of legal norms expressly compelling directors to address, on a day-to-day basis, the ESG issues that have arisen, e.g., in the NFS or raised by the stakeholders.

Hence, under Italian law, there is no directors' duty as such to change the strategy of the company to address ESG risks. Obviously, to the extent that an ESG issue triggers a potential breach of applicable legislation (e.g., related to waste management and environmental protection or duty to pay social contributions for the benefit of their employees), there would be a direct to act and a corresponding liability of the directors.

However, the entry into force in 2019 of a new Article 2086 of the Italian Civil Code (which was originally included in Article 375 of the new Insolvency Code (*Codice della Crisi*) whose entry into force has been halted due to the pandemic) has introduced new duties for entrepreneurs and directors to set up organisational, administrative and accounting structures that are adequate to the size and nature of the relevant enterprise. These structures are set up to avoid the rising of a crisis impinging on its economic and financial balance, considering the impact on cash flows as well as to protect the going concern of the business. This provision has *de facto* introduced a duty on directors to apply best governance practices that are aimed at reducing financial risks (directly affecting the corporate's economic and financial balance) but also non-financial risks and factors that could ultimately impinge on the going concern of the business.

Notably, the Italian *Corte di Cassazione*, in Decision Nos 5 of 3 January 2019 and 301 of 9 January 2019, has held that directors are bound to comply with the voluntary code adopted by the corporate they manage. In addition, a decision of the Court of Rome (8 April 2020) on directors' duties not to unreasonably depart from voluntary codes is particularly relevant as it potentially leads the way to a higher standard of diligence deriving from compliance with voluntary codes (including those related to ESG). The content of the provisions included in the voluntary codes entered into by the relevant corporate could then become particularly significant in defining directors' liability arising from an unreasonable failure to deal with non-financial risks. For example, to the extent a voluntary code requires the adoption of a strategy to address ESG risks, a director would not be able to depart lightly from such duty.

In addition, ESG issues also affect the scope of the potential criminal liability of companies. The above-mentioned Decree 231/2001 governs the administrative liability of companies (including foreign ones according to a recent ruling of the Italian *Corte di Cassazione* No. 11626 of 7 April 2020) for crimes committed or attempted by directors or employees in the interest or to the advantage of the company. Decree 231/2001 states that a company cannot be held liable and hence avoid penalties if, prior to the occurrence of the crime, it both adopted and effectively implemented organisational, risk management and control systems (the "231 Model") designed to prevent this kind of crime and has established a body for monitoring their functioning and compliance (the "231 Body")). While the 231 Model would normally address the processes and methodology that directors and employees need to adopt to manage the risk of certain ESG liability arising, this does not arguably translate into a specific duty to carry out an overall mapping of ESG risks and develop an ESG strategy accordingly.

Arguably, the application of the new Article 2086 of the Italian Civil Code, when applied together with Decree 231/2001, should require directors to map ESG risks or at least have in place appropriate organisation, administrative and accounting structures capable of carrying out the mapping. Hence, in the summer of 2021, Confindustria, the association of Italian entrepreneurs, issued updated guidelines for the preparation of the 231 Model indicating the need for an integrated approach to risk management and compliance where non-financial risks highlighted in the NFS are also addressed together with all other risks.

Borsa Italiana's new Code of Corporate Governance, which entered into force on 1 January 2021, provides that "*[t]he board of directors leads the company by pursuing its sustainable success*", which is defined as "*the purpose that guides the actions of the board of directors and that consists of creating long-term value for the benefit of the shareholders, taking into account the interests of other stakeholders relevant to the company*".

The Code also sets forth that the Board of Directors defines the strategies of the company and its group in order to pursue its sustainable success and to monitor its implementation. The adoption by Italian listed companies of the principles of the Code of Corporate Governance is voluntary, albeit subject to the so-called "comply or explain" rule. Incidentally, to date, only Snam S.p.A. ("Snam"), the giant gas transmission company, has updated its by-laws to expressly pursue "sustainable success".

By applying a risk-integrated approach, directors of listed companies adhering to the Code of Corporate Governance would first need to specifically address reputational, operational and funding risks related to ESG issues, which may also be raised by the internal statutory auditors or by external auditors.

Secondly, especially in a context where lenders, investors, suppliers and customers are exerting influence on the company, they ought to take action to address such issues in accordance with the principle of proportionality, after having taken into account their individual expertise and knowledge of such issues and the detriment that such issues would be causing to the company, e.g., in terms of impairment to reach out to new markets, the need to change its supply chain, and the inability to increase its funding.

Thirdly, directors of listed companies would need to have sound reasons for not addressing key ESG issues affecting the company or for not establishing mechanisms for engaging with and involving internal and external stakeholders in identifying, preventing and mitigating sustainability risks and impacts as part of their business strategy.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

It is becoming increasingly popular for Italian listed companies to have the Board of Directors appoint a Sustainability Committee (*Comitato di sostenibilità*), which could also be entrusted with risk management issues, made of independent and non-executive directors who provide recommendations and advice to the Board of Directors on ESG matters, including preparation of the company's strategic plan, assessment and monitoring of the implementation of the sustainability policy and of initiatives in the ESG space, and monitoring of the inclusion of the company in sustainability indexes.

In addition, following the adoption of a 231 Model, the 231 Body is required to effectively monitor how the company seeks to avoid criminal conduct by employees and/or directors on ESG matters, such as prevention of corruption and health and safety in the workplace.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

According to Borsa Italiana's Code of Corporate Governance, executive directors' and top management's remuneration should have a significant variable component that is linked to the payment of the variable components, which are (i) predetermined, measurable and predominantly linked to the long-term horizon, and (ii) consistent with the company's strategic objectives and with the aim of promoting its sustainable success, and including non-financial parameters, where relevant. The remuneration of non-executive directors is not related to financial performance objectives, except for a non-significant part.

Snam, the Italian gas transmission and storage group, introduced objectives connected with sustainability targets that have overall weight of 20% of the short-term variable component of the remuneration of the Chief Executive Officer, and the long-term variable components of the remuneration of the top management of the group. Short-term performance objectives include: the frequency and severity of accidents of employees and contractors; the inclusion and maintenance of Snam in the main sustainability stock indices, such as the Dow Jones Sustainability Index, FTSE4Good, and in ESG ratings such as CDP Climate Change; and reforestation projects in the national territory. Long-term objectives include equal representation in terms of gender diversity in the management team and the reduction of natural gas emissions.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Examples of ESG integration in daily activities of financial and non-financial companies vary according to the reference framework/principles adopted or pledge signed by individual companies. Larger groups tend to develop more complex and comprehensive sustainability strategies; therefore, ESG integration goes from basic, non-financial reporting to more complex climate change disclosures, supply chain assessment, and definition of ESG-linked remuneration policies, to the use of sustainable finance instruments (GSS bonds/loans).

Snam is one of the companies that has embarked in a comprehensive sustainability strategy where the company has committed to a number of objectives: reaching net zero carbon by 2040; ESG-linked remuneration of top management; integrated sustainability reporting; and TCFD reporting framework adoption, to name a few. Among a series of initiatives aimed at promoting an energy-saving culture and minimising its indirect emissions (also known as Scope 3 emissions), Snam has implemented: (1) the adoption of green procurement criteria for the procurement of goods and services; (2) sustainable mobility activities; (3) the implementation of energy-saving activities for employees (company shuttles, public transport subsidies, smart working and the use of videoconferencing systems for meetings); and (4) the launch of the CDP Supply Chain programme (formerly the Carbon Disclosure Project).

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Lack of transparency of ESG rating methodologies and significant differences in valuations among Sustainability Rating Agencies ("SRAs") or ESG data providers contribute to increasing scepticism by investors towards ESG ratings. SRAs are still unregulated entities; hence, they have no governance or transparency obligations as far as comparability, quality and disclosure of their ratings are concerned.

Therefore, despite good availability of externally developed ESG ratings, debt and equity providers seem to prefer to develop in-house expertise to build more sophisticated and nuanced ESG strategies; equity investors especially use ESG ratings as benchmarks together with many other ESG metrics. However, in case of debt (GSS bonds or loans) providers, they also rely on ESG ratings but more often on external reviews or verifications, such as second-party opinions and/or assurance reports (*see question 4.5*).

Comparability of ESG ratings will improve with the increase in the standardisation of non-financial data contained in non-financial reports, an objective that is pursued by two EU directives: the Non-Financial Reporting Directive dated 2014, to be amended by the proposed Corporate Sustainability Reporting Directive, and the Sustainable Finance Disclosure Regulation, which entered into effect in March 2021.

Credit Rating Agencies ("CRAs") have an obligation to disclose the impact of ESG risk factors on the creditworthiness of issuers.

The Italian market is well served by both SRAs and CRAs. SRAs operating in Italy include MSCI, Vigeo Eiris, ISS, Sustainalytics, Refinitiv, RobecoSAM, and FTSE Russell. These players offer ESG ratings, data analysis, and indices (governance/carbon). CRAs operating in Italy that disclose ESG risk factors in their credit rating opinions, in addition to the major international agencies like S&P, Moody's, Fitch, and DBRS, include quite a few challenger rating agencies like Scope, Cerved, CRIF Ratings, and modeFinance.

4.2 Do green bonds or social bonds play a significant role in the market?

According to a study published by SustainAdvisory srl, at the end of September 2021, the cumulative outstanding amount of GSS bonds issued by Italian entities amounted to €48.8 billion for a total of 73 instruments issued. Between 2017 and 2019, Italy's GSS bond volumes tripled, while in 2020, due to the COVID-19 pandemic, volumes dropped by 28% compared to the 2019 level.

Green is the dominant theme of Italian bond issues followed by sustainability and social bonds. Social bonds appeared on the Italian market in 2017 and grew noticeably in 2020 in response to the COVID-19 pandemic. More than 60% of Italian GSS bonds are originated by non-financial corporates, 13% by banks, 3% by insurance companies, and 19% by the public sector. Non-financial corporates are dominated by utilities (Enel, Hera, Iren, Acea, Eni) or infrastructure companies (Terna, Snam, Ferrovie dello Stato).

The second-largest issuer after Enel is the Italian Government: with the inaugural green bond in the BTP format, Italy placed €8.5 billion in March 2021. The bond is designed to support public expenditures with positive environmental impacts. Through the issue of a Sovereign Green Bond ("SGB"), Italy will finance public expenditures intended to contribute to the achievement of one or more of the environmental objectives of the EU Sustainable Finance Taxonomy. In addition, the use of proceeds will help Italy support the 2030 UN SDGs.

The SGB framework aligns with the GBPs issued by the ICMA in June 2018 and, as much as possible, with the draft EU Green Bond Standard. To be eligible under this framework, expenses must fall within the definition of one of the following green sectors: renewable electricity and heat; energy efficiency; clean transport; pollution prevention/control and a circular economy; protection of the environment and biological diversity; and research.

There is an ongoing debate on the use of social impact bonds for the construction of social infrastructures (such as schools and hospitals) and social housing, and this could lead to new issuances in the public finance space, especially if policy measures address the increased credit risk associated with these projects.

Notwithstanding the issuance of the SGB, the GSS debt issuance by Italian companies and public bodies is still well below the GSS bond volume issued in France and Germany, the two largest markets for green, social and sustainable debt in Europe.

4.3 Do sustainability-linked bonds play a significant role in the market?

Italy is home to the largest sustainability-linked bond corporate issuer: Enel. Enel was the first company to launch, through its subsidiary, Enel Finance International NV, an SDG-linked bond, formally opening a new market segment for sustainability-linked instruments; not only green bonds, but bonds linked to the entire strategy centred on the goals of the UN's 2030 Agenda (SDGs) with measurable targets – specifically, the reduction of direct CO_2 emissions by 70% compared with 2017 levels by year 2030, a goal that has also been certified by the SBTi. Given an initial discount on the interest rate, if Enel fails to meet the target, the bondholder will receive an increase of 25 basis points on the interest rate.

Since 2019, Enel Finance International NV has issued a total of €10.5 billion of sustainability-linked bonds. In October 2021, Enel placed the world's largest-ever sustainability-linked bond in all currencies, a multi-tranche US$4 billion in the US and international markets, overtaking its previous record of the €3.25 billion sustainability-linked bond issued in June 2021.

In consideration of the presence of this giant issuer, the Italian sustainability-linked bond market is highly concentrated. At the end of 3Q21, sustainability-linked bonds accounted for 42.4% of total GSS bonds issued in the Italian market with 21 instruments listed on the Italian Stock Exchange for a total of €16.6 billion. Enel accounts for 63.2% of the sustainability-linked bond volume.

Other sustainability-linked bond issuers include financial institutions and other energy and utility companies.

4.4 What are the major factors impacting the use of these types of financial instruments?

Green bonds represent a considerable innovation through their focus on green use of proceeds, tracking, impact reporting and external reviews. They have provided bond investors with an unprecedented degree of transparency; furthermore, in today's market, they satisfy ESG requirements and green investment mandates and therefore facilitate the diversification and commitment of the investor base. Issuing green bonds enhances the issuers' reputation and is an effective way to develop and implement a credible sustainability strategy to investors and the general public by clarifying how proceeds raised will contribute to a pipeline of tangible environmental projects. On the other hand, investors have limited scope for legal enforcement of green integrity.

Despite a common view of the economic benefits for issuers, created by the imbalance between investor demand and insufficient supply from issuers, it is often observed that such price benefit/advantage can be offset by greater transaction costs linked to the need for complex external review procedures and reporting requirements.

The GSS debt market in Europe and Italy is growing at a rate of 25% per year and is expected to continue to grow. The current major driver of growth is the deployment, at EU level, of the €750 billion NextGenerationEU recovery plan established to support Member States hit by the COVID-19 pandemic. At least 30% of NextGenerationEU resources are dedicated to expenditures compliant with the Paris climate accord and in line with the objectives of the European Green Deal, the EU flagship initiative to address climate change and achieve carbon neutrality by 2050. The catalyst for future growth will be the outcome of the COP26 negotiations in Glasgow.

Italy is the largest beneficiary of the European recovery package, with *c.* €200 billion of allocations. The national plan (*Piano Nazionale di Resilienza e Ripresa*, "PNRR") that the Italian Government submitted to the EU describing the strategy concerning investments to be made under the NextGenerationEU package defines six areas of intervention, including the green revolution and ecological transition, and the infrastructures for sustainable transportation. Together, these two areas will absorb about 43% of the available funds and will create green and sustainable assets. Although NextGenerationEU does not provide any direct support to the private sector, it can be expected that public spending will be a strong leverage for private investments that will find the most adequate financial instruments in the GSS debt market.

Social bonds are on the rise but are mostly linked to the funding of SME support due to the pandemic; the Italian PNRR will pursue many social objectives, like education, health, inclusion, culture, and therefore there will be more opportunities to increase and diversify the use of this instrument.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The verification and/or assurance processes are one of the external reviews recommended by the bonds and loans frameworks (the GBPs, the Climate Bond Initiative Standards, and other similar international initiatives) that, in connection with the issuance of a green bond or programme, the issuers request to confirm the alignment of their bond or bond programme with the core components of the principles/standards. The verification/assurance process should not be confused with other external types of reviews like the second-party opinion, certification, or credit rating/scoring. These recommendations are recognised as market best practices and, so far, are voluntary and unregulated.

The verification or assurance process is an independent verification against a designated set of criteria, typically pertaining to business processes, environmental criteria, and/or evaluation of the environmentally sustainable features of underlying assets funded by the proceeds of the green bond. It can also refer to the issuer's internal tracking method for use of proceeds, allocation of funds from green bond proceeds, statement of environmental impact, or alignment of reporting with a particular framework. Green bonds issued in the Italian market are structured under the GBP framework by the ICMA. The assurance/verification report can be provided by approved verifiers/audit service providers referring to the common audit standard (ISAE 3000).

With the introduction of the EU Green Bond Standard framework, these processes are expected to change. The EU Green Bond Standard will largely reflect the ICMA GBPs; however, the European standard will provide for greater transparency and disclosure requirements, more-focused application, and a supervision regime for external reviewers. While the standard will remain voluntary, once adopted, it requires much more stringent criteria of application. The EU Green Bond Standard framework will be aligned to the EU Taxonomy's environmental objectives, do no significant harm, social safeguards, and technical screening criteria; therefore, the "green assets" will be more clearly identified, and the spectrum of activities that can be funded will be broader as it will also include working capital and refinancing needs. As far as the supervision or regulation of controls is concerned, the current regulation proposal designates ESMA as responsible for the application of the framework through the creation of a centralised accreditation scheme for external reviewers/verifiers while the publication of the review/verification report will become mandatory.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

The outbreak of COVID-19 generated major turmoil in the Italian financial market. A massive and coordinated intervention by the Government and banks through a State-guaranteed lending scheme resulted in orderly management of the situation. A grace period (on interest and capital) was granted to businesses and retail customers that would submit such a request to the lending bank. The Italian Government provided financial support to businesses and individuals that were forced to close down or stop working during the lockdown periods. This emergency support package was partially funded by financial institutions through the issuance of social bonds.

Social bonds will continue to grow and be applied to purposes correlated to the post-pandemic recovery plan launched by the EU to support the private sectors of Member States and mitigate the unemployment risk of private individuals employed in sectors highly impacted by the pandemic crisis.

COVID-19 has accelerated and exacerbated problems that required quick reorganisation of priorities in favour of solutions that have been a catalyst for ESG adoption. Some of the solutions for working arrangements during COVID-19, primarily remote working or smart working, will continue even after the emergency is over. Smart working conditions in Italy will be contractually regulated for all Public Administration employees for the first time with the approval of the 2021 budget law. Among other measures, a mobility manager will be appointed to review working time schedules that allow more efficient and sustainable commuting solutions.

Also in the private sector, mainly in the service industry, smart working played an important role during the lockdown periods of the pandemic. Smart working options are now permanent features of employment contracts. A positive outcome of remote working during the pandemic was the repopulation of southern regions of the country by young, educated people that had previously emigrated to northern regions or abroad, escaping a sluggish job market and lack of opportunities. Between March and December 2020, when most of the restrictions were in place, the net south-north migration nearly halved compared with the same period in the previous year. This phenomenon was rebranded "*south working*", defining a concept of regained work-life balance. With 48% of ultra-broadband infrastructure investments in southern Italy as part of the recovery plan, the north-south gap will have a chance to decrease and "*south working*" might become a permanent change in the Italian job market.

6 Trends

6.1 What are the material trends related to ESG?

Material trends of the "E" factor are linked to the decarbonisation of industrial sectors with a special focus on transportation, a circular economy and biodiversity preservation. As mentioned in question 2.3, in 2021, the Ministry of the Environment and Protection of Land and Sea was renamed the Ministry for Ecological Transition to underly the strategic role that the institution will play in the transition from a fossil fuel-based system to a decarbonised economy. The budget for the "*Green Revolution and Ecological Transition*" within the PNRR allocates a total of €68.6 billion with the main goals of improving the sustainability and resilience of the economic system and ensuring a fair and inclusive environmental transition.

The "S" factor is primarily connected to the impacts of the pandemic; therefore, the focus is on inclusivity and social cohesion, reduction of the welfare gap between north and south, and enhancement of gender equality. The PNRR has allocated €82 billion to the south that can be distributed according to geographical criteria (i.e., 40%) and provides for significant investments in young people and women.

Regarding the "G" factor, the implementation of the European Sustainable Finance strategy will be the focus of the private and public sectors. The disclosure and reporting regulations, the concepts of the EU Taxonomy, will permeate any present and future investment processes. Financial institutions will be dealing with the incorporation of ESG factors and risks in regulatory and supervisory frameworks for credit institutions.

6.2 What will be the longer-term impact of COVID-19 on ESG?

While COVID-19 state aid in the form of guaranteed loans, grants, convertible bonds and equity investments being made available by the Government have not been directed so far towards a transition to decarbonisation and a circular economy, a substantial part of the NextGenerationEU recovery package funds will be deployed to support greener, more digital and more resilient infrastructures.

As described in question 4.4 above, Italy has one of the largest recovery packages (€200 billion) to accelerate the ecological transition and make the country more sustainable in the longer term through the decarbonisation of polluting sectors. The Government's plan will help repair the immediate economic and social damage brought by COVID-19, will reduce economic and social imbalances between the north and south of the country that have been exacerbated by the pandemic, and will facilitate the energy and technological transition with a focus on social justice, gender inequalities and inclusivity.

The modernisation of the economy will require a deep reskilling of the human capital. It is planned that outdated production paradigms will shift to a knowledge-based economy, which will in turn will create demand for "green jobs" and new skills. Therefore, in the immediate future, there will be an acceleration in the offer of highly technical education and training.

Most importantly, the longer-term impact of the pandemic will be the increased sense of urgency towards ESG issues, such as climate change, loss of biodiversity, and water pollution. The real-life experience of a global crisis and, on the other hand, the evidence of positive effects of reduced economic activity due to long quarantine periods and social distancing, contributed to boosting the public opinion that neglecting the environmental impacts of human activity can compromise the ability of future generations to meet their needs.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In Japan, there is no particular regulation that directly addresses ESG investment/financing, ESG disclosure or ESG business operations. While each of the components of ESG are addressed by some laws and regulations – namely, environmental matters (e.g., the Act on Promotion of Global Warming Countermeasures, and the Act on Special Measures Concerning Procurement of Electricity from Renewable Energy Sources by Electricity Utilities), social matters (e.g., the Act on Promotion of Women's Participation and Advancement in the Workplace, and the Act on the Promotion of Ainu Culture and Dissemination and Enlightenment of Knowledge about Ainu Tradition, etc.) and corporate governance matters (e.g., the Companies Act) – the concept of ESG has not been codified in a Japanese law/regulation. Rather, ESG has been developed and become popular through soft-law rulemaking in Japan.

The main Japanese soft-law rules relating to ESG are the Stewardship Code ("SS Code") and Corporate Governance Code ("CG Code"). Acknowledging the growing importance of ESG, the latest SS Code (as amended in March 2020) defines the "Stewardship Responsibilities" thus:

> The responsibility of institutional investors to enhance the medium- to long-term investment return for their clients and beneficiaries … by improving and fostering the investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment and *consideration of sustainability (medium- to long-term sustainability including ESG factors)* consistent with their investment management strategies. (*Emphasis added.*)

In addition, Principle 7 of the SS Code provides:

> *To contribute positively to the sustainable growth of investee companies*, institutional investors should develop skills and resources needed to appropriately engage with the companies and to make proper judgments in fulfilling their stewardship activities based on in-depth knowledge of the investee companies and their business environment and *consideration of sustainability* consistent with their investment management strategies. (*Emphasis added.*)

On the other hand, the CG Code, prepared by Tokyo Stock Exchange ("TSE"), and recently amended, in June 2021, sets forth the fundamental principles for corporate governance. It has been incorporated into TSE's listing rules in order to promote corporate governance in Japan. Under the TSE listing rules, a TSE 1st or 2nd Section-listed company is required to provide an explanation for non-compliance with any principle of the CG Code. In addition to corporate governance-related matters, the CG Code also addresses environmental and social matters in its General Principle 2-3: "Companies should take appropriate measures to address sustainability issues, including social and environmental matters." In the Supplemental Principle relating to General Principle 2-3, it is further provided that a board of directors should (i) acknowledge that addressing sustainability issues (e.g., environmental matters including climate change-related issues, human rights-related issues, and issues relating to welfare of employees, fair and proper transactions with counterparties and crisis management in respect of natural disaster) is one of the important business challenges that could lead to profitable business opportunities, and (ii) address such issues properly and carry out studies to actively deal with them.

1.2 What are the main ESG disclosure regulations?

The main regulations in connection with the disclosure of information relating to Japanese corporations are the Financial Instruments and Exchange Act ("FIEA") and the Companies Act. FIEA requires certain corporations and entities (such as listed companies) to prepare and submit a prospectus in order to disclose certain information for the benefit of their investors. The Companies Act requires corporations to disclose their financial information and business performance for the benefit of shareholders and creditors. Further, companies listed on a stock exchange (such as TSE) are required to disclose information in accordance with the listing rules of the stock exchange. Despite the existence of such strict regulations and rules, the subject information is mainly financial information and no provision directly requires ESG disclosure.

Nevertheless, following the amendment of the enforcement regulation pertaining to FIEA in 2019, more information relating to corporate governance is required to be disclosed in the prospectus. The following non-financial information must be disclosed in accordance with such amendment:

- Policy and strategy for corporate management.
- Explanation of programme for directors' remuneration.
- Explanation of reasonableness of cross-shareholdings (where shares are mutually held not for investment).
- More detailed information regarding corporate governance.

In addition, some of the environmental regulatory laws set forth certain disclosure requirements concerning environmental matters. For example, the Act on Promotion of Global Warming

Countermeasures requires certain business operators to disclose information about greenhouse gas emissions. Further, the Act on Rational Use of Energy requires the disclosure of energy use. Unless there is a disclosure regulation such as the foregoing, ESG-related matters are disclosed on a voluntary basis.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

General Principle 3 of the CG Code provides:

> Companies should appropriately make information disclosure in compliance with the relevant laws and regulations, but *should also strive to actively provide information beyond that required by law*. This includes both financial information, such as financial standing and operating results, and *non-financial information, such as business strategies and business issues, risk and governance*. The board should recognise that disclosed information will serve as the basis for constructive dialogue with shareholders, and therefore ensure that such information, *particularly non-financial information*, is accurate, clear and useful. (*Emphasis added.*)

Further, Supplemental Principle No. 3 relating to General Principle 3-1 of the CG Code provides, in summary, that listed companies should properly disclose how they deal with their sustainability issues; and, among them, the companies listed on the Prime Market should collect and analyse the necessary data regarding the effect of climate change risk on their business activities, etc., and develop their disclosure in accordance with the Task Force on Climate-Related Financial Disclosures or equivalent framework.

In accordance with such a concept, a number of Japanese corporations voluntarily disclose matters relating to ESG in the form of corporate social responsibility ("CSR") reports or similar. The government encourages corporations to perform such voluntary disclosure – for example, the Ministry of the Environment ("MoE") publishes a guideline for voluntary disclosure of matters related to the environment.

Sompo Holdings, Inc., for example – one of the biggest insurance companies in Japan, which is regularly ranked as a corporation that is highly sensible in its ESG matters – discloses a CSR Communication Report each year. In such report, Sompo Holdings discloses the details of ESG-related matters, such as the amount of greenhouse gas emissions, etc., diversity in human resources, contribution to social welfare, corporate governance system and internal education for compliance. As there is no regulation directly requiring ESG disclosure, the matter of how corporations disclose ESG-related information voluntarily to stakeholders depends on the individual corporation.

1.4 Are there significant laws or regulations currently in the proposal process?

No, there are none. As discussed above, in Japan, the concept of ESG has been developed through soft-law rulemaking and has not been codified. No particular law or regulation is currently in the proposal process.

1.5 What significant private sector initiatives relating to ESG are there?

The landmark action that boosted ESG development in Japan was the Government Pension Investment Fund's ("GPIF") commitment to the Principles for Responsible Investment ("PRI") in 2015. GPIF is Japan's biggest fund and manages more than JPY 186,000 billion. Its commitment to the PRI has significantly affected other investors and was a particularly big moment that hugely promoted ESG. Further, in 2017, GPIF changed its investment principles so that ESG consideration must be taken into account with respect to its investment. It is believed that many other investors have followed such approach of GPIF.

In addition, a number of Japanese corporations are keen to develop ESG (including ESG disclosure and ESG corporate management) and each of them has contributed to the recent development of ESG. There have also been some collective actions by large and well-known corporations to promote ESG. One example is an association named ESG Disclosure Study Group that was established by large Japanese corporations, such as Hitachi Corporation, Nippon Life and Mitsubishi UFJ Financial Group, for the purpose of promoting ESG disclosure. It is expected that such actions by corporations will have a hugely positive impact on ESG development.

Furthermore, the Japanese Bar Association has been conscious of ESG-related matters, and in 2018, it published the "Guide on ESG-related Risk Management", for Japanese companies, investors, and financial institutions to talk about and work together on managing risk related to ESG issues. Such guide has been prepared for lawyers providing legal advice to corporations/investors as well as for Japanese corporations/investors. Based on the SS Code and the CG Code, the guidance sets out (i) how to disclose non-financial information relating to ESG, (ii) how to prevent and grapple with corporate crisis management, and (iii) model clauses for ESG financing. The guidance is believed to be widely read and used among corporations and investors.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Currently, it is widely believed that more and more corporations, investors and asset managers have acknowledged that they will lose market share or profit unless they become more conscious of ESG issues. The current basic approach by Japanese investors/asset managers, however, differs somewhat from those in European countries or the US. According to the Global Sustainable Investment Review ("GSIR") in 2020, in terms of ESG strategy, the percentage of "negative/exclusionary screening" was low (compared to Europe/the US). Rather, Japanese investors/asset managers are inclined to adopt the strategies of "corporate engagement and shareholder action" and "ESG integration".

According to the statistics, though the developed ESG strategies are less diverse in Japan as compared to Europe/the US, ESG has recently developed quite rapidly in Japan. According to the statistics published by GSIR, the ratio of ESG investment increased from 3.4% in 2016 to 24.3% in 2020 (an overall increase of around 20%). The statistics also show that the amount of ESG investment acutely increased from USD 474 billion in 2016 to USD 2,784 billion in 2020.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Among ESG stakeholders, non-governmental organisations ("NGOs") and non-profit organisations ("NPOs") play an important role, although, in Japan, NGOs/NPOs are less powerful compared to in Europe/the US. Nevertheless, NGOs/NPOs are active in exerting influence over corporations/investors with respect to ESG. For example, the exercise by Kiko Network – an NGO acting against global warming – of the shareholders' proposal right under the Companies Act, at the shareholders' meeting of Mizuho Financial Group (one of the biggest financial groups in Japan) in 2020, has attracted a lot of attention. It is believed to be the first case where the shareholders' proposal right has been exercised in connection with global warming, and the proposal contained a request to Mizuho Financial Group to disclose a business plan that complied with the Paris Agreement. Although the proposal was rejected at the shareholders' meeting, it is remarkable that around 35% of shareholders approved the proposal. According to Kiko Network, major advisory companies such as Glass Lewis and Institutional Shareholder Services suggested that the shareholders support the proposal. Further, in 2021, Market Forces – an Australian NGO acting against global warming – took similar action against Sumitomo Corporation, but the proposal was also rejected.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

As there is no particular regulation that directly addresses ESG, no competent regulator that directly regulates ESG matters exists. Nevertheless, (i) the Financial Services Agency ("FSA"), which forms the committee for the SS Code, has played an important role with respect to ESG, (ii) the Ministry of Economy, Trade and Industry ("METI"), which is the competent authority for investment-related matters, is active in the ESG field and publishes reports relating to ESG, and (iii) MoE is very keen to promote ESG (in terms of "Environment"). In addition, although a quasi-governmental agency, TSE has also played quite an important role, especially by preparing the CG Code.

2.4 Have there been material enforcement actions with respect to ESG issues?

No, there have not. Due to the lack of a hard-law basis, there cannot have been material enforcement actions.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Litigation relating to global warming poses major ESG-related risks for corporations in Japan. Such risks are eminent especially for energy companies that own coal-fired power plants. There have already been several instances of litigation where local residents brought lawsuits against operating coal-fired power plants or coal-fired power plant construction projects. Local resident plaintiffs led by NGOs/NPOs have brought civil litigation to stop the operation of power plants as well as administrative law litigation alleging illegality in the environmental assessment process.

From the perspective of the Japanese government, which is to publish an updated energy mix target for FY2030 indicating 20% with respect to coal-fired power plants as of FY2030, a certain number of coal-fired power plants (provided that they are efficient and emit fewer greenhouse gases) are necessary to ensure a stable electricity supply (whilst the Japanese government pledges to achieve net-zero carbon in 2050). Such a relatively high rate of coal-fired power plants stems from the particular Japanese circumstance where it is quite difficult to newly construct or even to restart existing nuclear power plants due to the Fukushima Daiichi meltdown disaster in 2011. A reasonable balance between the requirement of divestment from coal-fired power plants and securing a stable energy supply is one of the biggest energy-related issues in Japan.

In addition, litigation risks exist with respect to the working environment, such as in relation to sexual harassment and power harassment. Corporations are keen to hold internal education sessions about harassment issues to prevent such risks. Further, corporations potentially face the risk of litigation over unpaid overtime work. There has been a peculiar Japanese office culture or atmosphere implicitly requiring a certain volume of overtime work without payment. The aggregate unpaid amount equivalent to the salary for such overtime work is believed to be huge.

2.6 What are current key issues of concern for the proponents of ESG?

It is recognised that key issues of concern for the proponents of ESG in Japan are: (i) no sufficient information is available to determine ESG investment; (ii) no firm confidence on monetary rewards/return for ESG; (iii) a number of uncertainties with respect to the factors (such as politics, scientific technologies and influence of global warming) that are to be considered in connection with ESG; and (iv) a need to construct an internal framework to utilise relevant expertise (e.g., leading scientific technology).

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

In connection with business operations and planning, each director and/or the board of directors of a company has principal responsibility for properly addressing ESG issues. The director's fiduciary duty (*chujitsu gimu*) and the duty of care as a prudent manager (*zenkan chuui gimu*) under the Companies Act can be the basis of such responsibility. Although there has been no court precedent where a director was accused of not addressing ESG issues and directors have broad discretion in making corporate decisions, given the increasing importance of ESG and its impact on business operations and planning, the possibility cannot be entirely ruled out that directors could be regarded as breaching their fiduciary duty or the duty of care as a prudent manager as a result of their failure to properly address ESG issues.

The role of such management body with respect to ESG issues comprises, *inter alia*, the following items:

(a) Environment: (i) establishing the corporation's policy for protecting the environment, energy efficiency and global warming, etc.; and (ii) establishing a compliance mechanism with respect to relevant environmental regulations.

(b) Social: (i) ensuring a socially and environmentally sound supply chain; (ii) ensuring a good and healthy working environment (e.g., less overtime, more support for childcare); and (iii) establishing a policy for contribution to social welfare and donation.

(c) Governance: ensuring a legally sound corporate governance system.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

A number of large corporations have a special committee/group/team to work specifically on ESG-related matters with a mandate from the board of directors. In such cases, corporate actions are to be made in accordance with the detailed policies/strategies set by such internal organisations. They might contain a member from a third-party advisor to ensure that they can create appropriate and reasonable policies/strategies. The board will supervise such internal organisations.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

More and more Japanese corporations are implementing incentive mechanisms with respect to compensation/remuneration for directors/officers. For example, Omron Corporation, a well-known industrial automation and healthcare equipment company, is one of the front runners having such mechanism. According to the disclosed information, it has incorporated a sustainability evaluation into the component corresponding to the mid- and long-term business performance (which constitutes around 40% of the components that are to be considered to determine compensation/remuneration). The evaluation is to be made in accordance with the Dow Jones Sustainability Indices. Another example is Sony Corporation, which has incorporated environmental and product quality matters into the business performance component, according to the disclosed information.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

According to the disclosed information of corporations that are highly ranked in privately published ESG rankings, the following are common examples of how companies integrate ESG into their day-to-day operations:

(i) Diverting energy sources to renewable energy (e.g., joining the RE100 initiative).
(ii) Pursuing greater energy efficiency in offices/factories.
(iii) Providing products and services that contribute to social welfare (e.g., products/services to support areas hit by natural catastrophe).
(iv) More diversity in board members or administrative positions (e.g., appointing more female directors/officers).
(v) Promoting a better working environment (e.g., less overtime work, more remote work and respecting LGBT rights).

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

It depends on the policy of each debt provider, but on the whole, providers are becoming more reliant on ESG ratings. For example, according to the disclosed information, one of the Japanese mega banks has developed an ESG financing scheme where a third-party institution, which collaborates with the bank, evaluates ESG-related components of a potential borrower and the bank provides finance based on such evaluation. Another example is a Japanese regional bank that is developing a platform to digitalise ESG-related factors in order to facilitate ESG finance for small or mid-sized business operators in provincial cities. Going forward, there is likely to be more financing that relies on ESG ratings.

4.2 Do green bonds or social bonds play a significant role in the market?

Both Green Bonds and Social Bonds play significant roles in the Japanese market. According to the Japan Securities Dealers Association ("JSDA"), in 2020, the total issued amount of Green Bonds in Japan was approximately JPY 775 billion and the number of deals was 74. Such figures are relatively small compared to Europe/the US; however, considering that the total amount in 2016 was merely around JPY 10 billion (only one deal) and around JPY 66 billion in 2017 (six deals), the market for Green Bonds has recently been rapidly expanding. In particular, the number of Green Bonds for renewable energy projects and green buildings is large.

Also, according to JSDA, the market for Social Bonds has recently been rapidly expanding as well. In 2020, the total issued amount of Social Bonds in Japan was approximately JPY 915 billion and the number of deals was 47, while the total amount in 2016 was merely around JPY 35 billion (only two deals) and around JPY 123 billion in 2017 (nine deals). One example of Social Bonds is a bond issued by one of the Japanese mega banks, which is for medical, educational, job-creating and affordable housing matters. Also, it is reported that the Japan International Cooperation Agency ("JICA") recently launched Social Bonds such that JICA appropriates the entire proceeds to international cooperation activities overseas, and the Japan Student Services Organization launched Social Bonds to support students. Furthermore, it is notable that FSA issued draft Social Bond Guidelines in July 2021, which provide guidance in relation to issuance of Social Bonds. It is expected that such guidelines will promote further increase of Social Bonds in Japan.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds have not yet played a significant role in Japan. If we follow the definition set by the International Capital Market Association ("ICMA"), which states that "Sustainability Bonds are any type of bond instrument where the proceeds will be exclusively applied to financing or re-financing a combination of Green and Social Projects and which are aligned with the four core components of the GBP and SBP", it seems hard for issuers to meet such requirements. Meanwhile, according to the disclosed information, Tokyo Metro Co., Ltd., which operates the underground network in Tokyo, recently issued sustainability-linked bonds in accordance with ICMA rules. The purpose is to introduce more energy-efficient train carriages (train cars), install safety facilities at stations and install renewable energy facilities.

On the other hand, some Japanese banks have developed sustainability-linked loans whereby the bank provides a loan to a borrower who commits to utilise the loan proceeds for businesses/projects that are good for sustainability. It is reported that a third party has verified the mechanism of such loans.

4.4 What are the major factors impacting the use of these types of financial instruments?

The most important positive factor for both issuers and subscribers is that they can externally and internally publicise their approach of committing to addressing ESG issues by using such financial instruments (hereinafter, collectively referred to as "ESG bonds"). The issuer has the chance to reach out to (new) ESG-friendly investors who would not have subscribed if the financial instrument had not been an ESG bond. Subscribers (investors) can show that their investment portfolio addresses the increasing need for ESG. Despite the relatively higher cost of ESG and their issuance being more time-consuming than for usual bonds, such positive factor is a big driver for involvement of issuers/investors in ESG bonds.

In the case of green project bonds where the financer for an environmentally friendly project (such as renewable energy projects) issues Green Bonds and procures money for its financing, the borrower may enjoy a lower interest rate or more favourable finance conditions as compared to conventional finance schemes (where big banks provide commitment loans).

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

There is no hard-law regulation directly relating to Green Bonds. In addition, the *Green Bonds Handbook* published on the Green Bond Issuance Platform established by MoE does not require a second-party opinion, verification or certification; rather, it only states that such assurance is recommendable. Having said that, under the current practice in Japan, it can be said that it is usual to have a second-party opinion/rating by a private credit rating company when a Green Bond is issued.

Under the laws of Japan, some rating companies are registered with FSA, and others not. Registered rating companies are subject to the regulations under FIEA. On the other hand, with respect to those that are not registered, if a regulated financial service provider under FIEA (e.g., a securities company) retains such a credit rating company, the financial service provider must disclose to its client that the credit rating company has no registration, and the details of the method of rating, etc., used by the rating company, in accordance with Sub-paragraph 3 of Article 38 of FIEA. As such, the rating is regulated and an assurance and verification process is in place.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

There is no report from a reliable source explaining how COVID-19 has impacted ESG practices in Japan. There seems to be a possibility that not a few companies could lose the financial leeway that allows them to continue ESG practices, owing to a sharp economic downturn because of COVID-19. However, for now, it is believed that there is no significant negative impact, and most corporations are believed to consider that ESG is still quite important even "with/after COVID-19". At least, no corporation that has explicitly announced significant changes to their ESG practices has been identified.

Rather, reports and articles that state that "with/after COVID-19" could have a positive impact on ESG practices, especially on social matters, can be easily found. Because of COVID-19, more corporations have become conscious of a safe and comfortable working environment, such as promoting a remote working environment to prevent infection. Under the circumstances of working from home, it is much less likely that employees will be stuck in an overtime working pattern, which has been one of the biggest employment problems in Japan. In addition, in the area of educational institutions, although most Japanese schools have insufficient tele-teaching systems, it is reported that schools are trying to improve the current situation.

6 Trends

6.1 What are the material trends related to ESG?

Firstly, one of the biggest recent developments in ESG is that the three Japanese mega banks announced that they will, essentially, refrain from newly providing finance to coal-fired power plants (and will also exit from existing finance in the future). New financing for coal-fired power plants has become markedly difficult. The move by these banks is regarded as a significant step to reasonably reduce the number of coal-fired power plants in Japan. In addition, in 2020, METI announced its policy of significantly reducing old, inefficient coal-fired power plants.

Further, investors are placing more importance on ESG disclosure as well as on how investee companies commit to ESG. Some Japanese investors have recently revised their policy for exercising their shareholders' rights such that action or inaction by investee companies that is problematic from the perspective of ESG shall, when the investors exercise their shareholders' rights, be deemed to be a situation impairing stock value. This kind of policy will place great pressure on investee companies to promote ESG actions.

Lastly, it is notable that, responding to demands from human rights-conscious customers/investors and the legislation of strict human rights-related regulations in Europe, the number of Japanese corporations that have realised the importance of human rights-related due diligence is increasing. It is expected that more corporations will carry out in-depth human rights due diligence when they peform M&A deals, invest in projects/companies and contract with suppliers.

6.2 What will be the longer-term impact of COVID-19 on ESG?

Firstly, because of the sharp fall in the volume of greenhouse gas emissions due to lockdown and the other economic constraints all over the world due to COVID-19, it seems that some attention has temporarily shifted from global warming issues to other issues. In particular, social matters that have newly occurred due to COVID-19 seem to be gathering attention. For example, corporations and people are keen to ensure better and safer working and studying environments in offices and schools (such as by creating internal rules to secure a safe office/school environment, and installing secure and convenient tele-work/studying systems). In addition, social support for those who are the most vulnerable to the pandemic (e.g., elderly people, college students and people with low incomes) is also attracting attention.

Secondly, due to the economic downturn and lots of constraints in the "with COVID-19" state, small and mid-sized companies are suffering and will suffer huge disadvantages (compared to large companies) in terms of ensuring operating capital. Some argue that it is a good opportunity to develop and promote issuance of Social Bonds to support such vulnerable small and mid-sized companies. As the amount of such bonds would be relatively small and the issuers are likely to have insufficient leeway to bear the relatively high issuing costs, the development of a certain kind of platform (such as one incorporating digitalisation of ESG scores), whereby small and mid-sized companies can easily issue the bonds, would be necessary.

Thirdly, enabling completely online shareholders' meetings for all joint-stock companies and establishing proper practice for such online shareholders' meetings will be a longer-term issue. Due to Japan's large cities being subject to the prolonged state of emergency and the progressive increase of COVID-19 infections, a number of companies have wanted to hold completely online shareholders' meetings in order to circumvent the risk of increasing infections at physical shareholders' meetings. Although many of these companies have already held a so-called "hybrid online shareholders' meeting" where shareholders can watch a shareholders' meeting online while a physical meeting takes place, one drawback of such a measure is that the shareholders joining online are not allowed to ask questions, etc. in most cases. Following the amendment of a related regulation in June 2021, it has become possible for certain listed companies to hold completely online shareholders' meetings. Although holding such a meeting is uncommon, it is expected that the scope will be expanded to encompass a wider range of companies and that proper practice will be established for such online shareholders' meetings.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Environment: The Framework Act on Carbon Neutrality and Green Growth for Responding to Climate Change was promulgated on September 24, 2021 and will take effect from March 25, 2022. This act aims to reduce greenhouse gas emissions by more than 35% by 2030 from the emission levels recorded in 2018. The law explicitly stipulates the goal of achieving carbon neutrality by 2050 as a national agenda. Other key provisions include the establishment of a Carbon Neutrality Green Growth Committee and the establishment of a framework to achieve the targeted goals in five-year milestones. The act also establishes a climate response fund to secure the resources necessary to execute the goals.

Social: On January 8, 2021, the National Assembly passed the Serious Accident Punishment Act ("SAPA"). SAPA imposes criminal liability on individuals and entities found responsible for "serious accidents", which not only include accidents occurring at industrial sites, but also defects in the design, manufacture, installation and management of products, product ingredients or in public facilities/transportation. SAPA imposes criminal liability against (i) business owners or executives (as defined by the law) who fail to ensure the safety of their business operations, and (ii) businesses or institutions that fail in their supervisory duties. In case of wilful misconduct or gross negligence, SAPA imposes punitive damages of up to five times actual damages. The impending passage of the class action and punitive damages legislation will have an impact on the enforcement of SAPA as it will significantly broaden the liability of companies and management.

Governance: On December 9, 2020, the National Assembly passed amendments to the Korean Commercial Code, the Monopoly Regulation and Fair Trade Law, and the newly proposed Act on Supervision of Financial Groups (termed together, the "Three Laws of Fair Economy"). The Three Laws of Fair Economy (i) require separate votes for audit committee members, (ii) restrict the misuse of corporate resources for self-gain, (iii) require greater disclosures on the activities of overseas affiliates, and (iv) prescribe in greater detail the illegitimate use of corporate resources for the benefit of individual controlling families of companies. Furthermore, on January 9, 2020, the National Assembly passed an amendment to the Financial Investment Services and Capital Markets Act obligating listed companies with total assets of KRW 2 trillion or more to appoint at least one female director to the board.

1.2 What are the main ESG disclosure regulations?

Environment: On March 24, 2021, the National Assembly passed an amendment to the Environmental Technology and Industry Support Act, aimed at bolstering environment-related disclosure by companies. Prior to this, only a specified subset of companies – those designated as "green companies", specific public institutions set forth in the enforcement decrees, and companies with significant environmental impact – were subject to disclosure obligations. The amendment expands these obligations to listed companies with total assets greater than or equal to KRW 2 trillion, reflecting the trend towards heightened obligations on managing environmental impact and related disclosures.

Governance: The Korea Exchange ("KRX"), as approved by the Financial Services Commission ("FSC"), has required listed companies with total assets greater than or equal to KRW 2 trillion on a consolidated basis to disclose corporate governance reports since 2019. Moving forward, a broader set of companies will be required to make the same disclosures. These obligations will be mandated on a staggered basis starting from 2022, starting with large companies (having more than KRW 1 trillion but less than KRW 2 trillion total assets on a consolidated basis) requiring compliance with such disclosures and eventually having all listed companies on the KOSPI Market Division of the KRX ("KOSPI Listed Companies") requiring disclosure by 2026.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

On January 18, 2021, the FSC and the KRX published their "Guidance on ESG Information Disclosure" to encourage companies to voluntarily publish reports on ESG matters. The guidance is aimed at providing companies with guiding principles for self-disclosures on ESG matters. Companies will be encouraged to make voluntary disclosures by 2025 while KOSPI Listed Companies with assets above a certain threshold will be mandated to make disclosures on a phased-in basis from 2025 to 2029, with all KOSPI Listed Companies being subject to the disclosure requirements from 2030. The guidelines emphasise the need for companies' boards and management to set ESG objectives, integrate the objectives into the company's operation, establish governance structures that can properly address ESG goals and objectives, and mandate related disclosures allowing for proper evaluation by stakeholders.

1.4 Are there significant laws or regulations currently in the proposal process?

On August 3, 2021, the National Assembly introduced amendments to four laws. These bills, which have been collectively termed as the "Four ESG Bills", include the Public Institutions Act, the National Finance Act, the National Pension Act and the Government Procurement Act. Generally, the amendments aim to implement legally prescribed ESG mandates into the operations of public institutions, public funds, the National Pension Service and in the selection criteria of companies bidding for publicly funded procurement projects.

The amendment to the Public Institutions Act will require public institutions to implement ESG mandates in the management evaluation process. The amendment to the National Finance Act requires a fund's asset management guidelines to promote sustainable growth of public pensions and funds. The amendment to the National Pensions Act will obligate the National Pension Service to consider ESG factors when selecting target investment companies. The amendment to the Government Procurement Act mandates commercial businesses wishing to participate in public procurement to disclose factors relating to corporate social responsibility as part of the government procurement process.

Unsurprisingly, major trade organisations have objected to the proposed amendments, citing the burdens of increased reporting and greater regulatory oversight. As the amendments cover a broad scope of issues, we anticipate that the changes will have a broad-reaching impact on many enterprises seeking to engage in transactions or raise funds from government agencies and institutions. These amendments are currently under review by the relevant sub-committees of the National Assembly. We believe it likely that these amendments will pass the National Assembly as they target public institutions rather than the private sector.

1.5 What significant private sector initiatives relating to ESG are there?

The Korean Corporate Governance Service ("KCGS"), which is a not-for-profit entity focusing on governance-related issues, is considered the leading advisory institution for institutional investors on issues of corporate governance and management of sustainability standards of listed companies. Various important KCGS member institutions include the KRX, the Korea Securities Depositary, the Korea Financial Investment Association, and the KOSDAQ Listed Companies Association.

KCGS publishes various codes of conduct and best practices related to corporate responsibility and governance and enforces and maintains the Korea Stewardship Code, a voluntary code of conduct followed by subscribing institutional investors. Many important institutions, including the National Pension Fund, have agreed to abide by the Korea Stewardship Code. Similar to ISS or Glass Lewis, KCGS also supports institutional investors by analysing those agendas promoted at the general meetings of shareholders of public companies, and provides institutional investors recommendations on how to vote on various agenda items. On May 21, 2020, KCGS also launched the "K-ESG Initiative", a Korean version ESG model. KCGS plans to study the Korean version ESG model, on the premise that certain Korean social norms or cultural values are not properly reflected or accounted for in global ESG standards.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

An increasing number of institutional investors are actively adopting more ESG policies. As mentioned above, many have adopted the Korea Stewardship Code. As of June 2021, 162 institutional investors have signed on to the Korea Stewardship Code, which is an increase by 37 institutions compared to the prior year. The National Pension Service and the Korea Teachers Pension Service have amended their investment policies to strengthen ESG considerations and augment their standards for making more responsible investments. The National Pension Service recently announced plans to accord higher evaluation marks to asset managers with investment policies that incorporate ESG and corporate responsibility standards. It will also require asset managers broadly to disclose matters relating to responsible investment in their fund management reports. The Korea Teachers Pension Service announced that from 2021, it will take into account ESG-related investment policies of fund managers and their track records in shareholder activities when evaluating asset manager appointments for managing investment portfolios of Korean corporates.

We expect the evolving standards and factors on ESG investments to impact how institutional investors engage with their portfolio companies including the portfolio companies' activities on ESG issues. We have seen greater engagement by institutional investors with their portfolio companies on ESG issues and we expect this trend to continue. For example, the cases of ESG issues raised by investors to their portfolio companies increased significantly compared to the prior year. According to KCGS, ESG issues accounted for more than half (54%) of the total number of issues that shareholders raised to companies between April 2019 and March 2020. This ratio increased further to 74% from April 2020 to March 2021.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

The public is another stakeholder of ESG issues. According to a recent poll conducted by the Korea Chamber of Commerce and Industry, 63% of the public cited that they consider a company's ESG track record when buying products. Seventy per cent also responded that they have not purchased a company's product if they had a negative perspective of the company on ESG issues. Eighty-eight per cent of respondents also noted their willingness to pay a premium to buy products made by companies they viewed as being ESG-friendly. The results of the survey indicate the public's growing awareness of ESG issues and their willingness to have these factors impact their purchasing power.

Even non-governmental organisations and other civil organisations spanning various age groups (particularly younger college students) have raised awareness of ESG issues, by engaging with the public through education and promoting awareness of such issues. For example, the Korea Green Foundation, Korea's first public service foundation specialising in environmental issues, seeks to promote ESG-focused management by recognising those companies that strive to create a sustainable society.

Labourers are also raising "S"-related issues, stressing the need for greater worker participation and voice in corporate governance and management. While this is a great source of conflict, there have been cases of companies where the management and workers were aligned on ESG issues. For example, in April 2021, the CEO and head of the labour union of Korea Telecom, one of Korea's three largest telecommunications companies, jointly announced their plans to initiate environmentally friendly management practices with the aim of achieving carbon neutrality by 2050. They also vowed to address social issues and to establish best practices through transparent governance and the formation of a labour-management ESG committee. Furthermore, workers have continued to urge the implementation of strong institutional mechanisms to protect worker safety and the adoption of SAPA, as discussed in greater detail in section 1 above. There has been continuing pressure from workers demanding SAPA to be expanded in scope, as it is argued that the law as currently drafted is too narrow to bring any real effect to workers.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The principal regulators for ESG issues include the FSC, the KRX, the Korea Fair Trade Commission ("KFTC") and the Ministry of Employment and Labor ("MOEL").

The FSC regulates the financial industry and issues financial policies, including those related to ESG finance and disclosures. The KRX is the main stock exchange of Korea, which also publishes regulations and disclosure standards applicable to listed companies. As mentioned above, on January 18, 2021, the FSC and the KRX published their "Guidance on ESG Information Disclosure" to encourage companies to voluntarily disclose reports on ESG matters.

The KFTC, Korea's main anti-competition agency, has also adopted stronger regulations on the potential abuse of bargaining position and unfair trade practices. One specific area for further oversight is unfair practice by e-commerce and platform providers, and the KFTC, on January 28, 2021, submitted a legislative proposal to the National Assembly entitled the "Establishment of Fairness in Transaction Brokerage on Online Platforms Act", which is currently under discussion by the relevant sub-committee of the National Assembly.

Recently, the MOEL has taken steps to strengthen worker and employee protections, particularly in industries most heavily impacted by the pandemic, as well as other industries with higher occurrences of assault, verbal abuse, and workplace and sexual harassment cases. With respect to industrial sites, the MOEL also recently announced in February this year a comprehensive plan to address the supervision of workers' industrial safety and health.

The National Assembly has also introduced and passed several pieces of legislation aimed at bolstering the importance of ESG issues. According to a study conducted by the Federation of Korean Industries, among all the ESG-related bills passed by the 21st National Assembly, 15% related to "Environmental" issues, 73% to "Social" issues and the remaining 12% to "Governance" issues. The bills relating to "E" involve climate change and the use of natural resources; "S"-related bills concern occupational safety and equal employment opportunities, as well as protection against harassment in the workplace; and "G"-related bills contain amendments to the Korean Commercial Code and practices related to antitrust and fair trade practices involving smaller affiliate companies of large Korean conglomerates.

2.4 Have there been material enforcement actions with respect to ESG issues?

Government agencies have taken enforcement actions with respect to mainly "Social"-related issues. For example, occupational and worker-related safety have risen to the forefront of public discourse. The MOEL has recently taken strict actions against companies, imposing fines and issuing recommendations to improve their health and safety standards and has intensified its supervision of companies' health and safety management systems. In particular, the MOEL has expanded its supervision to not only include oversight of on-site workplaces, but also "headquarters" of companies.

The practical effect is that KCGS can factor in these situations when it re-evaluates companies pursuant to its new ESG evaluation model. Other sanctions relating to illegal discharge of air pollutants, instances of workplace harassment and unfair marketing and advertising, and more, are expected to be reflected in a company's ESG rating in the future.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

A significant litigation risk involving ESG issues is the potential for criminal liability of management and corporations for the lack of oversight relating to worker safety as introduced by SAPA. With SAPA, we expect this risk against management and corporations to increase as the law is applied to a broader set of companies. Currently, the regulations apply only to large companies and will be rolled out in stages to smaller companies that require more time and resources to implement the regulations. While companies violating safety protocols and obligations in construction sites were subject to criminal responsibility prior to SAPA, the law's enactment has broadened the scope of criminal liability of companies. Thus, we expect the risk of criminal litigation on this subject to increase in the coming years.

For civil liability, the Supreme Court, in June 2021, acknowledged that a company was liable for damages stemming from light reflected off an office building, as the building's exterior was wholly made of glass and, as a result, reflected light at a level that was significant enough for neighbouring residents to suffer damages. This ruling indicates that the courts are increasingly taking into account the interests of a variety of stakeholders in determining liability. Additionally, the government has been actively promoting the enactment of the Class Action Act and revisions to the Framework Act on Consumers to promote and revitalise group/class action litigation. If these proposed pieces of legislation are passed, we expect a significant rise in civil litigation.

2.6 What are current key issues of concern for the proponents of ESG?

One of the key concerns for ESG proponents is the centralisation and standardisation of ESG guidelines. Considering the rapid shift of capital to ESG projects and companies invested in ESG sectors, the lack of standardisation can lead to disproportionate resource allocation. The ESG market is flooded with various evaluation agencies, both domestic and international, raising concerns of comparative value. The government has announced plans to prepare a "K-ESG Guideline" to not only streamline, but also to encourage, ESG disclosures and also to expand and strengthen ESG-related infrastructure.

The government has also announced its intention to develop a classification system of "Green Finance" dubbed "K-Taxonomy". These guidelines and classifications are intended to promote greater transparency and mitigate growing concerns over "greenwashing" in the market. Furthermore, as mentioned above, the government has announced its intention to introduce laws relating to the issuance of sustainability-linked bonds in the Korean capital markets.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

In addition to government regulations, KCGS is a market leader in best practices relating to Korean ESG issues. It has published the ESG Codes of Practice, which will become effective from August 2022. The principal concept underlying the code is that companies' top executives should be primarily responsible for addressing ESG issues. For example, companies will be required to implement company-wide ESG management systems addressing the variety of ESG-related topics, and the top executives will be required to manage these systems.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

There are various governance mechanisms supervising the management of ESG issues. The KRX's "Guidance on ESG Information Disclosure" requires executives and board members to set company's ESG objectives, establish company-wide governance policies that incorporate ESG issues and evaluate their performance on ESG issues. KCGS's ESG Codes of Practice specify that boards should recognise mutual cooperation with stakeholders relating to ESG issues, and thereby make efforts to establish and maintain cooperative relationships with all stakeholders. This requires the board and management to take a more proactive approach in dealing with ESG issues. Furthermore, the board and management are advised to consider how to best allocate limited company resources as it seeks to achieve ESG-related goals. The creation and presence of ESG committees at the board level are aimed at addressing these concerns.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

According to KCGS's ESG Codes of Practice, boards should design practices and policies to compensate executives on performance that aligns with the company's sustainability agenda and disclosure of their remuneration. In addition to both qualitative and quantitative compensation disclosures, boards are recommended to establish procedures pursuant to which they can claw back performance incentives if it is later found that the incentive payments were based on accounting fraud or other misstatements.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

KCGS annually awards companies demonstrating excellence in achievements in the management of ESG issues. Last year, KCGS awarded the recognition to KB Financial Group, a banking and financial holding company, and S-Oil Corporation, an oil and gas company. For example, KB Financial Group established a company-wide environmental standards management system and implemented an executive succession programme and performance evaluation system. It also protected and promoted workers' rights by setting up various support programmes and advanced systems aimed at managing human rights in supply chain systems. S-Oil Corporation led efforts by structuring an environmental management system based on standardised manuals and policies, set permissible discharge standards for environmental pollutants lower than those set forth by regulation, introduced a programme evaluating outside directors, and set forth environmental- and social-related goals in its annual business plans.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Institutional investors and pension funds are increasingly taking into account ESG factors when providing finance or selecting asset managers, and as such, have come to rely more on externally developed ESG ratings. Several institutional investors have hired external consulting firms or used internal resources to develop ESG evaluation metrics for their investment portfolios.

Banks are also keen to engage with their clients on ESG topics and are using promotional strategies, such as extending more favourable interest rates to companies that have strong ESG policies or ESG ratings.

The government also recently decided to suspend public financial support for new overseas coal-fired power plants, and in September 2021, announced guidelines to help implement this action.

4.2 Do green bonds or social bonds play a significant role in the market?

The Korean capital markets have experienced a surge in Green Bond and Social Bond issuances. In 2018, the total value of Green Bonds and Social Bonds issued was KRW 600 billion. In 2019, the issuance increased to KRW 26.7 trillion, and reached a record high of KRW 54.1 trillion in 2020. Furthermore, issuers have become more varied to include both private and public companies, as well as financial institutions and industrial companies.

This trend has continued in 2021 – as of the end of April, the total issuance value of ESG bonds (including Green Bonds and Social Bonds) reached KRW 29.2 trillion. Social Bonds account for an overwhelming 83% of the bonds by issuance amount, with Green Bonds accounting for the remaining value. By the issuer categories, public enterprises accounted for 79.7% of the total issuance amount, with financial institutions taking up 13.6% and the remaining 6.7% issued by other companies. As such, even though ESG bond issuances have been active recently, they are still predominantly issued by public enterprises and financial institutions, such as banks, to support corporate finance activities of companies rather than by the corporate themselves. While banks and financial institutions still issue many Green Bonds for their own projects, we find that a greater number of companies in the energy, natural resources and construction industries are taking steps to directly issue Green Bonds.

4.3 Do sustainability-linked bonds play a significant role in the market?

To date, no entity in Korea has issued sustainability-linked bonds. The KRX views Green Bonds, Social Bonds and Sustainable Bonds as similar bond categories, in that the proceeds are linked to a specific project or targeted to a specified usage. Sustainability-linked bonds allow issuers broader scope for the use of proceeds that are related to sustainability factors.

The government has recently made pronouncements relating to the issuance of sustainability-linked bonds, providing the impetus to potential future issuance. The FSC announced in August 2021 that it is conducting a comprehensive survey of the domestic demand for sustainability-linked bonds in Korea. While there is no express legislative provision or regulation prohibiting the issuance of sustainability-linked bonds (or *vice versa*), the FSC has stated that it could also consider expressly permitting the issuance of sustainability-linked bonds before 2023 if it believes there is sufficient market demand.

4.4 What are the major factors impacting the use of these types of financial instruments?

Frequently issued bonds have well-established standards adopted by market players. Green Bonds are most frequently issued in Korea, with the first issuance dating back to 2013. We think there is a prevalence of Green Bonds in Korea because well-established global standards issued by prominent institutions, such as the International Capital Market Association, exist. Green Bond issuers must comply with the same issuance procedures as general corporate bonds pursuant to the Korean Commercial Act and the Financial Investment Services and Capital Markets Act. Furthermore, in December 2020, the Ministry of Environment ("MOE") finalised and published the issuance standards for Green Bonds in its Green Bond Guidelines.

Meanwhile, there are no government-issued guidelines or standards relating to Social or Sustainable Bond issuances, and instead, private institutions like credit rating agencies and accounting firms have established their own private evaluation standards. Because of the lack of consistency and centralisation, market players are continually seeking greater clarity and guidance.

Cost of issuance and the risk that a company's credibility can be negatively impacted if it fails to properly (i) use the proceeds for qualifying ESG-related purposes, or (ii) implement follow-up disclosures, also impact their issuances and prevalence in the markets. These types of bonds also require more stringent certification and disclosures, because of their novelty in the Korean capital markets compared to other types of bond issuances, thereby increasing the overall issuance costs.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

According to the MOE's Green Bond Guidelines, issuers must conduct external reviews to determine whether their bond issuance framework is consistent with the four main pillars stipulated by International Capital Market Association: (i) use of funds; (ii) project evaluation and selection process; (iii) fund management; and (iv) reporting after the project's completion. External reviews include obtaining second-party opinions, verifications and certification, and obtaining a Green Bond score/rating from such external party. External agencies include accounting firms, credit rating companies, consulting firms and research institutions with background and experience in assessing ESG-related factors. The external agency's report must include the following information: (i) qualifications of the external review agency, the purpose and scope of the external review; (ii) the external review agency's policy for preventing conflicts of interest and securing independence; (iii) the approach and evaluation methodologies used by the external review agency; and (iv) the agency's conclusive assessment and opinions on the issuer's bonds, including any qualifications. Once the report is complete, it should be disclosed on the website of the issuer or that of the KRX. Third-party verification is important when issuing Green Bonds, as there is a risk that the issuer superficially presents itself as conducting ESG-related businesses, but in fact uses the proceeds to fund projects or businesses unrelated to ESG-related businesses. This external verification system helps to prevent and counteract against potential "greenwashing" by bad actors.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

Growing frustration over economic inequality exacerbated by the pandemic, and concern and awareness of climate change issues, have accelerated ESG issues to the forefront of public discourse. The government, in its part, enacted the Korean "New Deal" in July 2020, which promotes a lower-carbon economy (relating to the "E" part of "ESG"), which is both "inclusive" (relating to the "S" part of "ESG") and "fair" (relating to the "G" part of "ESG"). Furthermore, in December 2020, it also announced a strategy aimed at achieving carbon neutrality by 2050. In particular, the government has denoted 2021 as the "First Year" when ESG factors have become the agenda of company management and has promised to overhaul the ESG framework to minimise possible confusion and difference in ESG reporting requirements by improving disclosure standards, providing incentives and preparing government-backed ESG standards.

The market has also responded by boosting projects related to ESG, which has, in part, increased significant demand for the issuance of Social Bonds. The total value of ESG bonds issued by Korea's top-five commercial banks in 2020 was KRW 5.1523 trillion, a 52.9% increase from KRW 3.3696 trillion in 2019.

6 Trends

6.1 What are the material trends related to ESG?

We find the below to be the material trends developing in the field of ESG:

Environment: Several companies have recently announced their commitments to carbon neutrality, and company management are becoming more aware of its importance when seeking to raise funds from the capital markets. For example, a Korean conglomerate recently announced its plan to reach the goal of achieving carbon neutrality prior to the year 2050 by actively making investments that reduce greenhouse gas emissions and expand the use of renewable energies. A Korean electronics company also recently announced its plans to reduce carbon emissions by half by 2030, and has committed to build facilities that achieve higher energy efficiency and reduce greenhouse gas emissions during production.

Social: The National Assembly has recently adopted several laws that strengthen protections of workers, including the amendment to the Occupational Safety and Health Act in January 2020 and the enactment of SAPA in January 2021. These laws have come into place in light of the treatment of various gig-workers (such as delivery people working for logistics companies and/or food delivery services) during the pandemic, as well as ensuring greater safety for workers in industrial complexes. Additionally, the National Assembly has strengthened the laws and regulations relating to workplace harassment, unfair termination and workers' rights, including the mandatory 52-hour workweek ceiling. Companies have become more aware of and are taking greater efforts to publicly display support for workers' rights, with the understanding that public perception can directly and negatively impact their brand image in addition to regulatory sanctions and criminal/civil liabilities.

Governance: Companies have recently come to adopt or institutionalise new ESG committees within their organisations, with many of them under the supervision of their respective boards. A survey conducted by the Daeshin Economic Research Institute in June 2021 found that of the total 106 listed companies affiliated with Korea's 10 largest conglomerates, 50 of such companies had established ESG committees. Furthermore, KCGS has recently amended its Code of Best Practices for Corporate Governance to reflect ESG factors that should be included in its evaluation of public companies, and such factors will be included in its evaluation beginning in 2022. The best practices have been revised to place greater emphasis on the leadership, responsibilities and roles of both management and the board on environmental and social issues.

6.2 What will be the longer-term impact of COVID-19 on ESG?

We anticipate that the pandemic will increase pressure on management to engage more proactively with ESG issues. The pandemic has brought to light working conditions and the importance of workers' health. Given these insights, we suspect that companies' management teams will be more aware of rights of workers and the need for greater "S" improvements.

Public and private institutions have emphasised protection of human rights since the pandemic. For example, the National Human Rights Commission of Korea noted that protection and promotion of human rights is an urgent task that must be addressed to maintain a sustainable future after the pandemic. Furthermore, the Ministry of Justice has announced that it is currently in the process of drafting and enacting a Framework Act on Human Rights Policy, publishing a legislative notice and having held a public hearing on this proposed new law. If the existing ESG investment framework was passively developed over time to avoid investing in companies that could harm ESG values, the pandemic is expected to draw attention to the impact of actively finding and investing in companies that can better society.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

The ESG framework in Luxembourg comprises a number of EU regulations, EU legislative measures amending existing regulatory frameworks, national legislation and regulatory guidance, including:

(i) Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (the "**SFDR**");

(ii) Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment (the "**Taxonomy Regulation**");

(iii) Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (the "**Low Carbon Benchmark Regulation**");

(iv) five Commission Delegated Regulations and Commission Delegated Directives integrating sustainability issues and considerations into the following EU legislative regimes: (i) UCITS Directive 2009/65/EC, amended by Commission Delegated Directive (EU) 2021/1270; (ii) AIFMD 2011/61/EU, amended by Commission Delegated Regulation (EU) 2021/1255; (iii) MiFID II 2014/65/EU, amended by Commission Delegated Regulation (EU) 2021/1253 and Commission Delegated Directive (EU) 2021/1269; (iv) Solvency II Directive 2009/138/EC, amended by Commission Delegated Regulation (EU) 2021/1256; and (v) Insurance Distribution Directive EU/2016/97, amended by Commission Delegated Regulation (EU) 2021/1257;

(v) the law of 23 July 2016 on the publication of non-financial information (the "**2016 Law**"), which transposed Directive 2014/95 of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups into Luxembourg law; and

(vi) the *Commission de Surveillance du Secteur Financier* (the "**CSSF**") circular 21/773 on the management of climate-related and environmental risks for all credit institutions designated as less significant institutions under the Single Supervisory Mechanism and to all branches of non-EU credit institutions.

1.2 What are the main ESG disclosure regulations?

The main ESG disclosure regulations are: (i) the 2016 Law, which requires certain large undertakings and groups to disclose information relating to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters; (ii) the SFDR; (iii) the Taxonomy Regulation; and (iv) the Low Carbon Benchmark Regulation.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Voluntary disclosures beyond those required by law or regulation include the consideration of principal adverse impacts of investment decisions on sustainability factors. In addition, certain other ESG-related regulations have introduced voluntary disclosures; for example, the Low Carbon Benchmark Regulation has introduced two new categories of low-carbon benchmarks, namely: (i) a climate-transition benchmark; and (ii) a specialised benchmark that brings investment portfolios in line with the Paris Agreement regarding the goal to limit the global temperature increase. The categories are voluntary labels designed to assist investors who are looking to adopt a climate-conscious investment strategy. The Luxembourg Finance Labelling Agency ("**LuxFLAG**") promotes the raising of capital for sustainable investments by awarding a label to eligible investment vehicles on a voluntary basis. The categories that are covered include, among others, Environmental, ESG, Climate Finance and Green Bonds. Other voluntary ESG regimes include: (i) Principles for Responsible Investment; (ii) the Financial Stability Board's Task Force on Climate-related Financial Disclosures; (iii) the Global Reporting Initiative; (iv) the Sustainability Accounting Standards Board; (v) the Climate Disclosure Standards Board; (vi) the International Integrated Reporting Council; and (vii) CDP Global (formerly the Carbon Disclosure Project). The vast number of voluntary ESG regimes can pose challenges for companies incorporating and/or being evaluated by multiple frameworks, in particular as these are not always standardised, consistent and comparable in terms of scope, approaches to materiality and reporting standards.

1.4 Are there significant laws or regulations currently in the proposal process?

In addition to the ESG disclosure regulations noted above, there are several other legislative proposals in various stages of the EU's legislative process and these include the Non-Financial Reporting Directive (soon to become the

Corporate Sustainability Reporting Directive), an EU Green Bond Standard ("**EU GBS**"), the EU Ecolabel, Corporate Governance, the Solvency II Directive and Credit Ratings.

1.5 What significant private sector initiatives relating to ESG are there?

There are a number of private-public initiatives relating to ESG. Two significant initiatives include: (i) the Luxembourg Sustainable Finance Initiative ("**LSFI**"); and (ii) LuxFLAG. LSFI is a not-for-profit association that designs and implements the Sustainable Finance Strategy for Luxembourg's financial centre. Its objective is to raise awareness, promote and help develop sustainable finance initiatives in Luxembourg. LuxFLAG is a non-profit organisation that aims to promote capital raising for sustainable investments by awarding a recognisable label (see above) to eligible investment vehicles. Its objective is to reassure investors that the labelled investment vehicles invest in the responsible investment sector. In addition to these ESG initiatives, there are also a number of ESG-related public sector initiatives.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors are increasingly looking to align their investment decisions with their personal priorities. They are now not only focused on financial returns but also on non-financial outcomes and are seeking to invest in companies that have the capabilities to both achieve and maintain strong financial and ESG performance. This increased investor interest in ESG reflects the growing recognition that performance and value can be enhanced by the inclusion of ESG metrics into companies' business operations and investment decisions.

As ESG has become an integral part of the conversation between asset managers and investors and with many institutional investors actively pursuing a sustainable and responsible investing agenda, asset managers are embracing ESG in order to align stakeholders' interests and avoid short-term investments and results, in return for long-term incentives aligning investment practices with social responsibilities and principles in order to meet investor demands. Investors are also recognising the potential for ESG factors to affect the valuation and performance of companies they invest in, and this has resulted in investors pressurising companies to increase the amount of information disclosed to investors on ESG-related matters.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

ESG and sustainable finance is an area that is continuously evolving and growing to meet the expectations of a wide number of stakeholders, including shareholders, policymakers, regulators and central banks. Within the EU and Luxembourg, new regulatory frameworks are being introduced to address and support the European Commission's revised Action Plan on Sustainable Finance. This includes a number of regulations outlined above, including the Taxonomy Regulation, the SFDR, the Low Carbon Benchmark Regulation and the supporting secondary legislation with regard to the delegated acts. There are also a number of matters in progress, including the development of the EU GBS, the EU Ecolabel for financial products, and updating corporate financial reporting under the Non-Financial Reporting Directive. This is in addition to the European Green Deal, the European Commission's plan to make the EU's economy sustainable, which sets out an action plan to boost the efficient use of resources by moving to a clean, circular economy, restoring biodiversity and cutting pollution with the aim of the EU being climate neutral in 2050 with the proposed European Climate Law, which turns the political commitment into a legal obligation. Furthermore, shareholders have placed increasing pressure on companies with respect to social and governance issues, including gender and racial diversity on boards, requiring companies to adopt policies, and enhanced disclosure with respect to ESG matters.

In addition, the CSSF, as the supervisory authority of the financial sector in Luxembourg, is committed to contributing to the achievement of the objectives of the Paris Agreement. For example, it became an official member of the network of greening the financial system ("**NGFS**") in 2019. NGFS' purpose is to help strengthen the global response required to meet the goals of the Paris Agreement and to enhance the role of the financial system in managing risks and mobilising capital for green and low-carbon investments in the broader context of environmentally sustainable development. Moreover, the Luxembourg Government has also launched several initiatives to promote innovative financial ideas to fight against climate change.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The principal financial regulator in Luxembourg is the CSSF. The Environment Agency (*Administration de l'environnement*) is responsible for protecting the environment and the quality of the local living environment and may issue fines in certain circumstances.

More broadly within the EU, bodies such as the European Commission, the European Securities and Markets Authority ("**ESMA**"), the European Banking Authority, the European Insurance and Occupational Pensions Authority and the Technical Expert Group (the "**TEG**") are the principal regulators with respect to ESG issues. The key issues being pressed by these bodies are the renewed sustainable finance strategy and the action plan on financing sustainable growth, which includes the following: (i) developing an EU classification system for environmentally sustainable economic activities; (ii) developing EU standards (such as the EU GBS) and labels for sustainable financial products (via Ecolabel) to protect the integrity and trust of the sustainable finance market; (iii) fostering investment in sustainable projects; (iv) incorporating sustainability in financial advice; (v) developing sustainability benchmarks; (vi) sustainability in research and ratings; (vii) disclosures by financial market participants; and (viii) sustainability in prudential requirements, strengthening sustainability disclosures by corporates and fostering sustainable corporate governance and promoting long-termism.

2.4 Have there been material enforcement actions with respect to ESG issues?

At the broader European level, there have been a number of material enforcement actions with respect to ESG issues regarding issuers whose securities are admitted to trading on a regulated market. Investors are also increasingly demanding reliable and relevant disclosure on ESG factors. On 6 April 2021, ESMA, the EU securities markets regulator, published its annual report on enforcement and regulatory activities of European enforcers in 2020. The report presents the 2020 activities of ESMA and of European accounting enforcers when examining compliance of financial and non-financial statements provided by European issuers. In light of the increased importance of companies' ESG disclosures, European enforcers increased their enforcement activities on non-financial information in 2020, leading to examinations of 737 non-financial statements or 37% of the total estimated number of issuers required to publish a non-financial statement. These examinations brought about 39 enforcement actions, constituting an action rate of 5%.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The principal litigation risks arise from shareholder activism and related investor claims against companies and their directors, particularly in relation to materially false or misleading ESG disclosures or representations made in prospectuses or investor reports. We are not aware of any material decisions by the Luxembourg Courts in relation to ESG issues. Nonetheless, the trend of ESG-related litigation, which has arisen elsewhere, may surface to some degree in Luxembourg in the future.

2.6 What are current key issues of concern for the proponents of ESG?

The key issues of concern for ESG proponents are lack of transparency and lack of reporting standards. In addition, a lack of uniformity with respect to the various classifications available under the SFDR is also a concern for proponents of ESG. Many asset managers for whom ESG and responsible investing have been a cornerstone of their businesses are concerned that certain competitors may be gaining an unfair advantage as a result of these new classifications. The SFDR does not prescribe how an asset manager should determine the category to which its funds belong. The lack of guidance with respect to the exact measurement methodology as well as the potential to incorrectly categorise a fund may make it difficult to compare investment options and may potentially lead to greenwashing. Furthermore, there is a concern that asset managers may not have sufficient data to support certain SFDR classifications, as data does not exist for certain asset classes.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

ESG is no longer the sole responsibility of a company's sustainability officer. Instead, in light of investors' expectations that boards and senior management are fully engaged on ESG and managing companies for long-term success, they have an essential role in ensuring compliance with various ESG-related legislation, addressing an organisation's ESG issues and for assessing the potential impact of such ESG issues on the organisation's operating model. The key issue for management bodies is to identify ESG themes that are emerging as industry drivers ahead of their competitors in order to gain a competitive advantage. This requires management bodies to identify the various stakeholders, their incentives and the matters that may bring about change with respect to ESG, including obtaining insight in respect of the companies' social or environmental impact. By connecting business goals with the demands of investors with respect to ESG issues and differentiating from competitors, companies can increase revenue and gain competitive advantage. In order to set and change the strategy of a corporate entity with respect to ESG matters, management bodies should adopt strategic practices to establish accountability structures for ESG, identify and create a suitable corporate purpose and culture, enhance investor transparency, and ultimately seek to balance investors' ESG preferences against business priorities. Management bodies play a key role and are responsible for ensuring a company's mission is achieved.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The structures and processes in place to supervise management of ESG issues depend on the nature and scale of each individual company. Boards play an important role in driving ESG development within their companies, and board oversight on ESG issues can help businesses better manage their ESG-related risks and opportunities. This includes a board's oversight responsibilities. Boards also play an essential role in assessing an organisation's environmental and social impacts and understanding the impact of ESG issues on the organisation's operating model. Boards have a crucial role to ensure companies are aware of, and are able to navigate, the ever-changing landscape and exercise oversight in this respect; such oversight should be informed, strategic and aligned with the company's business model to create long-term value. The board will also play a role in identifying the issues as well as evaluating and recommending steps to be taken with respect to ESG issues.

Investors are increasingly turning towards the boards of companies for accountability. Key performance indicators ("**KPIs**") are also in place to supervise the management of ESG issues, used as a tangible measurement to quantify the extent to which a company is achieving its goals. Investors expect board members to be competent in the area of ESG matters.

With regard to providing oversight and supervision in this area, consideration should be given to allocating oversight responsibilities to consider: (i) which activities should be overseen by the board and those that should be delegated to a committee, for example, a sustainability committee, which could include providing guidance to management; (ii) disclosure of information with regard to information that should be shared between the board and management including, for example, KPIs and metrics in order to understand the importance of certain ESG issues; and (iii) ESG as part of the board's oversight and strategy by incorporating ESG initiatives into the overall company strategy, and establishing metrics to include ESG initiatives to assess these performance indicators against the overall company strategy and ensuring oversight of ESG integration.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

A large number of companies are introducing ESG targets in executive remuneration packages to hold executives to account for the delivery of sustainable business goals and using compensation or remuneration incentives to align executive compensation with shareholder interests with respect to ESG. Examples of such policies include paying bonuses only when shareholder return targets are reached for a number of years in succession. The desired outcome being that the company will increase transparency for shareholders and create more responsible standards for achieving long-term company growth and shareholder value over executive pay. One approach used to align incentives with respect to ESG is to have bonuses depend largely, or solely, on executives' success in respect of strategic opportunities related to sustainability, while continuing to monitor and disclose aspects of ESG performance, and insisting on seeing ESG metrics to ensure executives act responsibly, mitigate risk and comply with regulations. Compensation committees can use their discretion to adjust pay after the fact for sustainability performance in these areas. In order to integrate ESG issues into executive pay, companies should firstly adopt a clear process for identifying appropriate ESG metrics that relate to sustainable shareholder returns and company strategy. Linking ESG metrics to a reward system in a manner that forms a substantial component of the overall remuneration framework, and integrating ESG targets within a particular time frame that corresponds with the business strategy, will ensure that such ESG factors are used to incentivise high performance.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

ESG is fast becoming an inextricable part of how companies do business and in order to remain competitive and respected, companies must establish an ESG strategy. To this end, companies are taking proactive steps to integrate ESG into their business operations. One example of this is the creation of reward systems that link performance with ESG metrics and tying this in with employee compensation. This in turn may lead to the attraction of, and retention of, talent. Other examples include ensuring ESG considerations form part of the company's strategic objectives as well as offering ESG-focused solutions to existing and future challenges.

In addition, with regard to social issues such as insufficient diversity of talent as well as gender and racial inequality, companies have addressed this through their recruitment process, putting in place committees and policies to improve diversity and inclusion. Companies are also setting measurable goals (with a defined timeline) to increase diversity among senior leadership.

Environmental matters have also been integrated into the day-to-day operations of companies by reducing the amount of energy and resources used by companies, with certain companies committing to net-zero carbon emissions by 2040.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Issuers of debt and equity finance rely on both internally and externally developed ESG ratings and not just financial data in order to add value by both improving performance and reducing volatility returns. In the past decade, there has been a significant increase in the use of ESG information in the investment process with providers of debt and equity finance and investors alike recognising that ESG ratings have real value in driving investment performance. ESG ratings can complement existing factors such as liquidity, volatility and performance. Investors are increasingly considering a company's ESG rating when making investment decisions. Companies that produce low ESG ratings can be subject to criticism, whereas companies that produce high ESG ratings may see an increase in investor demand and investment flows.

4.2 Do green bonds or social bonds play a significant role in the market?

Both green bonds and social bonds play a significant role in the market. Green bonds are debt securities issued to finance or refinance green projects with positive environmental outcomes while social bonds tend to be used to finance or refinance projects with positive social outcomes.

In 2007, the Luxembourg Stock Exchange (the "**LuxSE**") listed the world's first green bond. Since then, the LuxSE has become the leading venue for this asset class. The Luxembourg Green Exchange ("**LGX**"), the world's first platform dedicated to green bonds, was launched in 2016. Today, LGX is the world's leading centre for the listing of green bonds and the European leader in responsible investment fund assets. LGX has now expanded to include social, sustainability and sustainability-linked bonds.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds ("**SLBs**") play an increasingly significant role in the market. SLBs aim to further develop the key role that debt markets can play in funding and encouraging companies that contribute to sustainability. However, unlike green bonds and social bonds, there are no restrictions on how the proceeds from SLBs may be used. SLBs are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves the predefined sustainability/ESG objectives within a set timeline. They represent a source of financing for companies (from any sector) that set clear and ambitious science-based targets to become more sustainable.

4.4 What are the major factors impacting the use of these types of financial instruments?

The green bond principles ("**GBPs**"), social bond principles ("**SBPs**") and sustainability-linked bond principles ("**SLBPs**") published by the International Capital Market Association (the "**ICMA**") provide guidelines relating to green bonds, social bonds and SLBs, respectively, including disclosure and reporting guidelines, and are a major factor impacting the use of these financial instruments. The GBPs, SBPs and SLBPs are voluntary for issuers and their advisors in structuring, disclosing and reporting on green bonds, social bonds and SLBs that outline best practices to incorporate forward-looking ESG outcomes and promote integrity in the development of the SLB market, as well as providing issuers with guidance on the key components involved in SLBs. The GBPs, SBPs and SLBPs emphasise the required transparency, accuracy and integrity of information that will be disclosed and reported by issuers to stakeholders through core components and key recommendations.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Industry-accepted GBPs developed by the ICMA ensure such "green bonds" meet the rules of the GBPs. There are also standards such as the Climate Bonds Standard and Certification

Scheme, an investor-focused organisation that seeks to mobilise investors, industry and government to catalyse green investments at the speed and scale required to avoid dangerous climate change and meet the goals of the Paris Agreement. The Certification Scheme allows investors, governments and other stakeholders to identify and prioritise "low-carbon and climate-resilient" investments and avoid greenwashing. In addition, following the establishment of the TEG on sustainable finance in 2018 by the European Commission, the TEG has made recommendations to establish the EU GBS. The TEG has proposed that any type of listed or unlisted bond or capital market debt instrument issued by a European or international issuer that is aligned with the EU GBS should qualify as an EU green bond. The TEG has also published the "EU Green Bond Standard Usability Guide" (the "**Guide**"), which offers recommendations from the TEG on the practical application of the EU GBS. The Guide aims to support potential issuers, verifiers and investors of EU green bonds. The TEG proposes that the use of the EU GBS remains voluntary, and builds on market best practices such as the GBPs developed by the ICMA. At present, issuers having an EU green bond voluntarily verified by an external verifier has become common practice. Guidance on voluntary verification has been available thanks to the ICMA's Guidelines for External Reviews. The EU GBS builds on these foundations while formalising it and requiring additional processes. It institutes mandatory prior verification of the alignment of green bond issues. The TEG has recommended that oversight and regulatory supervision of external review providers eventually be conducted via a centralised system organised by ESMA.

With respect to Luxembourg specifically, LuxFLAG launched a label for green bonds in 2017. The "Green Bond Label" is granted to eligible instruments that finance green projects but only after a rigorous assessment. It evaluates true investment strategy commitments and helps investors in the selection of products, and applicants must submit independent third-party assurance reports.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

Although ESG issues dominated the regulatory and public arena prior to the outbreak of COVID-19, there was a concern that interest in ESG would fade in the face of tough market conditions. However, the opposite appears to have occurred with COVID-19 seemingly accelerating ESG investing and sustainability practices. COVID-19 has provided companies worldwide with the opportunity to reflect on ESG, their business practices and responsible investing. It has also been the first test of whether investors and asset managers alike are truly dedicated to sustainable investments and ESG, or if ESG is just another case of greenwashing or PR spin. COVID-19 has increased investor focus on ESG, highlighting the role that good businesses and practices play in society; emphasising the social elements of ESG as well as the direct link between social responsibility and investing; and illustrating that a company's value is linked to ESG performance. ESG practices have aided companies throughout the crisis, and investors are increasingly looking toward sustainable investment strategies when making investment decisions. Companies that focus on ESG practices are more likely to be resilient in the face of a crisis such as COVID-19 if they are managed for the long term in line with societal megatrends. In addition, COVID-19 is likely to increase the efforts of boards with regard to governance and disclosures, and how companies address governance factors is likely to impact businesses going forward.

6 Trends

6.1 What are the material trends related to ESG?

Demand for ESG products and the number of investors expressing an interest in such products has already increased markedly and is set to continue on an upward trajectory. The inflows in ESG products are increasing with the launch of new funds, as well as the repurposing of non-ESG funds, and this has continued despite the impact of COVID-19. In the fixed income market, green bonds are the fastest-growing market. Asset managers are increasingly looking to integrate ESG factors in portfolio selection and investors are increasingly asking ESG questions as part of their discussions with asset managers. In addition, socially responsible and ESG exchange-traded funds have become an increasingly popular area of focus for investors and asset managers alike. Following COVID-19, new opportunities may arise for categories of impact funds such as health and wellbeing as key areas of the response to the pandemic. COVID-19 seems to be further widening the scope of strategies. The pandemic has also brought human capital and the broader group of stakeholders (including employees) into sharp focus, and board and workplace diversity and inclusion will be a critical consideration for companies going forward. For example, certain institutional investors have already articulated their expectations in relation to board and workplace diversity and inclusion, including requests for companies to provide specific disclosures with respect to matters related to diversity and inclusion. There may also be a greater drive for a more meaningful integration of ESG targets in executive remuneration packages.

6.2 What will be the longer-term impact of COVID-19 on ESG?

Early indicators show that COVID-19 is accelerating the demand for sustainable investing, introducing a renewed focus on climate change, increasing the importance of the social element of ESG and requiring both asset managers and investors to focus on a sustainable approach to investing. As a result of the impact of COVID-19 on the global economy, policymakers and investors are looking at alternative investments, including those relating to climate change, and ways to define and integrate social performance into investment frameworks. COVID-19 may be pivotal for ESG investing alongside traditional financial investing in the long term. Recent studies have highlighted the fact that investors see COVID-19 as increasing investor awareness in other areas such as climate change and societal issues, which should have a positive impact on ESG, particularly in the long term. The COVID-19 crisis is likely to increase the measures taken by boards and markets to factor in systemic risk, including disclosures related to ESG. It is also likely to increase pressure on companies to consider their wider group of stakeholders and enhance efforts around issues such as diversity and inclusion and community engagement. COVID-19 has led to enhanced scrutiny from investors in respect of ESG metrics. ESG products have performed strongly relative to non-ESG products during the market downturn, and it is expected that investors will add these relative performance metrics to their asset selection preference. To date, with respect to investment funds, much of the focus has been on environmental products, but the impact of COVID-19 on society is likely to see growth in social impact funds.

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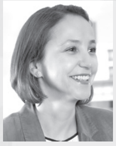
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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Mexico is still lacking an official taxonomy to define what substantial concepts, metrics and disclosure obligations should be considered as part of a comprehensive ESG body of laws or regulations.

To be sure, substantive ESG normativity is scattered throughout the entire Mexican legal framework, with Federal and State laws often regulating – and at times, duplicating – what is usually regarded as ESG substantive normativity.

In this context, we will adopt the framework laid out by the UN Principles for Responsible Investment ("PRI"), to provide a holistic and understandable overview of each of the topics considered part of the ESG trifecta that are regulated (albeit piecemealed) in Mexico.

Thus, the PRI considers the following as the main (but not the only) ESG factors:

Environmental	Social	Governance
Climate change	Human rights	Bribery and corruption
Resource depletion	Modern slavery	Executive pay
Waste	Child labour	Board diversity and structure
Pollution	Working conditions	Political lobbying and donations
Deforestation	Employer-employee relations	Tax strategy

Based on the foregoing, generally speaking, Mexico has a clear subject-matter division on ESG matters as set forth in the PRI, with specific substantive laws addressing these matters:

Environmental

- The General Law of Ecological Equilibrium and Environmental Protection (*Ley General del Equilibro Ecológico y la Protección al Ambiente*).
- The General Law for the Prevention and Comprehensive Management of Waste (*Ley General para la Prevención y Gestión Integral de los Residuos*).
- The General Law on Climate Change (*Ley General de Cambio Climático*).
- The National Waters Law (*Ley de Aguas Nacionales*).
- The Federal Environmental Liability Law (*Ley Federal de Responsabilidad Ambiental*).

Social

- Regarding human rights, slavery and child labour issues, the general framework is set forth in Mexico's Political Constitution, with specific laws at the Federal and State levels further developing these matters. To name a few:
  - the National Human Rights Commission Law (*Ley de la Comisión Nacional de los Derechos Humanos*);
  - the National Security Law (*Ley de Seguridad Nacional*);
  - the General Law on Victims (*Ley General de Víctimas*);
  - the General Law on the Rights of Girls, Boys and Teenagers (*Ley General de los Derechos de Niñas, Niños y Adolescentes*);
  - the General Law on Forced Disappearance of Persons (*Ley General en Materia de Desaparición Forzada de Personas, Desaparición Cometida por Particulares y del Sistema Nacional de Búsqueda de Personas*); and
  - State Laws to Prevent and Eradicate Human Trafficking.
- The Federal Labour Law (*Ley Federal del Trabajo*) addresses working conditions and employer-employee relations, including the right for unionisation and striking.
- The Federal Regulations on Health and Safety at Work (*Reglamento Federal de Seguridad y Salud en el Trabajo*) outline the minimum environmental, health and safety conditions that must be observed at the working site.
- Finally, pursuant to the Hydrocarbons Law and the Electric Industry Law – enacted after the Energetic Reform of 2013–2014 – oil & gas, as well as electric energy generation and transmission projects (renewables or otherwise) must undertake social impact assessments, and, if applicable, indigenous consultations, prior to development.

Corporate Governance

- The main aspects of corporate governance governing the internal life of companies, such as integration of the board of directors, vigilance and checks and balances bodies, rights and obligations of shareholders, rights of minority shareholders, distribution of profits and losses, etc. are outlined in the General Law on Commercial Societies (*Ley General de Sociedades Mercantiles*) and, in case of public companies, the Securities Exchange Act (*Ley del Mercado de Valores*).
- Regarding reporting entities, the CUE, including Exhibit "N" of the CUE (see question 1.2).
- Internal Regulations of the Mexican Stock Exchange (*Bolsa Mexicana de Valores* or "BMV").
- In addition, the BMV has adopted (and requested that publicly listed companies adopt) the Best Corporate Practices Code (*Código de Principios y Mejores Prácticas de*

Gobierno Corporativo), drafted by the Corporate Coordinating Council (*Consejo Coordinador Empresarial*), which raises the bar on corporate governance set forth by the General Law on Commercial Societies and the Securities Market Law.

- Corporate bribery, corruption, lobbying and donations regulations are overseen by the following laws:
  - the Federal Law to Prevent and Identify Operations with Illegal Funds (*Ley Federal para la Prevención e Identificación e Operaciones con Recursos de Procedencia Ilícita*);
  - the General Law of the National Anticorruption System (*Ley General del Sistema Nacional Anticorrupción*);
  - the General Administrative Liabilities Act (*Ley General de Responsabilidades Administrativas*);
  - Local and Federal criminal laws;
  - the Securities Exchange Act; and
  - the Investment Funds Act (*Ley de Fondos de Inversión*).
- Tax and fiscal planning are overseen in the Fiscal Code for the Federation (*Código Fiscal de la Federación*) and by each State in their own Fiscal Codes.

In terms of actual ESG regulations, on September 18, 2019, CONSAR, the authority governing Mexican pension funds (*Afores*), published the new general provisions on financial matters for pension funds. These new general provisions – the specific subject-matters of which are yet to be developed – establish that by January 2022, pension funds must include ESG factors in the criteria for risk and credit assessment of investments.

1.2 What are the main ESG disclosure regulations?

Pursuant to the general provisions applicable to issuers of securities and other participants of the Securities Market (also known as the *Circular Única de Emisoras* or "CUE") and Exhibit "N" thereto, companies that issue securities and register such securities in the National Securities Registry (*Registro Nacional de Valores*) are obliged to publish an annual report. In such report, issuers shall disclose whether they have environmental policies, environmental certificates or recognitions, projects for the protection, defence or restoration of the environment and natural resources, as well as relevant impacts, actual or potential, on climate change in their business. Additionally, issuers shall explain whether their activities represent an environmental risk and the measures taken. Likewise, reporting entities are required to disclose information regarding their corporate governance, board of directors, management, committees and shareholders, including the composition of the board of directors with respect to gender, among other information required.

Furthermore, according to the Internal Regulations of the BMV, for the listing of securities for trading, the public company must adhere to the Code of Professional Ethics of the BMV issued by the board of directors of the BMV and acknowledge the Code of Principles and Best Practices of Corporate Governance (*Código de Principios y Mejores Prácticas de Gobierno Corporativo*) issued by the Business Coordinating Council (*Consejo Coordinador Empresarial*). Likewise, once the securities are listed, public companies must submit an annual report regarding the adherence to the Code of Best Practices certified by the secretary of the board of directors. If applicable, the secretary of the board of directors must inform the board of directors, at least once a year, of the obligations, responsibilities and recommendations derived from the Code of Ethics, the Code of Best Practices and other applicable provisions, as well as the level of compliance with the latter.

Moreover, it is worth mentioning that ESG reporting is not considered *per se* as a listing rule in the BMV, and to date, reporting on environmental and social performance is voluntary; however, public companies in the BMV are required to include in their annual report whether they have environmental policies, environmental certificates or recognitions, projects for the protection, defence or restoration of the environment and natural resources, the description of the risks or effects that climate change may have on the entity's business, including decreases in the demand of products that require significant greenhouse gas emissions and increases in the demand of other products that require less emissions, among others. Likewise, information on the corporate governance of public companies must be reported, including the composition of the board of directors with respect to gender, the number of independent members and the process for appointment, among other information required.

Concerning the environmental performance of a company, applicable regulations make reporting – before applicable environmental authorities at the Federal or State level – of multimedia emissions mandatory (i.e. annual air emissions, including specific carbon-related and greenhouse gas emissions, wastewater discharges, hazardous and non-hazardous waste generation, etc.).

On the other hand, the environmental impacts that the development of any project may entail must be disclosed through an environmental impact assessment, which, by law, must be disclosed and may be accessed by the public.

As mentioned earlier, oil & gas and other energy-related projects (fossil-based or renewables) must undertake – prior to development – a social impact assessment and an indigenous consultation (in case indigenous communities are present on or near the project's area of influence). These social impact assessments are public and have built-in provisions to make the agreements and follow-up thereto transparent and readily available to all interested parties.

Finally, reporting entities are required to disclose current and potential indirect consequences about market trends that could be faced by the company as a result of climate change. This reporting obligation motivates the voluntary ESG investment reporting.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Many – albeit, not all – Mexican listed companies normally and voluntarily disclose ESG-related matters, using frameworks mainly as a reference such as the Global Reporting Initiative ("GRI"), the PRI and, to a lesser extent, the BMV's own Sustainability Guide. More recently, for example, AMEFIBRA, the real estate investment trusts association, launched an ESG manual for its members. Other commercial and industrial chambers are doing the same.

Hence, the ESG items disclosed in annual reports are normally those suggested by the GRI. As a token, one of Mexico's biggest publicly listed companies, Grupo Bimbo, included the following ESG disclosures in its 2020 annual report:

GRI 200: Economic Performance	■ Market share ■ Indirect economic impact ■ Supply and purchase practices ■ Anti-corruption safeguards in place ■ Anti-trust practices

GRI 300: Environmental Performance	■ Input: Materials and commodities ■ Energy (in and out of the organisation) and sources (renewables, conventional) ■ Water consumption and sources ■ Biodiversity affected (and protected) by the company ■ Emissions (greenhouse gases and others) ■ Throughput and waste ■ Environmental compliance with applicable regulations ■ Environmental assessment of suppliers
GRI 400: Social Performance	■ Job postings and benefits ■ Employee-company relations ■ Health and safety at work ■ Teaching and capacity building for workers ■ Diversity and equality ■ Unionisation ■ Child labour (and assessment within the supply chain) ■ Forced labour (and assessment within the supply chain) ■ Indigenous peoples' rights ■ Human rights assessment ■ Local communities ■ Social assessment of suppliers and within the supply chain ■ Public policy (and contribution to political parties and/or representatives) ■ Consumer rights, health and safety ■ Marketing and labelling ■ Socioeconomic compliance
GRI 100: General Content and Corporate Governance	■ Form of company's incorporation, activities, trademarks, products, size, supply chain and association memberships ■ Ethics and integrity ■ Governance structure, authorities, liabilities, appointment, committees, authority delegation and conflict of interest ■ Stakeholder engagement ■ Risk assessments ■ Remuneration and compensation policies and ratios

In sum, following international trends, most of the voluntary disclosure efforts by Mexican companies use the GRI framework; however, more sophisticated companies, which have been integrating ESG policies into their operations for the past few years, are also increasingly using Sustainability Accounting Standards Board ("SASB") and Task Force on Climate-related Financial Disclosures ("TCFD") standards.

1.4 Are there significant laws or regulations currently in the proposal process?

There are currently no specific laws or regulations in the proposal process dealing with ESG reporting or disclosure. We understand, however, that the Council for Green Finance, an organisation formed by all relevant stakeholders in the financial sector as well as infrastructure and energy developers, is working with the securities authorities to develop ESG regulations.

1.5 What significant private sector initiatives relating to ESG are there?

In July 2020, the BMV, supported by the S&P Dow Jones Indices, launched the S&P/BMV Total Mexico ESG Index, to create awareness, engagement and adoption of ESG benchmarks at the national level. The index applies exclusions based on business activities and United Nations Global Compact scores. As of October 2021, 29 publicly listed companies form part of this index, which include most of the top-tier Mexican companies and trendsetters, such as Alsea, Banco Santander, Cemex, Coca-Cola FEMSA, Fibra Uno, Grupo Alfa, Grupo Bimbo, Grupo Televisa, Industrias Peñoles, Kimberly-Clark, among others.

In addition, on September 30, 2020, 80 institutional investors, including *Afores*, insurance companies, investment funds and other entities operating in the Mexican finance market (who jointly administer assets amounting to MXN 6.31 trillion – about 25.5% of the national GDP), issued a public declaration demanding that companies listed in the BMV divulge ESG in a standardised and consistent manner, in order to take into consideration the recommendations provided by the TCFD and the SASB.

The abovementioned initiative was coordinated by the Mexican Consultative Council on Green Finances (*Consejo Consultivo de Finanzas Verdes*, "CCFV") in an effort to address the need for ESG information that is material, quantitative, comparable and relevant for financial analysis and investment decision making.

Moreover, the Institutional Stock Exchange (*Bolsa Institucional de Valores*, "BIVA"), supported by FTSE Russell, launched the FTSE4Good BIVA Index, an index that measures the performance of liquid Mexican companies demonstrating strong ESG practices. As of October 2021, this index comprises 23 constituents, including América Móvil, FEMSA, Grupo Banorte, among others.

Furthermore, BIVA, in a joint effort with Bloomberg, has also launched the Gender Equality Index, which evaluates female leadership and talent pipelines, equal pay and gender parity, inclusive culture and anti-sexual harassment policies and pro-women brands, among trading companies.

In October 2020, FIRA, an integrated group of public trust funds, issued Mexico's first Social Gender Bond in BIVA, using the Principles for Social Bonds of the International Capital Market Association framework. This was a groundbreaking issue, worth almost USD 150 million, that set in motion a multi-stage project destined to finance and empower female entrepreneurs.

In addition, in August 2020, five *Afores*, in conjunction with BlackRock, launched their first sustainable Exchange Traded Fund called the ETF iShares ESG MSCI Mexico, which has received well over USD 500 million to date.

Both BIVA and the BMV are members of the Sustainable Stock Exchanges.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Climate change remains the main threat being faced by the world today, not only in connection with environmental and social consequences, but also on financing and investment. As evidenced by the initiative sponsored by the CCFV, ESG is increasingly becoming a focal matter in investment decisions and resource allocation by investment funds, insurance companies and *Afores*.

For example, Enrique Solórzano, CEO of *Afore* Sura and Co-chair of the CCFV, believes that newer generations of finance analysts are incorporating ESG data into their investment models, while also assessing corporate strategies to adjust investment returns pursuant to ESG risks.

Indeed, fewer and fewer investment funds are making investment decisions without accounting for ESG variables and risks, and how they translate into capital impacts.

We have seen how ESG considerations are routinely incorporated by international financing institutions and development banks into credit contracts and project financing agreements in Mexico.

Naturally, the support from investors for ESG accounting and reporting becomes more evident when deciding where to put the money when adopting investment strategies and decisions, with the allocation of resources being skewed towards those companies who have a strong ESG track record, as evidenced in its annual reports or initial public offerings (when available).

In addition, investment funds are demanding increasing transparency (as evidenced by proper disclosure) in companies' operations, to avoid green- and pinkwashing or virtue signalling, just to attract investment or costumers.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

An analysis prepared by the consulting firm EY has made evident that the appetite for sustainable investment is increasingly being driven by millennials, who are investing in companies and funds that are amenable to their personal values.

Civil society organisations and non-governmental organisations ("NGOs"), including those that serve as consumer rights and anti-corruption watchdogs, consider ESG compliance and reporting to be crucial for the reliability of a company.

In addition, while it may be an issue of perception, Mexican consumers generally have higher regard for those companies that have a good record of accomplishment of ESG, which, coupled with strong supporting marketing efforts, may go a long way for buyers favouring their products.

In addition, the written specialised media is also increasingly shedding more light on ESG topics, which also significantly informs public opinion *vis-à-vis* those listed companies that have a good standing on ESG. On the contrary, companies that are caught underperforming, green- or pinkwashing, or that are in blatant non-compliance with substantive ESG regulations, are starting to be shunned as investment destinations and their products left unconsumed.

It is important to note that the main drivers towards ESG have been key investment funds that are incorporating ESG information into investment decisions.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

- The National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*);
- the Federal Environment and Natural Resources Ministry (*Secretaría de Medio Ambiente y Recursos Naturales*);
- the National Human Rights Commission (*Comisión Nacional de Derechos Humanos*);
- the Federal Labour Ministry (*Secretaría del Trabajo y Previsión Social*);
- the Federal Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*);
- the Energy Ministry (*Secretaría de Energía*); and
- the Federal Antitrust Commission (*Comisión Federal de Competencia Económica*).

These regulators address the substantive regulatory subject-matter of ESG issues and to them, the main issue is that of compliance with what is provided by the law.

2.4 Have there been material enforcement actions with respect to ESG issues?

Apart from routine regulatory enforcement by the agencies mentioned in the preceding question, whose mandate is to verify compliance with the law, specific ESG issues (in relation to finance and reporting) are not mandatory, so there is scant enforcement of these matters in Mexico.

The only binding regulations will become effective from January 2022 for *Afores*, and we will have to wait and see how they perform and whether any enforcement action is required or implemented.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Mexico does not have a very litigious culture in terms of torts or class actions. Hence, strategic litigation in Mexico for environmental issues, usually brought by NGOs, communities and other stakeholders in the sector – not to mention the administrative litigation brought by regulatory agencies for non-compliance with the law – has become routine, especially for big infrastructure projects or those that are undertaken in sensitive ecosystems. With varying degrees of success, these litigation efforts have ground the development of many such projects to a halt.

Poor social stakeholder engagement by companies (listed or otherwise) may also raise the prospect of continuous litigation, which naturally makes the appetite for investment in the holding companies, or the projects themselves, lower among investors and banking institutions alike.

The reputational aspects of having communities litigating against a project, or even against the holding company, is a natural deal-breaker for many investment funds and investors.

2.6 What are current key issues of concern for the proponents of ESG?

In Mexico, the main issue of concern for the proponents of ESG is that of corruption and undue political and influence peddling. ESG proponents are among the leaders in the fight to enact adequate, transparent, accountable and enforceable corporate governance checks to prevent corruption activities by any of the members of a corporation.

Indeed, accountability has become a hot topic in the Mexican ESG sector, with all stakeholders seeking to make companies accountable for the environmental, social and economic consequences of their activities.

Listed companies believe that addressing these issues, embracing a strong ESG policy, and including it as part of the corporation's ethos, will reflect in long-term viability and increasing financial returns, as public trust (and favour) in the brand is strengthened and regulators associate transparency and compliance with the company.

Another area of concern is the lack of regulation to guarantee transparency and avoid green- or pinkwashing.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Even though the approach to address ESG issues may vary from company to company, in order to develop and enact strong ESG concepts in the processes of the organisation, both the board of directors and the management must be aligned to drive changes in the organisation. It is common that Mexican companies already have a corporate social responsibility programme in their companies, but are starting to recognise the importance of taking a broader look at their impact on their stakeholders and implement ESG metrics and goals.

The board of directors often creates committees to guide the company's ESG strategy, which, in turn, will also lay out the mission and vision of the organisation to explicitly include ESG concerns at the core of its values and way of doing things.

However, it is widely accepted that there must be a person (be it a manager, director or even an officer) responsible for enacting and following up on the sustainability agenda of the organisation on a day-to-day basis. This agenda should not only include compliance with laws, but should go beyond and include a real engagement with stakeholders, corporate governance measures, diversity and inclusion, climate change, executive compensation, internal evaluations, etc.

The board of directors is also responsible for communicating the advances to shareholders and for the development of the initiatives that create value for the company. The ESG factors shall be aligned based on the industry and the particularities of the company, in order to then permeate into the corporation's DNA, to be picked up by the company's members and beyond, and be increasingly expanded to the entire supply and value chains.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The BMV Sustainability Guide suggests that strategic policies to strengthen governance should be defined and enacted, such as competition, anti-bribery, information withholding, etc., ensuring mechanisms and processes to guarantee compliance thereto.

Hence, when ESG issues are part of an organisation's policies and core values, and are thus integrated into the company's organisational culture, compliance with them should be evaluated systematically at all levels, including the value and supply chains, with improvement jointly developed and enacted.

Codes of ethics and of conduct are strongly encouraged and members of the board, committees, top management and staff should be evaluated on them from time to time, while also being constantly updated, to identify risks and create mechanisms to report deviations and follow-up thereto throughout the organisation. Moreover, it is advisable to have a confidential reporting line in order for employees and other stakeholders to report violations of the company's policies.

The periodical undertaking of audits also ensures compliance with ESG issues, with the audit management participating in the board of directors in order to provide information on performance and risks. This information is also crucial to informing and nurturing the board's decision making and to improving the company's performance on this matter, endeavouring to meet international standards.

The board and board committees then serve a double function as the bodies that lay out ESG benchmarks as part of the organisation's culture, and then receive information on the performance thereto as part of the improvement and decision-making processes.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

While, naturally, compensation or remuneration approaches may vary from one organisation to another, the BMV's Sustainability Guide suggests that human capital activities or processes should be based on a culture of identification with the company's core values, which should naturally include ESG concerns.

Hence, the BMV suggests that employees be evaluated to measure their performance, and these evaluations (and compensation or remuneration) should be linked to the achievement of strategic objectives, which should be measured by clear and achievable indicators.

Thus, when ESG becomes part of the organisation's objectives, and key processes are linked to the organisation's sustainability agenda, achievement of the benchmarks laid out by the board, its committees or the officers in charge of the ESG strategy should be used to determine the allocation of compensation and remuneration for the collaborators involved.

This may come in the form of bonuses, an increase in wages and/or other incentives, such as additional vacation days or material prizes, as the objective achieved so merits.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

When ESG benchmarks and objectives have been assimilated as part of the organisation's way of doing things, performance indicators and incentives are included as routine for all collaborators and beyond, to favour those companies in the supply chain that meet the organisation's ESG standards.

For example, water consumption reduction objectives may be set out, with the organisation's innovation committee being tasked with the obligation to come up with new technology or an improvement of production processes that will ensure the meeting of said objectives.

These types of objectives may also come, for instance, in the prevention and reduction of waste generation, or in efficient use of energy, or using cleaner technologies to reduce air emissions or polluting activities.

Companies have also increased their social outreach to community stakeholders, through volunteering campaigns, donations to community-led efforts or associations, and reforesting campaigns in environmentally degraded areas.

Inside organisations, healthy-eating campaigns may be undertaken, and accident prevention awareness programmes, education and capacity-building efforts may be routinely implemented. Unionisation is not frowned upon but encouraged. Diversity and inclusion quotas are constantly reviewed and improved.

Compliance with ESG benchmarks is being increasingly demanded from suppliers, with recycled and circular economy-oriented materials being favoured.

In addition, consumer rights may be considered as part of the organisation's mission statement, informing the way that products are manufactured and delivered to point-of-sale shelves.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Projects that are financed in Mexico typically need to comply with the Equator Principles, IFC's Environmental and Social Performance Standards or the IDB's Environmental and Social Policy Frameworks, which address environmental and social issues, but not necessarily governance factors. Such standards are not commonly required for corporate loans. Second-party opinions or ESG ratings have been obtained by Mexican issuers of green bonds in the past in order for investors to be able to participate in the corresponding offerings.

4.2 Do green bonds or social bonds play a significant role in the market?

The market for green and social bonds in Mexico is still developing, but the ball is indeed rolling: according to the BMV's 2020 Sustainability Report, during 2020, MXN 17 billion was issued through five sustainability bonds. In 2021, four companies issued green bonds for an amount of MXN 8.5 billion in the BMV. Moreover, during 2020, MXN 6.502 billion was registered through the issuance of three bonds in BIVA: two green bonds and the first gender bond in Latin America.

As an example, during 2020, Coca-Cola FEMSA, S.A.B. de C.V. ("KOF") issued a USD 705 million green bond. KOF is the largest franchise bottler of Coca-Cola trademark beverages in the world in terms of volume, with a presence in several Latin American countries. The offering was for USD 705 million with the condition that the proceeds must be issued by the issuer for financing or refinancing new or existing eligible green projects that are aligned with KOF's core components of the Green Bond Principles, which recommend transparency and disclosure to promote integrity with respect to sustainable bonds. The main categories of eligible green projects identified by KOF were (i) climate change risk mitigation and adaption of its operations, (ii) efficient use of water resources and hydrological safety in the territories where it has a presence, and (iii) waste management and recycling of PET plastic bottles.

4.3 Do sustainability-linked bonds play a significant role in the market?

In general terms, the Mexican market of bonds and the global market of Mexican issuers is limited. In September 2021, KOF issued the first sustainability-linked bond (divided into two series) in the Mexican market through the BMV for an amount of MXN 9.4 billion to reduce its water consumption in the coming years.

4.4 What are the major factors impacting the use of these types of financial instruments?

The main factors affecting the use or offering of green financial instruments by Mexican entities are the requirements of potential lenders and investors. A shift in the market is expected due to the importance of *Afores* in the markets and their legal requirement to include ESG factors in the criteria for risk and credit assessment of investments.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The Climate Finance Advisory Group launched the Green Bonds Principles MX in 2018 to present the requirements to determine the green credentials of a bond and to provide certainty to investors. In order to be considered green, bonds issued by Mexican entities must obtain third-party sustainability certifications or opinions for certifying that the proceeds will be used for eligible green purposes and that they are aligned with the Green Bond Principles issued by the International Capital Market Association, the Climate Bonds Standard and the UN's Sustainable Development Goals.

The issuer shall prepare a Green Bond Framework and make it publicly available prior to or at the time of issuance, which shall include, without limitation, confirmation that the bonds issued under the Green Bond Framework are aligned with the Climate Bonds Standard or any other applicable standards. These processes are not currently regulated in Mexico. Green, social and sustainable bonds maintain the same regulatory status as any other traditional bond and are issued through the usual institutional process.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

With the economic – and societal – shutdown brought about by the COVID-19 pandemic, ESG practices have been put on hold for the most part – as was the rest of the economy. However, it also made more evident the need for ESG investment and incorporation of ESG principles into all operations of corporations.

However, with the slow but consistent uptick and restart of companies' operations, those organisations that have adopted sound ESG practices will keep implementing and improving them as part of their day-to-day operations and way of doing things. In fact, concern for social and labour issues has become critical, as investors are closely seeing how the more resilient corporations will respond to future crises and ensure continuity of operations.

Recent reports have shown that Mexican ESG-oriented investment funds and related transactions actually grew during the pandemic.

While this increase in operations may be a reflection of what is happening on a global scale, where about 25% of global assets are managed under ESG criteria (and divestment even being encouraged from those companies that are not meeting ESG benchmarks and reporting), the fact of the matter is that, at the national level, two high-level actors (BlackRock and Citibanamex) jointly issued an ESG-oriented investment fund during the pandemic. In addition, Banco Santander also launched a similar ESG fund last July. Both funds have had varying degrees of success.

In light of the facts, it is safe to say that while COVID-19 had an initial significant impact on ESG practices, the market shows there is a healthy appetite for ESG-oriented funds, and that sound ESG policies have helped other companies be resilient and survive the economic downturn.

6 Trends

6.1 What are the material trends related to ESG?

In Mexico, the ESG trend is currently followed mostly by major corporations and transnational companies, due to the incorrect belief that the initial associated costs of implementing a successful ESG model may be unbearable by small and medium-sized companies.

However, investors, investment funds and *Afores* are pushing corporations to improve their practices, by directing their assets towards ESG-oriented organisations. Hence, competition for much-needed capital may become the crucial leverage to push Mexico's private sector decidedly towards the implementation of ESG policies and practices within companies, not only at a tokenistic level, but as a substantive way of doing business.

Indeed, as has been mentioned by BlackRock Mexico's Samantha Ricciardi, companies with sound ESG models are more attractive to investors, since "they have a better performance and are significantly more efficient in their operations, having a decreased risk related to environmental factors and a better management of human capital".

Consequently, if companies and organisations wish to become investment destinations, the incentive for rolling out ESG policies is clearly there.

6.2 What will be the longer-term impact of COVID-19 on ESG?

As is true with most other economic, social and environmental endeavours, the COVID-19 pandemic threw a wrench in the works for implementing ESG policies, as part of what should be considered a business-as-usual scenario in Mexico, not only for listed and publicly traded companies, but for all types of organisations in general.

However, there are no signs, nor is there any reason to believe, that the ESG trend will be halted or pushed back as a consequence of the COVID-19 pandemic.

On the contrary, we believe that, in the long haul, COVID-19 will be seen as a parenthesis in the steady movement towards comprehensive ESG policies and models. Indeed, the pandemic will be seen as a period of opportunity used by organisations to recap and gain momentum towards institutionalising ESG matters, and to focus on these transcending matters that, in addition to making them more resilient to stochastic impacts such as the pandemic (or, for that matter, other environmental risks such as climate change), will make them more attractive to investors and consumers alike.

Acknowledgment

The authors would like to thank Rodrigo Rivera for his valuable contribution to this chapter. Rodrigo has been passionate about the banking system and financing transactions since the beginning of his career. After 10 years of working as in-house counsel for the corporate and investment banking department in one of the largest banks in Mexico, he joined Galicia where he was made partner in 2018.

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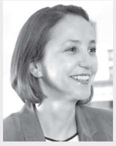

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

ESG is a theme that encompasses a wide range of regulations. In part, ESG-related matters are regulated through general rules of law. An example is the general standard of tort, which has historically been used as a basis for civil redress for environmental protection. Similarly, the general approach under Dutch company law regulating a board's obligations is not a strictly shareholder-centric model. Instead, it requires considering the interests of both the company and its enterprise, as well as the interests of all stakeholders in the company and its enterprise.

In addition, existing legislation is in place for specific areas within the sphere of ESG. First, focusing on the "E", environmental protection is mainly regulated through the Environmental Protection Act (*Wet milieubeheer*), the Nature Conservation Act (*Wet natuurbescherming*), and the Soil Protection Act (*Wet bodembescherming*). In mid-2022, the Environment and Planning Act (*Omgevingswet*) is expected to enter into force, replacing the duties of care in each of the aforementioned acts with a mixed model of, amongst others, a general duty of care and a duty to perform or to refrain from performing an activity that results in significant adverse consequences for the physical environment, or if such consequences threaten to arise from it. Apart from this, climate change is, of course, a topic that has the attention of the legislature. In 2019, the Dutch Climate Act (*Klimaatwet*) was enacted requiring specific reductions of greenhouse gas emissions in the Netherlands by 2030 and 2050. To implement this, the Climate Act requires five-year climate plans from the government.

A second example of ESG-related legislation, focusing more on the "S" in ESG, are the Child Labour Due Diligence Act (*Wet zorgplicht kinderarbeid*), which was enacted in 2019 (but has not yet entered into force), and the Equal Treatment Act (*Wet gelijke behandeling*).

A third example, focusing on the "G" in ESG, is the Dutch Corporate Governance Code, which stipulates that management boards have a fiduciary duty to weigh the environmental and societal impact of the company's strategy. ESG-related interests or objectives may, under certain circumstances, have to be given priority over creating shareholder value.

EU law on ESG matters is, of course, relevant in terms of establishing Dutch jurisdiction, including, for example, the EU taxonomy rules. In the regulatory framework for financial institutions, specific attention for ESG matters is also developing. For example, in the 2019/1238 EU Regulation on a pan-European Personal Pension Product (PEPP), Article 41 provides that "PEPP providers shall invest the assets corresponding to the PEPP in accordance with the 'prudent person' rule and in particular [...] within the prudent person rule, PEPP providers shall take into account risks related to and the potential long-term impact of investment decisions on ESG factors". This is a development in comparison to, for example, the 2016 IORP II Directive (directive on the activities and supervision of institutions for occupational retirement provision). This directive merely provided that Member States "shall allow" the institutions regulated under that directive to take this impact into account.

In addition, the "EU Climate Law", which was adopted in June 2021 (EU Regulation 2021/1119), regulates "a framework for the irreversible and gradual reduction of anthropogenic greenhouse gas emissions by sources and enhancement of removals by sinks".

In the Netherlands, there is not necessarily a strict watershed between these various regulations and soft law instruments, such as the Organisation for Economic Co-operation and Development (OECD) Guidelines and the UN Guiding Principles on Business and Human Rights (UNGP). For example, in its May 2021 *Shell* ruling in first instance (subject to appeal), the Hague District Court found that in determining the unwritten standard of care required under general Dutch tort law, the UNGP are suitable as a guideline, regardless of whether the defendant company involved committed to them because, according to the court, their content is "universally endorsed".

1.2 What are the main ESG disclosure regulations?

For disclosure regulations in the Netherlands, EU law is particularly relevant. For large companies, the Dutch Civil Code requires the board's statement in the annual report to include a statement on non-financial performance indicators (Articles 2:391 and 2:397 Dutch Civil Code).

With the implementation of EU Directive 2014/95 regarding disclosure of non-financial and diversity information by certain large undertakings and groups (NFRD), the government decided not to expand its scope compared to the requirements at the EU level, although various interest groups had advocated for it.

ESG disclosure requirements have since increased. In 2021, EU Regulation 2019/2088 on sustainability-related disclosures in the financial services sector entered into force, and EU Regulation 2020/852 on the establishment of a framework to facilitate sustainable investment will begin to apply in 2022 in part.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Companies in the Netherlands frequently voluntarily expand their disclosures on ESG-related issues. For example, many companies refer to the GRI Sustainability Reporting Guidelines and the Task Force on Climate-related Financial Disclosures recommendations on their websites and in other official platforms, and report on their operations and policies.

Specific sectors have also formalised voluntary additional reporting. For example, many parties active in the pension sector have committed to the 2018 Covenant on International Socially Responsible Investing (IMVB), which recognises the reporting obligations under the IORP II Directive and adds to those.

1.4 Are there significant laws or regulations currently in the proposal process?

Legislation on ESG-related matters is rapidly developing.

At the EU level, a 2020 European Parliament resolution on sustainable corporate governance, and a far-reaching 2021 resolution on corporate due diligence and corporate accountability, are under serious consideration. The European Commission has committed to submitting a draft directive on these topics in autumn 2021. These resolutions emphasise a broad duty of care directors have *vis-à-vis* stakeholder interests, value chain responsibility in terms of due diligence, and corporate policies. Aiming for a level playing field, these resolutions intend to expand the scope of such obligations to non-EU companies active in the EU market.

Disclosure regulations are also in development at the EU level. In April 2021, the European Commission adopted a proposal for a Corporate Sustainability Reporting Directive, amending the NFRD.

These developments at the EU level are closely related to similar initiatives in the Netherlands. In March 2021, members of Parliament submitted a draft Bill on Responsible and Sustainable International Business Conduct. This legislative proposal would impose a duty of care on all companies within the Netherlands to address human rights violations and environmental damage in their value chains. Companies that qualify (i.e., meet at least two of the following criteria: (a) EUR 20 million balance sheet total; (b) EUR 40 million annual turnover; and/or (c) employ more than 250 people) will have to implement the six due diligence steps in accordance with the OECD Guidelines, essentially transforming such previously soft law instruments into a binding instrument. In late 2020, however, the government clarified that, with a level playing field in mind, it had a preference for EU-wide legislation on the issue of international sustainable corporate business conduct. Nevertheless, members of Parliament submitted the draft bill.

A final point worth noting is the "Fit for 55" legislative initiative presented by the European Commission in July 2021, based on the 2019 EU Green Deal. This initiative is a broad package of legislative proposals aimed at realising the EU's climate ambitions. The legislative proposals will significantly affect Dutch law.

1.5 What significant private sector initiatives relating to ESG are there?

See question 1.4.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors and their asset managers are actively aware that ESG factors become increasingly relevant to their investment decisions. Regulations requiring, *inter alia*, disclosures on policies pertaining to ESG factors play a role here. Some ESG factors are also considered relevant for the valuations of a certain investment. Public scrutiny, non-governmental organisations (NGOs) and regulators further contribute to the increased relevance of ESG factors.

Because of the financial strength of the Dutch pension sector, its views and perspectives are particularly relevant. Through the IMVB, for example, pension funds have committed to observing certain ESG policies. These include adhering to ESG due diligence steps in conformity with OECD Guidelines, and the enshrining of the UNGP in outsourcing to external service providers, such as asset managers.

Climate Action 100+ provides an example of investors exerting influence in support of their views on ESG factors. This investor-led initiative urges companies to take action on climate change by cutting emissions, improving governance and strengthening climate-related financial disclosures. The initiative actively engages with targeted companies. Large investors in the Dutch financial sector are actively contributing to this initiative.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

As with any issue, stakeholder views on ESG tend to vary. Public debate on ESG remains ongoing. NGOs and certain sectors of academia, politicians and the press are taking an active interest in drawing attention to ESG and demanding action. Publicity is one way in which influence is exerted, but this also extends to research, litigation and the promotion of further regulation (such as the initiative bill from members of Parliament mentioned in question 1.4 above).

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In the Netherlands, regulators generally drive ESG issues relevant to the matters within their scope of regulation.

For example, in September 2020, the Netherlands Authority for Consumers and Markets (ACM) published guidance on sustainability claims in marketing products and services. According to the ACM, consumers increasingly weigh sustainability considerations in their purchasing decisions. The ACM seeks to prevent false or misleading ESG claims ("greenwashing"). These guidelines were finalised in January 2021. Furthermore, the ACM published in July 2020, ahead of their EU partners and counterparts, an important Guidance on Green Cooperation, showing how market participants can enter into sustainability agreements and where competition law draws the line. In February 2021, the ACM published a revised draft.

The Dutch Central Bank is one of many financial sector regulators. In its 2021–2024 outlook, published in November 2020, it announced a strengthening of its supervision in relation to financial institutions controlling substantive sustainability risks. In January 2021, the European Central Bank (ECB) (which also acts as regulator for several major Dutch financial institutions) announced that it had created a climate change centre. In June 2020, the Dutch Authority for the Financial Markets published a position paper on sustainability, emphasising the important role of the financial sector therein. It further announced that it would pay particular attention to certain ESG-related themes while exercising its supervision, including the risk of shocks in the valuation of financial instruments, information gaps, reliability and standardising of information, and preventing "greenwashing".

2.4 Have there been material enforcement actions with respect to ESG issues?

Regulators actively engage with market participants on a wide range of ESG issues. ESG is a broad concept and the legal framework is actively being developed. Accordingly, material enforcement actions by regulators are currently not the main driver of developments in that broad sense. However, on specific ESG-related issues, such as environmental pollution and privacy, of course, enforcement actions are not uncommon.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

ESG-related issues have already been the subject of a wide range of litigation.

For example, for several years, sustainability claims in advertising have been challenged before the Advertising Code Committee. The rulings frequently attract much publicity.

Similarly, several ESG-related matters have been presented in the non-binding process at the OECD national contact point. One matter concerned the manner in which a bank weighed emissions into its climate change credit decisions. This non-binding process can result in voluntarily committing to observing specific steps, and to submitting a public report on the process and its implementation.

Civil litigation on ESG-related issues is on the rise. A groundbreaking civil case in 1987 saw the Dutch Supreme Court allow public interest litigation by representative organisations (since codified), where NGOs sought an injunction against environmental pollution. Since then, NGOs increasingly seek particularly far-reaching decisions from civil courts. In a civil suit by Urgenda, an NGO, the Dutch Supreme Court ruled against the State, holding that the State had an obligation to reduce CO_2 emissions by a specific percentage in 2020 (in view of climate change). In its May 2021 *Shell* ruling in first instance (subject to appeal), the Hague District Court ordered Shell to reduce CO_2 emissions by a specific percentage, based on a claim by NGOs, in the interest of Dutch residents. The basis for this ruling is discussed in question 1.1 above.

Public law litigation initiated by NGOs has also had a major impact in recent years. In 2015, the highest administrative court ordered the Minister to reduce natural gas production because of safety concerns over induced earthquakes in the gas-producing province of Groningen. NGOs and many individuals initiated this litigation, and it has led to a shift in policy focus from energy and financial to social and safety concerns. In 2019, another case initiated by a small NGO led to a ruling by the highest administrative court that government policy developed in relation to nitrogen could not be used as a basis for permits, as it did not comply with the Habitats Directive. The impact of the ruling is significant because it has implications for many construction and other projects. Resolving it is still a major point of attention for the government.

NGOs and various groups of residents seem to be increasingly pushing for criminal enforcement of ESG-related issues. These groups demand that companies are prosecuted for harm they cause to the environment or for how they contribute to several health impediments.

Finally, there are also cases where courts have issued injunctions against NGO initiatives to address ESG-related issues. For example, several injunctions were issued against Greenpeace where its actions were found to be unlawful; for example, because they posed a risk to other persons and property. In August 2021, a court of first instance issued an injunction against an NGO for publicly advertising that specific practices were particularly painful for breeding cattle. Lacking sufficient factual basis, the NGO was found to have acted unlawfully against the interests of farmers.

2.6 What are current key issues of concern for the proponents of ESG?

At a general level, the legally binding nature of instruments relating to companies and ESG is a key driver behind several public and legislative initiatives. Some ESG proponents want more concrete legally binding regulations, including at the EU or national level (see question 1.4).

Disclosures are another key point. Not only are there more laws in development that further regulate ESG disclosures (see questions 1.2–1.4 above), but several regulators have also expressed their intention to make the accuracy of such disclosures a point of particular attention (see question 2.3).

Substantively, a key overarching theme that has the active attention of the legislature and ESG proponents alike is taking action against climate change.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Dutch companies can have a one- or two-tier board structure. In a one-tier board structure, the management board has both executive and non-executive directors. In a two-tier board structure, the company has both a management board and a supervisory board. Although nuances can be made, for the purposes of the questions in this section, references to supervisory directors and the supervisory board can be read to include non-executive directors in a one-tier board. References to the management board can be read to include executive directors in a one-tier board. Furthermore, we focus on listed companies.

Management boards have principal responsibility for addressing ESG issues. The management board is assisted by members of the company's leadership team, including the chief legal officer, the internal auditor and potentially a designated ESG or sustainability officer. For its part, the supervisory board supervises and advises the management board. The role of the supervisory board is further described in question 3.2.

In setting and implementing the strategy, the management board must act in the interest of the company and its business enterprise. This means that the management board should not only (or primarily) consider the interests of the shareholders. Instead, it should consider and weigh the interests of all stakeholders involved. Consequently, and as reflected in the Dutch Corporate Governance Code, the management board has a fiduciary duty to weigh the environmental and societal impact of the company's strategy. ESG-related interests or objectives may, under certain circumstances, have to be given priority over creating shareholder value.

Furthermore, the management board is primarily responsible for designing and monitoring the internal risk management and control systems. As an integral part of this, the management board must oversee any arising environmental, social and governance risks. A third key responsibility of the management board (in the context of ESG issues) relates to ESG-related reporting, both financial and non-financial, irrespective of whether such reporting is mandatory or voluntary.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The supervisory board is tasked with supervising the management board. As ESG forms an integral part of management board duties, it also forms an integral part of supervisory board supervision. ESG-related items are therefore relevant to the supervisory board as a whole and to all of its committees as well.

Over time, supervisory boards have intensified their supervising and advising role. The broader and more active role of supervisory directors has significantly increased the workload that comes with the position. More recently, supervisory director remuneration has started to reflect this trend as well.

Under Dutch law, supervisory board committees are tasked with assisting the full supervisory board in its decision making. The supervisory board as a whole adopts the relevant resolutions and bears end responsibility. In practice, however, committees – particularly the audit committee – play an important role in the supervision of the management board.

For example, in the context of ESG, the audit committee is tasked with supervising the company's ESG-related reporting, including any frameworks or standards the company is using, and looking at company compliance with new ESG regulations. The audit committee also oversees that adequate processes and controls are in place to ensure that ESG disclosure is accurate, and whether an independent assurance should be obtained.

The selection and nomination committee considers which ESG-related skills should be reflected in the board skills matrix, and how to further integrate ESG within board training programmes and director performance evaluations. For the remuneration committee, ESG may play a role in setting non-financial performance indicators (see following question). More recently, supervisory boards are looking into forming a dedicated ESG or sustainability committee to provide a more holistic oversight of all ESG matters. Several have already done so.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Directors are remunerated in accordance with a remuneration policy adopted by the general meeting. The supervisory board sets the remuneration of the managing directors within the framework provided by this policy. The supervisory board reports to the general meeting annually in a remuneration report on how it has implemented the policy. This report is subject to a non-binding advisory vote of the general meeting.

The requirements for the remuneration policy are based on the European Shareholder Rights Directive II, which requires remuneration to contribute to the company's sustainability, among other things. This requirement does not necessarily mean that non-financial, ESG metrics must determine a portion of director pay. However, in accordance with international developments, non-financial performance indicators, including ESG metrics, often determine a substantial part of the variable portion of director income. Furthermore, the Sustainable Finance Disclosure Regulation requires certain financial advisors and financial market participants to include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks and to publish this information on their websites.

These international developments are also reflected in the remuneration guidelines for portfolio companies of various Dutch institutional investors, which stipulate that the variable portion of director remuneration should also look at non-financial performance metrics. These guidelines are in accordance with the "remuneration principles" as issued by Eumedion, the Dutch institutional investors association, recommending that companies base the granting of variable remuneration elements on environmental, societal and/or governance goals.

In addition to the requirements as outlined in the Shareholder Rights Directive II, the Dutch legislature has stipulated that the remuneration policy must also specify how it integrates public support in the policy. In practice, companies may do so, for example, by engaging with relevant stakeholders (such as employee representative bodies) and involving remuneration consultants before a final proposal for a remuneration policy is submitted for adoption by the general meeting.

Supervisory directors typically only receive fixed remuneration. Therefore, ESG-related incentives do not play a role.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

ESG is a broad theme and touches upon many aspects of company business. One example of how companies integrate ESG into their day-to-day operations is by letting ESG metrics determine part of individual performance and remuneration (see question 3.3). More broadly, increased reporting obligations (whether legally required or voluntary) have resulted in a dynamic where the need to report further supports policies being formed and implemented to monitor ESG considerations. Also, after assessing which actions have priority, companies often communicate their objectives on achieving specific goals pertaining to their day-to-day operations. For example, certain retail companies have publicly stated their intention to drastically reduce packaging in view of environmental considerations.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Larger issuers (for example, ING, NN Group, the Dutch State, and TenneT – the Dutch electricity Transmission System Operator) increasingly develop internal frameworks for their green or social bonds, and their sustainability-linked bonds. Debt and equity finance providers active in the markets for green bonds or sustainability-linked instruments often require large external ESG ratings providers (for example, Sustainalytics, ISS ESG, CICERO, Climate Bonds Initiative) to review such frameworks and issue second-party opinions on the credibility and consistency with the issuer's overall sustainability strategy.

Alternatively, sustainability-linked bonds can be linked to the issuer's overall ESG performance measured by external ratings (for example, EcoVadis).

4.2 Do green bonds or social bonds play a significant role in the market?

Although, according to the Dutch Authority for the Financial Markets, the sustainable bonds market (green and social bonds combined) is still relatively small compared to the aggregate amount issued on the Dutch bond market (approximately 4% in 2019), both green and social bonds – the proceeds of which must typically be used for predetermined, eligible projects – have become increasingly popular in recent years. The market for green bonds especially has been rapidly growing over the past few years, further accelerating since 2019. This trend is set to continue as companies rely on sustainable debt instruments in their transition to a sustainable and climate-neutral business. In the past couple of years, social bonds have also played an increasingly important role in the market, although this may be linked to the COVID-19 pandemic, and it remains to be seen at what pace the social bond market will continue to develop.

In addition to the growing Dutch market for corporate green bonds, the Netherlands became the first triple-A-rated sovereign issuer of a green bond in 2019. By early 2021, a total amount of over EUR 10 billion had been tapped thereunder. The proceeds will be allocated to green or climate-related expenditures and investments by the government. The Dutch State Treasury Agency indicated that it intends to remain active in the green bonds domain and will explore opportunities for further issuances, the need for which may be further accelerated by the developments referred to in question 1.1.

4.3 Do sustainability-linked bonds play a significant role in the market?

A market for sustainability-linked bonds (bonds whose financial characteristics are impacted by reaching certain pre-determined ESG targets) has emerged over the past five years but has not yet reached the same maturity level as the green bonds market, although the percentage of sustainability-linked bonds issued in the Netherlands by use of proceeds is somewhat higher than the global average. Sustainability-linked bonds provide more flexibility to companies, as these involve the setting of sustainable targets (which are then linked to a certain reward or penalty – for example, a step-down or step-up in coupon payment or a cash premium payment at maturity), rather than requiring that the proceeds be used for financing particular green or sustainable projects. For the setting of sustainable targets, see question 4.1.

Sustainability-linked bonds, however, are still less popular than sustainability-linked loans. For example, due to minimum size considerations and extensive prospectus requirements for bond issues, sustainability-linked bonds are less viable for medium and smaller-sized companies when compared to sustainability-linked loans. Further growth is therefore particularly expected in the sustainability-linked loans market, as sustainability-linked loans provide the same flexibility as described above but are also accessible to a larger and more diversified pool of companies.

4.4 What are the major factors impacting the use of these types of financial instruments?

Two major and interrelated factors impacting the use of green or sustainability-linked bonds (as well as loans) are the defining of ESG projects or targets and the verification process. The initial establishment of an internal ESG financing framework (see question 4.1) and external verification process (see question 4.5) is often costly and, depending on the nature of the business of the issuer, it may be difficult to define ESG-eligible projects. However, corporate issuers are subject to more public demands to transition to renewable energy or to take other ESG-related steps. Investor demand for these types of instruments is rising. With the guidelines and principles provided by external parties (including the International Capital Market Association (ICMA) for bonds and the Loan Market Association for loans) becoming more advanced, the markets for these instruments will mature even further and the related costs for issuers will be reduced. As a result, the share of green or sustainability-linked bonds is expected to continue to rise.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Although there is still no market standard for these types of products, several trade associations have developed ESG guidelines or principles, such as the ICMA Green Bond Principles. So far, these guidelines and principles are voluntary in nature, but most issuers preparing internal frameworks opt to comply with these standards, also to increase investor demand for their bonds. External reviews and critical investors further enhance verification. Issuers often engage an independent auditor or second-party opinion consultant to provide limited assurance and to review the allocation of the proceeds of any green or social bonds issued (in addition to the second-party opinion provided on their green bond framework). In addition, issuers report on their ESG performance in their integrated annual reporting.

Proposed regulation in this field, such as the EU Green Bond Standard, will provide further uniformity in the market, create a level playing field for issuers and mitigate the risk of "greenwashing".

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

In many ways, the COVID-19 situation has led to ESG considerations being tested in several sectors.

In particular, the economic uncertainty that arose at the outset of the pandemic triggered banks, insurers and their regulators to consider their role in society in the midst of such uncertainty.

The ECB took various measures to ensure liquidity. At the same time, banks and insurers were called upon to limit dividend distributions at the time (EIOPA, the European Systemic Risk Board, the ECB and the Dutch Central Bank all issued statements on this point). As the ECB stated, "capital resources to support the real economy and absorb losses should take priority at present over discretionary dividend distributions and share buy-backs". The Dutch Banking Association quickly responded to the situation by announcing that banks would voluntarily take measures such as temporarily suspending repayment of consumer loans, and liquidity measures for businesses.

6 Trends

6.1 What are the material trends related to ESG?

As set out above, one trend is the ongoing development of legislation in relation to companies and ESG, including disclosures.

Substantively, the challenge of effectively addressing climate change is the subject of active debate and legislative initiatives. As is evident from, for example, the European Commission's Fit for 55 package, this is an area where large parts of society will see significant changes in the next few decades.

The social component of ESG is receiving increased attention, for example, on the fundamental issue of equal treatment, in light of various societal developments related to gender and sexual orientation, and the Black Lives Matter movement. These developments also extend to claims and litigation. For example, in 2020, Bureau Clara Wichmann, an NGO, initiated an action leading to compensation from the State for transgender persons suffering from mandatory sterilisation in the past, and initiated proceedings to have free birth control provided to young women.

6.2 What will be the longer-term impact of COVID-19 on ESG?

It remains to be seen what the longer-term impact of COVID-19 on ESG will be. The pandemic has triggered extensive debate on the proper balance between individual fundamental rights on the one hand, and group protection on the other. For example, an extended curfew initially met resistance, and there is ongoing debate on the voluntary nature of vaccines and requiring people wanting to engage in certain activities to be vaccinated.

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De Brauw is the leading law firm in the Netherlands, handling cases that are at the forefront of legal innovations and societal developments. With its outstanding practices across many relevant areas, De Brauw is unmistakably the leading law firm to deal with cross-expertise ESG matters that are key to our clients and their business.

De Brauw's practices span many areas, such as corporate advisory, regulatory enforcement and complex litigation. Our professionals are regarded at the top of the market and are able to stand beside our clients in their most complex matters. De Brauw has worked on several groundbreaking ESG matters and is particularly skilled and experienced in handling ESG-related matters.

Our role of trusted advisor is rooted in our history as a firm, and is integral to who we are today. From our head office in Amsterdam, we advise more than 70% of the largest companies headquartered in the Netherlands. We also stand beside our clients in their international transactions, litigation and compliance work. This is why we have offices in strategic locations like Beijing, Brussels, London, and Singapore, and why we work closely together with top-tier local counsel in all jurisdictions.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Norway has implemented a number of regulations that relate to E, S and G topics, whereas some acts apply across all industries, and some are industry specific. Some of the main substantive ESG-related regulations in Norway that apply across industries include the Human Rights Act, the Working Environment Act, the Gender Equality and Discrimination Act, the Act on Biodiversity, the Pollution Control Act, the Company Act and the Penal Code as well as national legislation incorporating Norway's international commitments.

1.2 What are the main ESG disclosure regulations?

The main ESG disclosure regulation currently is the Accounting Act with provisions that require Norwegian public companies and other large companies to publish annual reports on environmental, social and corporate governance (ESG) factors, health, safety and the working environment as well as corporate social responsibility. The statute is in line with the current EU Directive on the disclosure of non-financial information (Directive 2014/95/EU).

The non-financial part of the report may be incorporated in the annual report, or presented as a separate, publicly available document referenced in the annual report.

Listed companies are, in addition, subject to the Norwegian Code of Practice for Corporate Governance, issued by the Norwegian Corporate Governance Board, and to the Euronext Guidance to Issuers for ESG reporting, which is voluntary and based on the standards developed by the Global Reporting Initiative (GRI). Adherence to the Code of Practice is based on the "comply or explain" principle.

In 2021, Norway adopted a new Act on Business Transparency and Work on Basic Human Rights and Decent Working Conditions (the Transparency Act), imposing further ESG-related disclosure requirements on Norwegian companies, which is further described in question 1.4 below.

As part of the European Economic Area (EEA) Agreement, Norwegian companies will be subject to additional ESG disclosure regulations, including Regulation (EU) 2019/2088 and Regulation (EU) 2020/852, as well as the new Corporate Sustainability Reporting Directive. Regulation (EU) 2019/2088 and Regulation (EU) 2020/852 will be incorporated into Norwegian law through a new Act on Disclosure of Sustainability Information in the Financial Sector.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

ESG reporting has, since the implementation of the disclosure requirements in the Accounting Act in 2013, gradually become fuller and more to the point. Finanstilsynet (the Financial Supervisory Authority of Norway, or FSAN) emphasises the importance of conducting materiality assessments, identifying the opportunities and risks facing companies, and the need to identify companies' various stakeholders and their interests. Companies (and regulators) are focusing on moving away from "blind" disclosure and "tick the box" exercises according to recognised standards, and towards more adapted, relevant and business-specific disclosures. This often includes specific goals, key performance indicators (KPIs), results and strategies, allowing the board of directors to use the reporting in the governance of the company's ESG efforts. We also see that companies emphasise different specific topics within ESG in their reporting depending on the type of business, and the geographies in which they operate.

Internationally recognised standards are commonly used by larger companies, which are met with higher expectations in terms of ESG disclosure and have resources to collect and process comprehensive data sets. The Norwegian government in 2019 communicated that it expects large companies to report on climate-related risk in accordance with the Task Force on Climate-related Financial Disclosures. Forty-four per cent of the top 100 companies report in accordance with GRI or the Sustainability Accounting Standards Board.

1.4 Are there significant laws or regulations currently in the proposal process?

The substantial regulations in the process of being implemented are the various initiatives from the EU. Norway is part of the EU's single market for most goods and services through its membership in the EEA. EU Directives and Regulations resulting from the "Sustainable Finance" initiative taken by the European Commission will therefore be applicable in Norway. Regulation (EU) 2020/852 on establishing an EU classification system (taxonomy) for sustainable economic activities is within the scope of the EEA Agreement and will be implemented into Norwegian law, as well as Regulation (EU) 2019/2088 on sustainability-related disclosure in the financial services sector. In addition, the new Corporate Sustainability Reporting Directive is expected to require adjustments in current Norwegian provisions on non-financial reporting. Regulation (EU) 2020/852 and Regulation (EU) 2019/2088 will be implemented into Norwegian law through incorporation.

On a national level, Norway has adopted the Transparency Act. The objective of the Act is to ensure and promote companies' respect for fundamental human and labour rights, and require companies to carry out due diligence assessments and give the public access to information. The Transparency Act is based on the United Nations Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises. The Act applies to larger companies domiciled in Norway, offering goods and services in or outside Norway, and larger foreign companies that provide goods and services in Norway, which are taxable in Norway.

1.5 What significant private sector initiatives relating to ESG are there?

Recent public debate has resulted in a number of *ad hoc* ESG initiatives. Some of these are by significant, individual investors, and some by business and trade associations. By way of example: (a) the Norwegian government publishes an annual white paper to parliament, which sets out, *inter alia*, its expectations regarding ESG to the (Norwegian) companies in which it is a sole or significant shareholder. It is a significant shareholder in several of the most valuable Norwegian issuers listed on the Oslo Stock Exchange, including DNB, Equinor, Hydro, Telenor, and Yara; (b) Norges Bank Investment Management, which manages the Norwegian sovereign wealth fund (Government Pension Fund Global), publishes an annual report on responsible investment, setting out its expectations to the (foreign, as the fund only invests abroad) companies in which it invests and also evaluates issuers for exclusion from the investment universe on certain publicly communicated criteria; (c) the Norwegian Corporate Governance Board put sustainability as a separate topic for the first time on its agenda for its annual Corporate Governance Forum in 2019; and (d) the Norwegian Shipowners' Association has proposed ESG reporting guidelines for the shipping and offshore industries.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

With the increase in public debate and disclosure requirements, and best practices set to become more demanding, investors' attention to sustainable investments and ESG is rising. Investors realise that ESG deficiencies can harm their investments and their own "licence to operate" in the short term as well as in the long term, while also recognising the potential opportunities paying attention to ESG considerations creates. ESG considerations have moved beyond solely being about responsible investments, and are seen to have a direct impact on financial results. This is particularly important for long-term investors and is evident, e.g., in terms of how companies approach climate adaptation and the transition to a low-carbon economy. In addition, green debt financing may receive preferential terms compared to "brown" financing, as it is contemplated that green economic activities will generate excess returns in the long term.

Asset managers and investors have aligned interests in having a strong focus on ESG in the portfolio. This is operationalised by engaging with boards and company management through active ownership and disclosure requirements, as well as considering ESG factors as an integrated part of the initial commercial investment process and due diligence.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

ESG is rapidly becoming more and more of a focus area in the public domain. Younger generations in particular are strongly engaged in the climate debate. Consequently, companies with a strong and matured ESG profile may experience a competitive advantage in recruitment processes. Pressure groups of various sorts will seek influence through media coverage and, if given access, direct discussions with companies. We also see variations of the "cancel culture" among consumers where companies not performing on ESG factors (or rather, underperforming) are met with withdrawal of support and boycotts from groups of consumers. The availability of commercially provided services from consultants (such as law firms) selling certification services, practice manuals, etc. to companies means it can be more difficult than it would otherwise have been for companies to stand up to the pressure to "do the right thing".

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

FSAN is the supervisory authority with respect to the disclosure requirements set out in the Accounting Act. FSAN will also be the supervisory authority for companies subject to Regulation (EU) 2019/2088 and Regulation (EU) 2020/852 when the Regulations enter into force in Norway. FSAN is focused on how companies, with their boards and management, perform materiality assessments to pinpoint the continued ESG efforts. It is our impression that FSAN's focus has recently been more turned towards environmental disclosures. FSAN expects financial institutions to include, e.g., climate risk in their risk and capital management, and are pressing financial institutions to quantify financial implications of identified climate risk. Examples of specific risks under current scrutiny include impairment of value of stranded assets and greenwashing.

2.4 Have there been material enforcement actions with respect to ESG issues?

Over the years, there have been several investigations of ESG-related crimes. The Norwegian enforcement authorities mainly focus their investigations on bribery and corruption, work-related crime such as exploitation of foreign workers and unlawful working conditions and rights, and environmental non-compliance such as illegal emissions and discharge limits and illegal dumping of waste in the sea. Some investigations have resulted in indictments, and also convictions.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The main risk for companies and directors is incorrect or insufficient disclosure resulting in losses that could have been avoided if the disclosure was correct and complete. We are not aware of any litigation having been initiated in Norway on the basis of deficient or incorrect ESG disclosure. With the introduction of Regulation (EU) 2020/852 and Regulation (EU) 2019/2088, asset managers and in-scope companies will be subject to more regulations on how they brand their financial products or business activities in terms of how "green" they are. Asset managers will be required to classify their financial products on a scale of green. In-scope companies will be required to report on their share of business activities that are "green". This may lead to increased liability risks towards end investors relating to misclassification and/or inability to deliver on promises relating to "greenness". However, it is worth noting that currently, litigation action on the basis of disclosure deficiencies is rare.

2.6 What are current key issues of concern for the proponents of ESG?

Currently, and especially following the IPCC 2021 report, which corresponded in time with extreme weather events in Europe, the main topic in Norway relating to ESG concerns is the climate crisis. In connection with the general election in September 2021, the politicians' response to the climate crisis was one of the most debated issues. Hot topics included how Norway's vast oil reservoirs shall be managed in the future, and how Norway may capitalise on other natural resources that play a role in the transition to a low-carbon economy, such as offshore wind.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The principal responsibility for addressing ESG issues and integrating ESG considerations into companies' strategies lies with the board of directors, which manages the company generally. The board of directors is responsible for setting and changing the strategy of the corporate entity in general, including on ESG issues.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The board of directors shall ensure a proper organisation of the business of the company and draw up plans and budgets for the company's business. The board of directors may also lay down procedures and guidelines for the business. The board of directors shall keep itself informed of the company's financial position and is obliged to ensure that its activities, accounts and capital management are subject to adequate control. This applies to ESG issues as much as to other important issues.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Performance on ESG metrics may be part of KPIs and assessments for variable remuneration for management and leader groups. It is not uncommon for institutional investors to include this as an expectation to portfolio companies. To the extent that performance on ESG metrics is reflected in financial performance or value of the company, customary compensation arrangements would work to incentivise the right behaviour. Boards devote significant attention to ensuring that management incentives are aligned with the long-term interests of the company. Several recommendations in the Code of Practice, particularly with regard to board and executive remuneration, are aimed at promoting value creation over the long term.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Early examples include prominent disclosure about accidents and fatalities at work, sick leave and gender diversity. More recent examples are disclosures about carbon footprint and carbon footprint offsetting measures, combined with specific targets and actions to reduce emissions. Many companies are moving from disclosure of the facts as they have been, to active positioning of what they are doing to deal with the various ESG issues that their businesses are faced with.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Judgments on ESG risk may be part of the rating/assessment model for any investment, but in the (current) absence of generally acknowledged standards for disclosure and assessments, these tend to be qualitative rather than quantitative. There are, however, a number of certification services available that allow for classification and rating.

4.2 Do green bonds or social bonds play a significant role in the market?

The Oslo Stock Exchange was the first stock exchange to have a separate list for green bonds. Euronext, the owner of the Oslo Stock Exchange, has launched an ESG bonds list, which includes green, sustainability, social, blue, and sustainability-linked bonds listed on all Euronext locations. Only green bonds and sustainability-linked bonds are currently issued on the Oslo Stock Exchange. Blue bonds raise capital for projects with marine or ocean-based benefits. No blue bonds have been listed on any Euronext exchange yet, but Euronext expects additional blue bond issuance in due course. The uptake of blue bond listings will be interesting to follow due to Norway's major marine industries.

Nordic Trustee estimated the volume of outstanding "Nordic green bonds" issued by Nordic issuers at the end of 2020 at EUR 14bn after growing 46% in 2020, representing 14% of the total outstanding volume in the Nordic corporate bond market.

Sweden has in previous years been the primary market for green bond issues, but with a decline in local issues in 2020, and a very strong Norwegian market tripling its issue volume, the two markets ended up with equal issue amounts of EUR 2.6bn in 2020. Real estate is the key industry sector for green bonds in the Nordic countries.

4.3 Do sustainability-linked bonds play a significant role in the market?

The first ever sustainability-linked bond was listed on the Oslo Stock Exchange in 2021. Currently, there are only three sustainability-linked bonds listed.

4.4 What are the major factors impacting the use of these types of financial instruments?

Green and sustainability-linked bonds allow access to capital dedicated to such investments, which, all other matters being equal, could lower the cost for issuers of accessing that capital. In addition, issuing green or sustainability-linked bonds may benefit the issuer's ESG credentials.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Issuers looking to list green bonds on the Oslo Stock Exchange must adhere to the regular listing requirements applicable for all listed bonds. In addition, the Oslo Stock Exchange requires an independent review that certifies the environmentally friendly nature of the bonds, consistent with the International Capital Market Association guidelines for external reviews. External review documents should be constructed by recognised and experienced verifiers. The issuer must also submit a declaration form containing information on which framework the bond is aligned to (recognisable industry guidelines or frameworks). Issuers must submit material information and reports regarding the "ESG status" of the bonds on an ongoing basis, and notify the exchange with any information that may cause the bonds to no longer qualify as a green bond.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

Our assessment is that COVID-19 has not had a significant impact on ESG practices. However, see below for our assessment of the longer-term impact.

6 Trends

6.1 What are the material trends related to ESG?

Due to the forthcoming implementation of Regulation (EU) 2019/2088 and Regulation (EU) 2020/852, Norwegian companies have started investing time and resources into preparing for the new disclosure regimes. There is a strong focus beyond just the disclosure requirements and the compliance aspect of the Regulations, with asset managers and companies analysing the EU Green Deal and "Fit for 55" initiatives in a larger context to identify potential commercial risks and opportunities. This may include transaction activities in the form of reorganisations and spin-offs, separating "brown" activities of a company from the "green" activities.

Overall, we believe both the regulatory landscape and investor and pressure group expectations will result in a sustained, increased focus on ESG issues in the time to come.

6.2 What will be the longer-term impact of COVID-19 on ESG?

We do not expect COVID-19 in itself to impact regulatory or market initiatives on ESG. It could be argued, and it is argued by many, that the pandemic may have a positive impact on ESG as it may lead to more capital being channelled into more resilient businesses, which are likely to be those companies that are managed for the long term with ESG considerations integrated in their operations and thereby better equipped to handle sudden crisis and economic downturn. However, it is too early to tell the long-term impact of COVID-19 on ESG. To the extent that COVID-19 should cause global finance to be less integrated, it may cause ESG requirements and practices to diverge among markets rather than converge – or not.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

Poland has implemented the requirement of the disclosure of non-financial information set out in *Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups* ("***Directive 2014/95/EU***"), primarily by amending the Accounting Law (Act of 29 September 1994 on Accounting). However, apart from the Accounting Law, there are also other regulations concerning disclosure of information about the environment, society and corporate governance in Poland. They facilitate investment in clean energy, regulate issues such as air, land and water pollution, protect human rights, workers and consumers, protect animal welfare, prevent unfair competition, and foster equality in all aspects of life. These are:

(i) the Polish Act of 20 February 2015 on Renewable Energy Sources;
(ii) the Polish Act of 20 May 2016 on Investments in Wind Power Stations;
(iii) the Polish Act of 10 April 1997 – Energy Law;
(iv) the Polish Act of 20 July 2017 – Water Law;
(v) the Polish Act of 27 April 2001 – Environment Protection Law;
(vi) the Polish Act of 14 December 2012 – Waste Law;
(vii) the Polish Act of 26 June 1974 – Labour Code;
(viii) the Polish Act of 23 May 1991 on Trade Unions;
(ix) the Polish Act of 21 August 1997 on Animal Protection;
(x) the Polish Act of 30 May 2014 on Consumer Rights;
(xi) the Polish Act of 16 February 2007 on Protection of Competition and Consumers;
(xii) the Polish Act of 15 October 2000 – Commercial Companies Code; and
(xiii) the Polish Act of 3 October 2008 on Access to Information on Environment and Its Protection, Public Participation in Environmental Protection and Environmental Impact Assessment. On 13 May 2021, amendments to this act came into force, which aim to align Polish law with EU law – Article 11 (1) and (3) of *Directive 2011/92/EU of the European Parliament and of the Council of 13 December 2011 on the assessment of the effects of certain public and private projects on the environment*.

In addition, Poland is bound by *Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088*, and the Convention for the Protection of Human Rights and Fundamental Freedoms of 4 November 1950. Poland is also bound by *Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosure in the financial service sector*, which came into force on 10 March 2021.

1.2 What are the main ESG disclosure regulations?

Poland has implemented the requirement of the disclosure of non-financial information by companies – like most EU countries – within the minimum requirements set out in *Directive 2014/95/EU*. The Accounting Law, which implements *Directive 2014/95/EU*, does not impose any additional disclosure responsibilities or burdens other than the minimum required by the EU. Companies with more than 500 employees should submit non-financial information statements, including at least:

(i) a brief description of the business model;
(ii) key non-financial performance indicators related to the entity's operations;
(iii) a description of the policies applied by the company with respect to social, labour, environmental, human rights and anti-corruption issues, as well as the results of their application;
(iv) a description of due diligence procedures, if the company applies them under the policies with respect to social, labour, environmental, human rights and anti-corruption issues; and
(v) a description of significant risks related to the activity of the company that may have an adverse impact on the issues referred to in point (iii), including risks related to the entity's products or its relations with external parties, including contractors, as well as a description of managing those risks.

When preparing the statement on non-financial information, the company presents non-financial information to the extent to which it is necessary to assess the development, results and situation of the company and the impact of its activities on social, labour, environmental, human rights and anti-corruption issues.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

In Poland, non-financial reporting is becoming more and more significant each year. More companies are ESG-oriented and voluntarily choose to publish data on customer relations, ethics and anti-corruption, product liability, employees, the environment, and dialogue about the environment and social involvement. Moreover, the transparent presentation of this information makes these companies more credible to stakeholders, potential investors, customers, employees, regulators, non-governmental organisations, the media, academics and even competitors. Most reports are published by companies from the fuel, energy, banking, food industries and transport and logistics sectors. There is also growing interest in voluntary reporting in the healthcare, retail, and construction sectors. The companies usually report the following categories of information:

(i) ESG-related risks: internal risks from the main business activities of the company or external risks from the external environment and competition.

(ii) ESG-related opportunities: all internal and external opportunities; for example, new challenges and opportunities connected with development of new products or services, changing competencies and capabilities.

(iii) Management: resources, projects, actions, schemes, targets and initiatives aimed at preserving the company's value for the shareholders and generating income.

(iv) Governance: organisational oversight of the entire ESG strategy, the policies implemented by the company and information circulation, and the financial decision-making structure within the company.

(v) Strategy: strategic objectives for the company's business model and maximising opportunities, as well as risk management.

(vi) Targets: objectives and results the company intends to achieve, including crucial performance indicators, timelines and goals.

(vii) Performance: responsible investment strategies implemented by the company, level of returns in the time range of a few years to several-dozen years, long-term outcomes and sustainability as a tool to create company value.

However, surveys show that companies still have a long way to go in ESG reporting. According to the report prepared in 2021 by PwC, CFA Society Poland, FRN and the Association of Independent Supervisory Board Members, investors have a low opinion about the quality of currently prepared non-financial statements/reports of companies and derive their knowledge from various other sources. This is mainly due to the fact that, in Poland, there is no uniform approach to the sources of information and criteria for evaluating portfolio companies and ESG reporting for companies. This may change soon as, in May 2021, the Warsaw Stock Exchange, in cooperation with the European Bank for Reconstruction and Development, published the "Guidelines for ESG Reporting", a guide for issuers on reporting ESG factors, which systematises and organises recommendations in this area. Another important factor that may change the attitude of investors is the introduction of a single European reporting standard by the newly proposed Corporate Sustainability Reporting Directive ("**CSRD**") and its simplified version for smaller entities. Thanks to this regulation, ESG data will become easily accessible and comparable.

1.4 Are there significant laws or regulations currently in the proposal process?

Public policies and laws are crucial to incentivise or compel investors to comply with the rules of responsible and sustainable investing. Polish law provides for many restrictions imposed on investors in order to ensure that all undertaken investments do not affect the environment with respect to provided indicators. Public authorities have a significant role in granting appropriate permits, and public consultations are carried out beforehand.

While there are currently no pending bills that would significantly impact ESG reporting, the enactment of new legislation and/or amendments to existing laws seems to be inevitable. Adoption of the CSRD by the European Parliament and its subsequent entry into force, which is expected to take place on 1 January 2023, will also necessitate amendments to Polish law. Pursuant to the CSRD, all listed companies and large private companies (with more than 250 employees) will be subject to mandatory ESG reporting, if they meet certain criteria. This means that about 3,600 companies in Poland will become obliged to report ESG, which is a huge increase compared to the current regulation, which covers only 150 companies. Moreover, the CSRD provides that ESG reports will have to be audited in the same way as financial statements.

1.5 What significant private sector initiatives relating to ESG are there?

In the private sector, there are many initiatives related to ESG. In October 2019, the following conference was held: *Social Challenges of Business after 30 years of Free Market Economy in Poland*, organised by the Ministry of Development and Investment, during which a list of social business projects of the highest value for society in the last 30 years was announced. In the rankings, the 30 best-performing national and local projects were selected in separate categories from 90 nominations. The list was created by the THINKTANK Centre and coordinated by the Responsible Business Forum.

The list of the awarded initiatives is diverse and includes educational programmes, environmental programmes, and activities for excluded groups, aimed at increasing road safety or relating to new technologies, including, amongst others:

(1) Allegro for its *Charity platform.allegro.pl* initiative, launched in 2014.

(2) ANG Cooperative for its *Non-responsible* initiative, launched in 2013.

(3) Avon Cosmetics Poland for its *Cabinets with Pink Ribbon* initiative.

(4) Gazeta Wyborcza (Agora Group) for its *School with class (style)* initiative (original title: *Szkoła z klasą*).

(5) GlaxoSmithKline for its *I have a way for a cancer* initiative (original title: *Mam haka na raka*).

(6) Aterima Group for its initiative to publish *Counteracting human trafficking among workers posted to work abroad*, a casebook for employers.

(7) PKP Group for the *Reducing the scale of homelessness in and around railroad stations* initiative, launched in 2014.

(8) IKEA Retail Poland for its *It will be useful* programme (original title: *Przyda się*), launched in 2018.

There are also several other private sector initiatives that aim to build or strengthen the ESG idea. NN Investment Partners TFI, CFA Society Poland, Erste Securities and the Warsaw Stock Exchange have organised a number of conferences on ESG in business. The conferences focus on the financial sector, with the main topics being stock indices to fight global warming – PAB and CTB – and the new regulatory framework for ESG-based financing.

ESG Leader is a title awarded by NN Group, amongst others, to companies and institutions that have implemented and/or are implementing an outstanding ESG strategy, have offered and/or are offering innovative products and services with a positive impact on the environment, and have conducted and/or are conducting effective information and promotion campaigns in the area of sustainable development. The special distinction of the Visioner of Green Transformation is awarded to persons who support responsible business with their attitude and authority.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Paradoxically, the global financial crisis has created fertile ground in Poland for the development of a concept of responsible investors to act as a counterbalance to an exclusively financially oriented approach to the functional aspects of business. In recent years, there has been an increase in the number of jobs for corporate social responsibility ("**CSR**") specialists and managers. This confirms that CSR – also understood as the sustainable development of companies – is no longer a market niche in Poland important only to a small group of international corporations and leading Polish companies.

Although, in 2017, non-financial reporting became mandatory for only the largest listed companies (those with more than 500 employees and a balance sheet total of more than PLN 85 million or net revenue of more than PLN 170 million), banks and investment funds, many companies (such as Żabka, the convenience store chain) carry out such reporting even though they do not have such an obligation. Even before 2017, some companies did this voluntarily, in the form of "social" or CSR reports.

According to the Responsible Business Forum's "CSR Managers" survey conducted in 2020, 80% of respondents noticed increasingly strong integration of CSR values in their companies' business activities. Two-thirds of CSR managers and executives surveyed believed that the role of environmental and social topics will become increasingly important, and that the social and environmental responsibilities of companies for investors will increase. They also believed that increasing pressure will be exerted by customers, and that the spread of CSR activities will also occur through increasing demands from business partners.

Among the most useful tools for CSR managers are employee volunteering and stakeholder dialogue. The latter, in their opinion, is too rarely used, as is sustainable supply chain management.

Managers also pointed out the positive influence of business on the field of education – both general and focused on the fight against digital exclusion, then on the promotion of healthy lifestyles and the fight against discrimination of any kind. One-third of respondents emphasised the positive impact of business on eliminating unethical behaviour in business relations.

Compared to the survey conducted five years ago, the importance of support in the area of social assistance has decreased, while the fight against various types of discrimination has increased.

However, in the opinion of more than 50% of CSR managers, the main obstacles to the implementation of CSR are the understanding of CSR as a sponsorship activity and lack of understanding by company managers, and lack of staff education.

Changes in the attitude of investors are also visible, especially in large companies that have foreign funds among their shareholders. Their analysts have recently begun to inquire about greenhouse gas emissions, the fight against climate change, human rights protections, gender equality and diversity in corporate governance. This practice is only just beginning to develop in Poland; however, it may change quickly, as Polish investors are also increasingly interested in the CSR activities of companies in which they want to invest.

One of the main emerging ESG policy drivers are banks, which include non-financial initiatives as their crucial long-term goals. PKO Bank Polski S.A. – the biggest Polish bank – has adopted ESG indicators and included them in the bank group's non-financial targets for the coming years. The bank has committed to eliminate its exposure to the coal mining sector by 2030 and to increase green financing by at least 5% year-on-year. The indicators also include a commitment to reduce the bank's greenhouse gas emissions to 40,000 tonnes in 2025, a 60% reduction from 2019. The bank wants to maintain a high percentage of women in key management positions and has committed to no less than 35% in 2025. A similar strategy was announced by the second-largest Polish bank, Bank Pekao S.A., which set ambitious goals for the years 2021–2024. It is therefore the banks, as the primary fund providers for various projects, that will shape the trends aimed at strengthening ESG-related projects in Poland.

Moreover, Poland launched the Chapter Zero Poland programme, which is part of the international Climate Governance Initiative established by the World Economic Forum. The programme brings together members of supervisory boards and presidents of major companies to raise awareness of the consequences of climate change for business and the impact of business on climate. It provides knowledge and creates a platform for the exchange of experience between members of management and supervisory boards as well as experts.

The coronavirus pandemic has encouraged not only many social endeavours, but also environmental, social and management investments. Many companies have allocated considerable amounts to support the fight against coronavirus and to provide personal protection equipment for medical services, for example: (i) ERGO Hestia purchased equipment for paramedics and donated PLN 1 million for their immediate needs; (ii) Kompania Piwowarska donated almost 260,000 cans of soft drink B-life to those most in need during the pandemic; (iii) Henkel Polska donated 6,500 packages of cleaning products to 15 hospitals to aid hygiene; (iv) PGE Polska Grupa Energetyczna provided seven hospitals with funds to support activities related to the fight against coronavirus; (v) Polpharma financed the purchase of 100 ventilators to medical services for the total amount of approximately PLN 7 million; and (vi) Polpharma, in cooperation with Herbapol Lublin and Belvedere Restaurant, delivered daily over 500 meals with juice and tea to Warsaw hospitals and emergency stations. The above list provides just some examples of companies that have supported healthcare and is not exhaustive.

During the pandemic, many companies also took social action, such as IKEA in Poland (IKEA Retail and IKEA Purchasing) and Ikano Bank, which conducted a campaign of in-kind donation of beds, bedding and many other IKEA products for community quarantine centres. The action was joined by a number of other companies, including Puro Hotels, SSAB Poland, SAM EXECUTIVE SEARCH, JULA and Medicover Foundation, as well as Castorama, Jysk and Decathlon.

In addition, one of the PZU Group companies, Armatura Kraków S.A., launched production of hand disinfectant and offered it free of charge to care homes, local government units and educational institutions.

Companies have also supported schools and students during the pandemic, such as BNP Paribas Bank Polska, which allocated PLN 1 million to purchase over 500 laptops with routers for students struggling with digital exclusion.

The current situation shows that social and environmental suitability are not mutually exclusive with corporate goals. They are becoming interdependent and hopefully this symbiosis will be even greater in the phase of economic recovery after the COVID-19 pandemic.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

As consumer income increases, so does their awareness of the origin of products, the activities of producers, distributors and vendors. Consumers expect from companies and brands not only that they provide good-quality products, but that they also engage in social and/or environmental matters. However, price is still the main factor influencing the purchase, yet more and more consumers are starting to look at companies by the prism of their actions. Consumers pay attention to such elements as companies' treatment of employees, use of substances less harmful to the environment and use of recyclable materials, not testing their products on animals, the manner in which they package their products, and providing transparent information to consumers, in particular relating to the origins of their products.

Many young and eco-oriented consumers nowadays choose their clothing and cosmetics brands, banks or investment funds more often on the basis of their environmental, social and management credentials. There is also increasing pressure for sustainability from policymakers, regulators and politicians. Slowly, low ESG factors become a threat to the reputation not only of the businesses, but also of political stakeholders. This is mainly due to the fact that the Polish public is increasingly interested in the solutions offered in terms of climate change, social inequality and discrimination based on race, gender and sexual orientation.

Throughout the COVID-19 pandemic, so-called "craft food" has become increasingly popular and many start-ups have proven successful in developing this new area. This is yet another example that consumer awareness regarding non-financial factors is increasing and for many is becoming the main driver as regards their choices and preferences.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

As the ESG concept itself combines many different issues, such as human rights, equality and diversity, consumer protection and animal welfare, corporate governance issues, climate change, and the prevention of unfair competition, there are several regulatory authorities in Poland responsible for overseeing the various areas of ESG performance. The most important regulators in Poland are:

(i) the Ombudsman, who is responsible for the protection of human and civil rights and freedoms, including the principle of equal treatment;

(ii) the Children's Ombudsman, who is responsible for the protection of children's rights, especially such as the right to life and health protection, education and decent social conditions;

(iii) the General Director of Environmental Protection, who is responsible for the protection of nature and the environment;

(iv) the President of Polish Water Management, who is responsible for management of water resources;

(v) the President of the Office of Competition and Consumer Protection, who is responsible for creating anti-monopoly and consumer protection policies and issuing statements on public aid projects;

(vi) the President of the Energy Regulatory Office, who is responsible for regulating fuel and energy management and promoting competition;

(vii) the Chief Labour Inspector, who is responsible for the inspection of hygienic and safe working conditions and compliance of employers with labour laws; and

(viii) the Chief Sanitary Officer, who is responsible for food inspections and supervision of the import and export of food.

Currently, when political and legal changes have indeed led to the undermining of the principle of triple power in Poland, the most active role is played by the Ombudsman, who has opposed many political actions that violate human and civil rights and freedoms, including the principle of equal treatment.

The Ombudsman opposed national populism and the questioning of constitutional values by the ruling party, the approach to women's rights and the rights of homosexual, bisexual and transgender persons.

2.4 Have there been material enforcement actions with respect to ESG issues?

In 2021, one of the largest grocery store networks in Poland was fined over PLN 60 million (EUR 13.3 million) for intentionally misleading information regarding the geographic origin of products sold. In some of its stores, the countries of origin of more than 20% of fruit and vegetables on sale were wrongfully indicated, which could have influenced the decision of the consumers when buying such products.

The other material enforcement action was undertaken by the Regional Inspector for Environmental Protection in Łódź, who imposed a fine of PLN 1 million (approximately EUR 220,000) on a company that stored waste in a landfill in Zgierz. Many tons of waste were stored there from the United Kingdom, Italy, Germany and other countries. The waste was burned, and the burning landfill had a significant negative impact on the environment and its elements. Therefore, the fine was appropriate to the size of the company and the level of environmental damage.

Finally, in April 2021, it was discovered that waste illegally transported from Germany to Poland has been stored in more than 30 locations in western Poland. Managers responsible for this infringement may face up to five years in prison and significant fines.

There have been many other enforcement actions conducted by the regulatory authorities. This shows how important ESG issues are for Polish regulators and how robust their actions are in counteracting all violations.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The obligation to disclose information on the company's environmental, anti-corruption and anti-bribery policies, respect for human rights, social responsibility and treatment of employees, and diversity on company boards (in terms of age, gender, education and professional experience), may give rise to civil action, provided that there is damage caused by a shareholder relying on false ESG disclosures and that there is a natural causal link between the false ESG disclosure and the damage suffered.

In addition, compliance with laws on a hygienic and safe working environment, labour laws, including equal treatment in employment and the prohibition of discrimination, in particular on grounds of sex, age, disability, race, religion, nationality, political opinion, trade union membership, ethnic origin and sexual orientation, poses a significant risk to the employer. Employee rights are further protected by a special, employee-focused procedure for dealing with labour law cases.

Furthermore, civil liability for damages caused by a violation of any environmental law is also a significant litigation risk. However, it is necessary to establish the damage relationship and the natural causal link between the violation and the damage suffered. Such claims based on an unlawful violation of environmental law can be pursued as class action lawsuits by a group of at least 10 plaintiffs.

2.6 What are current key issues of concern for the proponents of ESG?

Currently, the key issues of concern for proponents of ESG activities in Poland are environmentally harmful single-use plastics, air pollution, which often exceeds the permitted indicators in urban areas, equal access to medicine and the healthcare system during the outbreak of the COVID-19 pandemic, counteracting unfair competition and the protection of consumer rights, tolerance and acceptance for sexual and national minorities, and gender equality. The aforementioned issues are both Polish and global concerns.

Some of these issues have been recently addressed by the legislator or regulators, e.g. the introduction of a special administrative fine for the sale of single-use plastic bags in 2019, and the introduction of a high administrative fine for the illegal sale of boilers that do not meet the environmental requirements, also in 2019.

Thirteen provinces in Poland have adopted the so-called anti-smog resolutions. They impose replacement of old boilers, stoves and fireplaces with modern ones and sometimes introduce a total or partial ban on burning coal and/or wood. Anti-smog resolutions are based on emission classes in accordance with the PN-EN 303-5 standard, and according to the class of the boiler they require its replacement within a specified time.

Since 2018, there has been a government programme known as "Clean Air", the main goal of which is to accelerate the replacement of old heat sources in households that most pollute the environment, i.e. manual boilers powered by wood, tiled stoves and low-efficiency coal boilers. The granted subsidies may also be used to insulate the building, to replace windows and doors and to install and modernise central heating and hot water systems, as well as to partially finance the construction of renewable energy sources and ventilation with heat recovery (recuperation). The programme will operate until 2029, and applications for funding can be submitted until 31 December 2027. The total budget of the "Clean Air" programme is currently PLN 103 billion.

Interestingly, a relatively new issue has arisen of increased production of single-use masks covering the nose and mouth and also gloves due to the COVID-19 pandemic, accompanied by increased waste production. Used masks and gloves are often not correctly recycled or are simply thrown away. Therefore, people incidentally litter pavements, forests, and reservoirs, which constitutes a danger for animals. Moreover, the masks and gloves are light enough for the wind to move them a significant distance. This issue is urgent and must be addressed on both a national and global level.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The primary responsibility for dealing with all company matters, including ESG matters, lies with the board of directors. The board of directors is the body responsible for managing the company's affairs and representing its interests. It is increasingly common for ESG matters to be addressed in public statements made by company boards. This approach emphasises the importance of ESG issues and allows companies to build good relations with their stakeholders.

Moreover, companies are introducing policies friendly to ESG performance and appointing managers responsible for policy implementation within the company structure. Large public interest companies with more than 500 employees are subject to non-financial reporting on their environmental, social and management policies.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Public companies are governed by a two-tier board system, with the supervisory board presiding over the management board. Supervisory boards can also be appointed in limited liability companies (in LLP companies where the share capital exceeds PLN 500,000 and there are more than 25 shareholders, establishing a supervisory board or an audit committee is mandatory) and joint-stock partnerships. It supervises the company's activities in all areas, including environmental protection, social issues and corporate governance. Special duties of the supervisory board include evaluation of the management board's reports on the company's operations and the financial statements for the previous financial year, in terms of their compliance with the records and documents, as well as with the actual state of affairs, and the management board's motions concerning the distribution of profit or coverage of loss, as well as submitting an annual written report on the results of this evaluation to the shareholders' meeting.

In order to perform its duties, the supervisory board may examine all documents of the company, demand reports and explanations from the management board and employees and review the state of the company's assets. Each member of the supervisory board may independently exercise the right of supervision, unless the articles of association provide otherwise.

In addition, the board is also responsible to shareholders for implementing all policies, including environmental, social and corporate governance policies. The board presents to the shareholders a report on the company's activities, which is reviewed and approved by a shareholders' resolution. The limited liability company's shareholders may review the records and documents, accounts, and minutes of the shareholders' meeting and request copies of resolutions certified by the board.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Companies often pay (or reimburse) their employees to participate in various courses and/or training. They also promote a work-life balance culture and offer benefits such as multi-sport cards, access to private medical care, language courses, and reimbursement of the cost for glasses. They create sports challenges within the company as well as appoint sports teams and compete with other companies in the same industry.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

The most common examples of how companies have integrated ESG into their day-to-day operations are:

(i) Codes of conduct providing all employees with a clear benchmark of what is regarded as ethical behaviour and the policies implemented within the company's structures. This set of rules outlining proper practices, approved norms or rules and imposed obligations are introduced usually in order to protect the company's business and inform all employees about the company's expectations of them.

(ii) Dedicated training for all employees, including online training and online tests, regarding ESG concerns and policies introduced by the company.

(iii) Dedicated means of anonymous contact for all employees where they are permitted to submit all reports regarding unethical or incorrect behaviour or abuse of power within the company.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Relying on externally developed ESG ratings is still very rare. The first financing project in Poland in which such mechanism was applied took place in 2019, where a consortium of banks granted a loan of PLN 2 billion (approximately EUR 430 million) to a Polish company from the energy sector in which an external rating agency evaluated ESG factors in relation to the borrower. The ESG rating formed the basis for an evaluation/adjustment of the margin. In December 2020, PKN Orlen S.A., the largest Polish company (operating in the oil industry), issued a sustainability-linked bond in which the level of margin depends on the rating of an ESG agency.

4.2 Do green bonds or social bonds play a significant role in the market?

In general, green bonds are a crucial financial tool used in raising capital for eco-friendly projects that benefit the environment. They are becoming more and more popular in Poland.

In December 2016, Poland was the first country in the world to issue its inaugural green bond. The bond served to highlight the government's support for projects with clear environmental benefits, as well as finance Poland's key environmental goals, i.e. Poland's National Renewable Energy Plan and the National Programme for the Augmentation of Forest Cover.

It is intended and encouraged both by the EU and the Polish government that green bonds should become a means to attract capital for municipalities. However, only recently, in October 2020, the first municipality, the city of Grudziądz, decided to issue the first green bonds to finance water sewage projects. At the beginning of 2021, Łódź – the third-biggest city in Poland – issued its first green bond. The funds will be used to finance construction of retention reservoirs and to carry out investments in low-emission transport. At the same time, green bonds are also becoming popular amongst private companies. In June 2021, a Polish solar projects developer issued PLN 150 million (EUR 33.5 million) worth of green bonds as part of their newly announced programme for up to PLN 1 billion in total issuances.

Social bonds do not currently play any role in the market.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds are rather uncommon in Poland. Last year, two state-controlled companies from the energy sector issued their first sustainability-linked bonds in Poland. The first, issued by Tauron S.A., was the largest bond issue in the corporate sector since the beginning of the coronavirus pandemic in Poland and the funds from the bond issue are to support the transformation of the group and will be used to finance the costs of construction/acquisition of projects involving renewable energy sources, to finance distribution and general corporate activities. PKN Orlen S.A., the issuer of the other bond, was the first in Central Europe to issue an ESG-linked bond. The company plans to use the financial resources obtained from the bond issue for general corporate purposes, including achieving its ESG targets.

4.4 What are the major factors impacting the use of these types of financial instruments?

The main drivers impacting the use of these types of financial instruments are:

- pressure from society and clients of financial institutions (expecting to invest their funds in undertakings that prevent climate change);
- enormous investment needed in order to achieve the 2030 Agenda's Sustainable Development Goals;
- adoption of the EU climate neutrality target in 2050 and the European Green Deal, requiring mobilisation of EUR 1 trillion in funding between 2021–2027, of which approximately EUR 300 billion is to come from additional private funds in order to supplement public funds; and
- changing strategies adopted by financial institutions, including requirements imposed by financial regulators.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The assurance and verification process for green bonds relies mainly on internal policies of the bond issuer, as well as external guidelines such as the International Capital Market Association's Green Bond Principles. To a certain extent, issuers rely on a second-party opinion or an external review. These should confirm that a green bond adheres to industry-accepted principles. They verify the issuer's transparency, disclosure and use of proceeds. These processes are, at this time, minimally regulated and rely therefore on good industry practices.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

The pandemic has increased the role of CSR issues related to employee and community issues. According to a survey conducted by the Responsible Business Forum in 2020, nearly all of the managers surveyed indicated that the new way in which companies operate due to the pandemic has changed their jobs. Some received new tasks related to ensuring the safety of employees and customers, including development of procedures and organisation/change of purchasing processes. Many ESG programmes were modified, while some were suspended (such as the reduction of single-use packaging, which was stopped for safety reasons), some moved to the virtual world (which often led to increased popularity), and some were postponed. There were also new support actions for health centres, schools, uniformed services and local communities (see question 2.1 above).

The slowdown in ESG investment seems a natural reaction to the extreme degree of risk and uncertainty in all markets caused by the COVID-19 pandemic. In times of crisis, the need to find solutions to the most pressing economic and financial problems overcomes the long-term perspective.

However, ESG practices seem to be robust and recover quite quickly. Polish and foreign investors have recognised the value of sustainability and clean energy, and they have also noticed the importance of climate change and environmental risks, and therefore they see investments that account for ESG factors as stable and profitable in the long term. They are interested in investing their money in Poland, especially in photovoltaic systems and wind power stations. Thus, clean energy practices have experienced the greatest leap forward.

6 Trends

6.1 What are the material trends related to ESG?

An ethical approach, managing social impacts, and long-term sustainability are crucial to investors, companies and their employees. Companies operating in Poland are aware that integrity, diversity and inclusion are factors of significant importance for employees, and that these factors are used to evaluate their ability to retain talent, passion and experience. Employee loyalty and morale depends on the way a company operates, because loyalty is a so-called "two-way street". Thus, there is a great emphasis on trust and the reputation of the employer in the Polish labour market.

Forward-looking investors are also environmentally cautious because they are looking to enhance their long-term outcomes. Therefore, investing in renewable sources of energy, such as photovoltaic systems and wind power stations, continues to be consistently on the rise in Poland. We expect responsible investment strategies incorporating ESG factors to become even more popular in the near future.

ESG investing might become a new mainstream, both in the Polish and European markets. It is more important to a greater number of people to live in a balanced, sustainable and environmentally friendly world, and there is therefore more place for ESG investments every year. Speaking in terms of long-term profits and returns, ESG investments seem to be the only way forward.

6.2 What will be the longer-term impact of COVID-19 on ESG?

The COVID-19 crisis could become a major turning point for ESG investments in the long term. The economic crisis caused by the pandemic is regarded by many investors as a potential catalyst. The crisis itself accelerated the trend for a more sustainable approach in investing. Moreover, it accelerated the same trend for a sustainable approach amongst many legislators, decisionmakers and policymakers, too. This trend is naturally not limited only to Poland but seems to be a European and worldwide phenomenon. Currently, people are prioritising a sustainable and long-term approach over short-term solutions. It is a trend in many areas, such as investing, employment matters and governance.

Matters of sustainability, clean energy and environmental risks are very likely to become crucial factors determining business models, and there are many positive adjustments expected. The global economy has been badly affected by all shutdowns implemented in order to stop the spread of coronavirus and contain the disease. Nevertheless, in the long term, it is very likely to revolutionise the approach to ESG investments. We are probably going to witness a real revolution in this area, a good one and with long-lasting effects. We could never have imagined that the crisis would have such a positive impact on ESG law.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In Portugal, there are several legal instruments directly or indirectly linked with substantive ESG matters.

On the one hand, EU legislation imposes relevant standards in ESG-related areas. Notably, the Taxonomy Regulation – Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, the Low Carbon Benchmark Regulation – Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 as regards EU climate transition benchmarks, EU Paris-aligned benchmarks and sustainability-related disclosures for benchmarks, and the Air Quality Directive – Directive 2008/50/EC of the European Parliament and of the Council of 21 May 2008 on ambient air quality and cleaner air for Europe, establish essential standards on environmental matters.

Additionally, domestic legal instruments also set out important rules in ESG matters. Regarding the environmental component, it is important to point out that the Portuguese Criminal Code sets out different types of environmental crimes and that environmental damages may determine the attribution of compensation according to the Portuguese Civil Code. Law n. 19/2014 determines the foundations of environmental policy and from it stem several regimes regulating specific subjects in a more detailed manner, such as: *(i)* Decree-Law n. 178/2006 on waste management; *(ii)* Decree-Law n. 151-B/2013, which transposes Directive 2011/92/EU and Directive 2014/52/EU, establishing the Legal Regime of Environmental Impact Assessment; *(iii)* Law n. 58/2005, transposing Directive 2000/60/CE known as the "Water Law" as it sets out the institutional framework for sustainable water management; and *(iv)* the National Action Plan for Energy and Climate, establishing, in accordance with Directive 2012/27/EU and Directive 2009/28/EC, the national energy strategy for the period of 2021–2030.

Concerning social matters, arbitrary discrimination is prohibited in all areas of the Legal Order, from the Portuguese Constitution, Criminal Law, Civil Law and, more specifically in certain areas, Labour Law. In addition, Law n. 93/2017 establishes the regime for prevention, prohibition and combatting of discrimination and Law n. 62/2017 establishes the regime for a balanced representation between men and women in management and supervisory bodies of corporate public sector entities and listed companies.

Lastly, governance matters are mostly regulated by the Commercial Companies Code and the Portuguese Securities Code for companies in general. There are also additional corporate governance rules in force for financial firms, namely stemming from the Portuguese Banking Law, the Portuguese Insurance Activity Law and the Portuguese Regime on Investment Funds. Moreover, some developments have been observed concerning the regulation of certain companies with social objectives; for example, through Law n. 18/2015 determining the Legal Regime of Social Entrepreneurship Funds. Soft law instruments are also relevant in corporate governance matters, namely the IPCG Corporate Governance Code (2018), which presents a set of recommendations applicable to listed companies.

1.2 What are the main ESG disclosure regulations?

Disclosure standards are often included in the substantive regimes regulating ESG matters. Nevertheless, it is important to point out that there are instruments particularly focused on disclosure, such as in the case of: *(i)* Regulation (EU) 2019/2088 (the SFDR); *(ii)* the abovementioned Taxonomy Regulation; *(iii)* Decree-Law n. 89/2017, transposing Directive 2014/95/EU on the disclosure of non-financial and diversity information by certain large undertakings and groups; *(iv)* the Portuguese Securities Code, transposing Directive (EU) 2017/828 in respect to institutional investors' disclosures; and *(v)* Decree-Law n. 28/2021, establishing the Energy Labelling Scheme, through the transposition of Directive 2010/30/EU.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Presently, there are no uniform global standards for ESG disclosures. The abovementioned EU regulations (see *supra* question 1.2) have begun an important path of convergence in ESG disclosure matters, but it is too soon to tell if we are close to achieving a truly worldwide standard in this respect. However, companies have increasingly started to disclose information on this matter, through the adoption of sustainability policies, the publication of ESG commitments, and even in companies' annual accounting reports. Currently, 84 Portuguese companies, enterprises or entities are members of the UN Global Compact, meaning that they have committed themselves to improve their corporate responsibility by assessing, defining, implementing, measuring and/or communicating their sustainability strategy. Furthermore, the Portuguese securities market regulator, the Securities Market Commission (CMVM), has approved a non-binding template for disclosure of non-financial information, which has inspired some voluntary ESG disclosures by major listed companies.

These publications are often in accordance with the European Commission's non-binding guidelines on non-financial reporting or influenced by the Guidelines for a Sustainability Report issued by the Portuguese Institute of Internal Audit, based on the Global Reporting Initiative guidelines.

Moreover, the Bank of Portugal published a commitment to sustainability and financing in 2020 and became a member of the Network of Central Banks and Supervisors for Greening the Financial System in 2018.

Finally, ESG disclosure scrutiny is becoming more embedded in commercial transactions in general. Namely, it is becoming more and more common to include ESG factors in the due diligences carried out before M&A transactions.

1.4 Are there significant laws or regulations currently in the proposal process?

At this juncture, one of the most significant legislative proposals being discussed is the Climate Law Framework, which aims to determine the guidelines for public policies in all areas concerning climate, namely by establishing decarbonisation targets, measures regarding the electricity production system (particularly concerning energy efficiency and energy poverty), a monitoring entity and planning and financing instruments.

At the EU level, attention must also be paid to the important EU Proposal for the Corporate Sustainability Disclosure Regulation. This Regulation will amend Directive 2014/95/EU, significantly enhancing the standards and imposing the audit of non-financial information.

The adoption of an instrument regarding human rights in the Digital Era is also being discussed, as well as changes to the Consumer Rights Law in order to ensure a right to environmental protection and sustainable consumption.

1.5 What significant private sector initiatives relating to ESG are there?

An increased commitment to ESG and its connecting areas can be observed throughout the private sector. Besides the already mentioned reporting commitments assumed by several companies, there are a number of associations promoting the implementation of ESG standards.

These associations can either be directly connected to companies, as is the case for the Business Council for Sustainable Development, a company association that aims to strengthen recognised norms and practices aligned with management, ethical, social, environmental and quality standards, or can be non-governmental organisations (NGOs) advocating for the implementation of ESG concerns, as is the case for ZERO, Quercus and the Portuguese Environment Agency. Flexdeal, a Portuguese listed management company, is also developing a relevant ESG project for small and medium-sized enterprises with the advisory support of SÉRVULO.

Additionally, the role of the press and of academic institutions has been essential to raise awareness for ESG issues, both through the publication of articles and news pieces, as well as through the organisation of events and conferences on the matter. Law firms are increasingly playing a relevant role through the creation of departments or services focused on ESG law, as is namely the case for SÉRVULO.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

There is increasing concern amongst investors and stakeholders regarding the impacts of their investments. Stakeholders are starting to look for opportunities that also encompass ESG standards and promote positive social changes, which is reflected in the gradual growth of funds complying with these criteria.

Asset managers are also starting to increase their offer of ESG products as a way to keep up with international trends, which consequently increases the interest of investors in these types of products (i.e. banks are converting funds in ESG products, imposing ESG criteria on existing funds, and offering funds with ESG stamps).

Currently there are seven products in the market following sustainability criteria, which are responsible for the management of approximately 400 million euros. Mostly, these funds exclude entities that directly or indirectly cause negative externalities, through exclusionary screenings based on the Stoxx Sustainability Index or the Barclays MSCI Euro Corporate SRI + ESG Index.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Increasingly, stakeholders besides investors are gaining awareness of the importance of ESG standards. In all sectors of civil society, a growing concern regarding ESG matters can be observed.

On the one hand, companies' shareholders have become more concerned with the compliance of ESG standards in the companies they invest in, which determines more frequent discussion of these topics in General Meetings of companies. Consequently, companies have been adopting governance structures that are aligned with ESG criteria and seek to develop more active and intervening strategies on the matter, which is increasingly seen as a competitive factor by the market.

The support for ESG has also been highly influenced by financial regulators, as well as the legal sector overall, as academia and law firms have engaged in the definition of standards and policies. The role of civil society has also been essential to raising awareness of these matters, as well as through the adoption of more informed and sustainable consumption habits.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

ESG issues, in general, are regulated by public entities, thus each component of ESG is more particularly regulated by specialised entities.

The issues connected with the environmental component are mostly regulated by the Ministry of Environment and Climate Action, in cooperation with the Ministry of Agriculture and the Ministry of the Sea. Public entities such as the Portuguese Environment Agency, the Inspectorate-General for Agriculture, Sea, Environment and Land Management and the Directorate-General for Energy and Geology (IGAMAOT) perform an important role in the implementation of regulations and the observance of already adopted rules.

Regarding social issues, although all areas of activity may potentially influence its regulation, the Ministry of Labour, Solidarity and Social Security and the Ministry of the State and the Presidency, namely through the State Secretariat for Citizenship and Equality and the State Secretariat for Integration and Migrations, play the most prominent regulation roles in the matter. Additionally, the Authority for Work Conditions (ACT) and the Portuguese National Human Rights Committee monitor and supervise labour and human rights issues, respectively.

Governance matters are essentially regulated by the Ministry of Economy and Digital Transition. However, in the financial sector, the Bank of Portugal, the Insurance and Pensions Authority (ASF) and the CMVM play a vital role in the regulation of ESG standards as well.

2.4 Have there been material enforcement actions with respect to ESG issues?

Enforcement actions with respect to ESG issues are mostly led by regulators that, while monitoring entities within their competency, identify a situation of non-compliance with imposed standards.

These actions may include actions imposing the compliance of environmental standards by IGAMAOT, which may lead to administrative fines, as non-compliance with imposed standards often constitutes an administrative environmental offence.

Similarly, non-compliance with anti-money laundering and anti-corruption regulations may lead to the imposition of fines in investigation procedures initially led by the Bank of Portugal.

Non-implementation of proper work regulations and conditions is monitored by the ACT, while the violation of human rights often determines the opening of judicial procedures. The ACT has namely put in place a permanent compliance programme regarding the gender pay gap.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The Portuguese legal system does not have a strong tradition in litigating matters concerning ESG issues, although some administrative offences may evolve into judicial procedures and liability actions may be entered into by different stakeholders.

The possibility of being held liable for damages is an important risk with ESG-related litigation, especially concerning environmental matters. For instance, there is currently an ongoing civil class action against the national steel industry in Seixal for environmental damages, namely atmospheric pollution, which was proposed by an environmental NGO. The application of the NGO requests for the immediate suspension of operations until the steel industry complies with basic administrative environmental requirements and for the payment of 500 million euros.

Also currently underway is a procedure brought by NGOs in the Lisbon Administrative Court to prevent the construction of a new airport in Montijo as, according to the organisations, the Environmental Impact Statement reflecting the project's environmental assessment does not comply with EU law.

Moreover, there are relevant reputational risks associated with ESG-related ligation, particularly in the case of non-compliance with anti-money laundering or work condition rules, as these matters tend to be highly mediatised. Additionally, greenwashing cases, framed as unfair commercial practices, are expected to arise as public awareness to advertising that does not have a real green impact is increasing.

2.6 What are current key issues of concern for the proponents of ESG?

The increased general awareness over ESG issues creates a growing concern of consistent implementation of standards and of developments in this area.

Besides this eagerness for consolidation of these matters, the main issues that are currently being discussed revolve around strategies to avoid greenwashing and to ensure proper transparency and reporting standards, namely through the approval of green quality labels. In this matter, the transposition and implementation of the EU Taxonomy Regulation also constitutes an important incentive and matter of concern.

The application of the EU Recovery Fund and its use in a fair climate transition is also a key concern for ESG proponents, as it can effectively determine change for widespread development and implementation of ESG standards and rationale in the economic and market paradigm.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

ESG is a broad topic and therefore, some distinctions are useful to be drawn beforehand.

Firstly, some basic differences separate regulated and unregulated companies. In respect to unregulated companies, the responsibility for addressing ESG issues lies mainly with the boards.

Within the catalogue of board member duties, the Portuguese Companies Code refers explicitly to loyalty duties, which take into account the long-term interests not only of shareholders but also other stakeholders relevant for the sustainability of the company (Article 64). This rule was apparently influenced by Section 172 of the UK Companies Act 2006. It applies to any company, irrespective of its form.

In relation to supervised companies (listed companies and financial institutions), regulators have been adopting an increasing role in respect to ESG topics. Portuguese regulators with competences in this area include the Bank of Portugal (banking), the CMVM (capital markets), and the ASF (insurance and pension funds).

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Corporate governance is not solely one of the ESG pillars (the "G" pillar). It also represents the decision-making processes and procedures by which ESG gains traction and is effective. ESG is to be embedded in the governance system, and therefore there are multiple mechanisms that are adequate to manage ESG issues.

In Portugal, according to corporate law, board committees are not mandatory, and ESG committees are still an exception rather than the rule. However, some examples are found in listed companies, such as Corticeira Amorim (ESG committee) and GALP (sustainability committee).

On the other hand, ESG risks are often integrated into the mandate of risk committees. One example of this is EDP, where risks related to sustainability are monitored under the risk committee. EDP also publishes quarterly ESG information.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

The IPCG Corporate Governance Code (2018), currently in force for listed companies, has some indications regarding remuneration policy and namely recommends the following:

- In the annual report, the managing board should explain in what terms the strategy and main policies defined seek to ensure the *long-term success of the company and which are the main contributions resulting therein for the community at large.*
- The remuneration policy of the members of the managing and supervisory boards should allow the company to attract qualified professionals at an economically justifiable cost in relation to its financial situation, induce the alignment of the member's interests with those of the company's shareholders – taking into account the wealth effectively created by the company, its financial situation and the market's – and constitute a factor of development of a culture of professionalisation, *sustainability*, promotion of merit and transparency within the company.
- Directors should receive compensation that: *(i)* suitably remunerates the responsibility taken, the availability and the expertise placed at the disposal of the company; *(ii)* guarantees a performance aligned with the long-term interests of the shareholders and promotes the *sustainable performance of the company*; and *(iii)* rewards performance.

Two examples merit to be indicated in this context. On the one hand, GALP has a remuneration policy for corporate bodies that incorporates, as a key performance indicator, the safety and environmental sustainability of the company's relevant activities.

One the other hand, Jerónimo Martins' remuneration policy is based, in addition to other factors, on priorities of a qualitative nature considered fundamental to the long-term sustainability of the business.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

An increasing number of companies are starting to integrate ESG into their cultures. Below you may find some examples of sustainable measures that companies have adopted in Portugal.

GALP has committed to acting ethically and responsibly, engaging with stakeholders, valuing human capital, and has commitments regarding energy and climate, among others. Its goals are to achieve 33% of women on its board of directors after 2022, to implement human rights impact assessments in the most significant geographies, to ensure 70–100% of local purchases, to promote an autonomy, responsibility and meritocracy culture, to reduce the carbon intensity of its assets and operations, and others. For this purpose, GALP has appointed a sustainable committee, established a diversity policy for its management and supervisory bodies, and endorsed the Plan for Gender Equality 2020. GALP has already reached 75% of local purchases, launched the Leading@Galp programme that aims for self-knowledge and sharing future experiences and skills, reviewed recruitment standards, and reinforced its commercial offer of renewable energy to clients.

Jerónimo Martins has also announced its objectives on respecting the environment, buying with responsibility, supporting surrounding communities, becoming a reference employer, among others. In 2018–2020, its objectives were to reduce its carbon footprint by 5%, per 1,000 euros of sales. Jerónimo Martins has also initiated at least one community investment project per year aimed at protecting/benefitting children, young and elderly people from vulnerable backgrounds and has improved the quality of life of collaborators through the social responsibility programmes, and others. In 2020, Jerónimo Martins published a document that demonstrates its progress regarding these objectives. Some of them were fulfilled, such as a 37% reduction in its carbon footprint, the purchase of food products from local suppliers, the support of 157 local causes from an investment of 150,000 euros, and the support of more than 1,100 employees through the Social Emergency Fund.

Finally, TAP Air Portugal has also endorsed environmental and social commitments. In 2020, TAP created the project RECICLA+, which intends to increase the rate of waste going to recycling. TAP also has a Disposable Plastic Reduction Program. Under this programme, TAP has already introduced wooden coffee mixers to replace the previously used disposable plastic ones. Regarding TAP's social commitment, TAP has created a programme called TAP Donate Miles. This initiative allows its clients to donate miles to various non-governmental and non-profit organisations, which are then converted into travel.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

In Portugal, internal ESG ratings are not common. Most financial intermediaries rely on external ESG ratings, such as Morningstar, Fitch, and Moody's. Furthermore, ESG ratings are yet to be regulated in our jurisdiction. At a global level, it is interesting to note that the International Organization of Securities Commissions has prepared a set of recommendations addressed at ESG ratings.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds are still a growing trend in our market. However, there are some Portuguese companies that have issued green bonds.

The first Portuguese green bond issuer was EDP, which issued its first green bond in the amount of 600 million euros in October 2018 that intends to finance or refinance renewable projects, solar and wind. In January 2019, EDP issued its first green hybrid bond worth a billion euros. In September 2019, EDP issued its third green bond worth 600 million euros, and issued another green hybrid bond in 2020 worth 750 million euros. The last transaction was in April 2020, a green bond in the amount of 750 million euros. EDP's total green bonds have reached 3.7 billion euros, which represents 27% of the total debt that EDP holds.

In 2019, Grupo Pestana became the first hotel group to issue a green bond. This green bond, worth 50 million euros, refinanced two projects: Pestana Troia Eco-Resort; and Pestana Blue Alvor.

Moreover, in February 2019, Sociedade Bioelétrica do Mondego issued a green bond, in the amount of 50 million euros, for the development of a 34.5 MW-capacity biomass power plant.

Another relevant transaction was the issue of green bonds by Corticeira Amorim worth 40 million euros in December 2020.

4.3 Do sustainability-linked bonds play a significant role in the market?

Although the green bond market is rapidly growing, as mentioned above, we have not yet found any sustainability-linked bond issuers in Portugal.

4.4 What are the major factors impacting the use of these types of financial instruments?

One major factor is transparency. There needs to be a release of non-financial information so that investors can make a clear investment decision. Companies must be transparent and accurate regarding their non-financial information and, through data-based information and third-party assurance, should avoid the risks and pitfalls arising from misleading information. These are critical aspects to avoid greenwashing.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Presently, there is no mandatory assurance and verification process for green bonds. However, the European Commission has presented a Proposal for a European Green Bond Standard, which intends to be a voluntary standard for how companies can issue green bonds and help reduce the risk of greenwashing. The European Green Bond Standard will be open for issuers located outside of the EU, and will be helpful for issuers and investors.

In some cases, green bonds are second-party opinions referred to in the offer documents, namely in the following cases: Grupo Pestana turned to DNV GL for a second-party opinion; and EDP consulted Sustainalytics, such as Sociedade Bioelétrica do Mondego, and Corticeira Amorim.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

It is undeniable that COVID-19 has had a significant impact on ESG, both positive and negative.

It should be stressed that one of the main priorities of Ursula von der Leyen's European Commission was to launch the foundations to ensure that Europe is carbon neutral by 2050, with the European Green Deal being the cornerstone of such enterprise. However, a few months after the beginning of her mandate, the EU, and the rest of the world, was emersed in fighting back COVID-19 with inevitable impacts on the foreseen dates. As such, one of the most significant and negative impacts of COVID-19 on ESG practices has been the delay on the implementation of new legal solutions, as well as the deviation of attention from private actors, since ESG was no longer the focus at the time. A clear example is the so-called European Climate Law, which was presented by the European Commission in March 2020 but was only approved by both the Parliament and the Council in June 2021.

Taking a more granular perspective, a change in certain behaviours and practices has been noted. For example, there has been a reduction in the reuse of materials, which is clearly against legislative efforts such as Directive (EU) 2019/904 on the reduction of the impact of certain plastic products on the environment but constitutes a necessary measure to contain the spread of the virus.

However, COVID-19 has also had significant positive impacts on ESG practices. In the one hand, the pandemic has fostered the idea that sustainable development oriented towards growing environmental and social awareness is imperative to guarantee resilient societies. On the other hand, COVID-19, by leading to the need for economic and social recovery, is being seen as an opportunity to introduce certain changes that were previewed before the pandemic. Indeed, one should never waste a good crisis.

6 Trends

6.1 What are the material trends related to ESG?

There are different material trends related to ESG concerning each of its different pillars, which are motivated by an increasing awareness of the importance of ESG both at a regulatory level and in the public eye.

Regarding the "E" pillar, the abovementioned European Climate Law assumes a leading role, since it aims to raise the emissions reduction target for 2030 from 40% to at least 55%. Moreover, increasing public awareness regarding greenwashing practices may lead companies to have a more cautious approach when advertising their products as eco-friendly.

Concerning the "S" pillar, we must point out the continuous initiatives to achieve gender equality within the workplace and in labour market access. It should also be noted that the need for employers to comply with human rights standards is also becoming a more mainstream concern, showcased by the growing efforts on disclosure in these matters, especially when it comes to the control of supply chains. Lastly, the forced shift to adopting remote working regimes has led to a rethinking of work patterns, stressing the importance of work-life balance and of rights to be further developed, such as the right to disconnect.

Relating to the "G" pillar, the most interesting trend concerns the use of ESG performance indicators in remuneration policies. This is especially noted in long-term incentive plans and plays a major role in enforcing ESG objectives.

6.2 What will be the longer-term impact of COVID-19 on ESG?

Although COVID-19 is not yet overcome, the reshaping of society allows us to forecast some of the more probable longer-term impacts of the pandemic on ESG.

Firstly, there has been a huge development in the digitalisation of society, which has obvious environmental gains but also raises concerns, with some sectors of the population (elderly and poor people) not having easy access to the necessary technology.

Secondly, COVID-19 has also represented a huge shift from how companies used to be run, which poses interesting challenges in their governance. The flexibility in working from home, workplace safety and employee mental and physical well-being are all concerns that are expected to be increasingly addressed by companies. In fact, healthcare is starting to be seen as a component of ESG criteria, since the pandemic has stressed very well how important it is for the basic functioning of society and the economy.

Lastly, an interesting parallel may be drawn between COVID-19 and the climate crisis. Due to its very clear and palpable effects, COVID-19 has led governments all over the world to stop business as usual and forced them to come up with new and innovative solutions to solve this crisis; the results have been tremendous, with the rapid production of several vaccines being the paramount example. This means that, if the climate crisis was treated with the same urgency (or at least some of it) as the pandemic, we could now be in a less disturbing situation. It is desirable that the way COVID-19 is being tackled is seen as an example to follow and has increased the will of different stakeholders to increase investment in ESG practices leading to a greener, fairer, and more equal society.

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Paulo also chairs the General Meeting Board of the Portuguese Banking Association and of the Portuguese Observatory of Regulatory and Compliance, as well as the General Meeting Board of several financial institutions. He is coordinator of Governance Lab, an independent research group dedicated to corporate governance, and a member of the Drafting Committee of the *Financial Law and Capital Markets Journal*, a member of the Scientific Commission of the *Competition and Regulation Journal*, and a member of the Monitoring Committee of the IPCG Corporate Governance Code. He is former Director of the Portuguese Securities Market Commission (CMVM – *Comissão do Mercado de Valores Mobiliários*).

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In 2016, the United Nations Environment Programme reported that "the financial sector in South Africa has been a leader and an innovator in integrating environmental, social and governance (**ESG**) issues into its practices". Regulation has been a key driver of ESG integration in South Africa. In this regard, the main substantive ESG-related regulations create an enabling environment for ESG, and are as follows:

For pension funds, Regulation 28 of the Pension Funds Act, 1956 requires a pension fund and its board to "before investing in and whilst invested in an asset consider any factor which may materially affect the sustainable long-term performance of the asset including, but not limited to, those of an environmental, social and governance character". The Regulation does not prescribe what ESG factors must be considered, instead requiring *any* factor that may materially affect the sustainable long-term performance of an asset to be considered.

- Environmental aspects of concern in South Africa include climate change, energy, water scarcity and usage, biodiversity, destruction of natural habitats, pollution, and waste management.
- Social issues include employment and labour issues, employee benefits, diversity, health and safety, human rights, community relations, and the manner in which broad-based black economic empowerment (**B-BBEE**) (government policy and legislation aimed at redressing historical race-based inequalities) is advanced.
- Governance matters include corporate structure and management, strategic direction and oversight, compliance, anti-bribery and corruption, board composition, and executive compensation.

The Financial Sector Conduct Authority (**FSCA**), a regulator, has issued guidance on Regulation 28 that makes the consideration of ESG factors integral to evaluating the sustainability of an asset. It describes "sustainability" as "the ability of an entity to conduct its business in a manner that primarily meets existing needs without compromising the ability of future generations to meet their needs". Conducting business sustainably includes managing the interaction of the business with the environment, the society and the economy in which it operates, towards a better long-term outcome. Evaluating the sustainability of the business of an entity includes the consideration of economic factors and ESG factors. The "sustainability of an asset" implies the sustainability of the entity giving rise to the underlying value of the asset.

While Regulation 28 applies to pension funds, it has had a marked influence on the ESG practices of other institutional investors and asset managers in South Africa.

Insurers, including life insurers, non-life insurers and reinsurers, are required to prepare their investment policies in accordance with Prudential Standard GOI 3, issued by the Prudential Authority (**PA**). This requires an insurer's investment policy to, among other things: (i) set out the insurer's strategy for investing, including asset allocation strategies and how these will be managed; and (ii) take into account any factor that may materially affect the sustainable long-term performance of assets, including ESG factors.

The Public Investment Corporation (**PIC**) Amendment Act, 2019 was signed into law in 2021. In terms of the amendment, the PIC, a state-owned company responsible for managing public pension fund assets, is now explicitly required, when investing deposits, to consider "the benefit of the members or beneficiaries of the respective depositors" and "the corporation must, as far as possible, seek to invest to … promote sustainable development". The PIC is by far the largest asset management firm in Africa with over R2 trillion worth of pension fund assets.

Specific ESG-related laws and regulations have also been promulgated, for example, in respect of carbon tax, energy efficiency, and a national minimum wage.

A revised draft Code for Responsible Investing in South Africa (**CRISA**) 2.0, a voluntary initiative that seeks to guide institutional investors in developing and implementing sustainable, responsible and long-term investment strategies, was published for comment in November 2020. It sets out various principles and practice recommendations with a clear emphasis on ESG and broader sustainable development issues. It also proposes a shift from an "apply or explain" to an outcomes-based, "apply and explain" application regime. Draft principle 1 of the revised draft CRISA contemplates: "Investment arrangements and activities reflect a systematic approach to integration of sustainable finance practices, including the identification and consideration of materially relevant ESG and broader sustainable development considerations." Principle 2 places a greater emphasis on the diligent discharge of stewardship activities: "Investment arrangements and activities demonstrate the acceptance of ownership responsibilities (where applicable) and enable diligent discharge of stewardship duties through purposeful engagement and voting." Its practice recommendations propose that "investment arrangements and activities should incorporate mechanisms that support the diligent discharging of stewardship duties generally and particularly as it relates to ESG and broader sustainable development concerns".

The above are also supplemented by a well-developed corporate governance framework in various laws and the King Codes prepared by the Institute of Directors of Southern Africa, of which the King IV Report on Corporate Governance for South Africa, 2016 (**King IV**) is the latest iteration. King IV sets out 17 principles that an organisation either must or should apply in order to substantiate a claim that it is practising good governance, reflected in four outcomes: ethical culture; good performance; effective control; and legitimacy. Many asset owners and investment managers subscribe to King IV and take it into account in their governance. Insurers and public companies whose shares are listed on the Johannesburg Stock Exchange (**JSE**) are obliged by the JSE Listings Requirements to apply King IV, and report on their application of King IV principles and recommendations in their annual integrated reports.

King IV regards sustainability as an element of the value creation process relevant to all organisations, and emphasises sustainable development as "a primary ethical and economic imperative". Principle 17 of King IV recommends that the board of an institutional investor should ensure that responsible investment – an approach that incorporates ESG factors into investment decision making, to better manage risk and generate sustainable long-term returns – is practised by the organisation to promote good governance and the creation of value by the companies in which it invests. To this end, an organisation must adopt a recognised responsible investment code, principles and practices.

Principle 3 of King IV, with respect to pension funds only, requires that the board should ensure that the fund is seen to be a responsible corporate citizen, which requires that its investment analyses and practices take account of sustainability, including ESG considerations.

1.2 What are the main ESG disclosure regulations?

Under the current disclosure regime in South Africa, there is no explicit duty to provide disclosures on ESG matters. However, JSE-listed companies are subject to general continuing disclosure obligations under the JSE Listings Requirements, which apply to financially material ESG issues. Additionally, the JSE requires JSE-listed companies to annually report, on an "apply and explain" basis, the extent to which they have complied with King IV. This is often in an integrated report, which King IV describes as a "concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term". ESG is an important aspect of the integrated report, informed by guidance and standards from several frameworks, including the Global Reporting Initiative (**GRI**), International Integrated Reporting Committee (**IIRC**), the Financial Stability Board's Task Force on Climate-related Financial Disclosures (**TCFD**) and the Sustainability Accounting Standards Board (**SASB**). JSE-listed companies publish ESG and/or sustainability reports annually.

The EU regulation on sustainability-related disclosure in the financial services sector (**SFDR**) came into effect on 10 March 2021. The SFDR lays down "harmonised rules for financial market participants and financial advisers on transparency regarding the integration of sustainability risks, the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products". The SFDR is expected to be influential in the development of mandatory disclosure of ESG matters in South Africa.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

King IV recommends that the responsible investment code adopted by an institutional investor in terms of Principle 17, and the application of its principles and practices, should be disclosed. CRISA Principle 5 recommends that "institutional investors should be transparent about the content of their policies, how the policies are implemented and how CRISA is applied to enable stakeholders to make informed assessments". The draft revised CRISA goes a step further by incorporating into each of the other principles focused implementation and reporting elements, in addition to a transparency principle.

Given these recommendations (and pressure from beneficiaries and other stakeholders), institutional investors often publish ESG policies and/or ESG reports, as well as *ad hoc* communications in respect of ESG matters. The FTSE/JSE Responsible Investment Index Series and FTSE ESG Ratings have been influential in promoting ESG disclosures. South Africa's level of ESG disclosure is one of the highest rated in the world among emerging and developed markets assessed by FTSE.

On climate change, the TCFD recommendations, which seek to improve and increase reporting of climate-related financial information, have had some influence locally and are used by NGOs in corporate accountability campaigns.

1.4 Are there significant laws or regulations currently in the proposal process?

The National Treasury, as part of its ongoing Sustainable Finance initiative, recently published a draft Technical Paper 2020: Financing a Sustainable Economy, the objectives of which are to:

- define sustainable finance for all parts of the South African financial sector including banking, retirement funds, insurance, asset management and capital markets;
- take stock of the global and national financial sector policy, regulatory and industry actions taken to date in dealing with environmental and social risks and opportunities;
- identify market barriers to sustainable finance and the implementation of environmental and social risk management best practices; and
- identify gaps in the existing regulatory framework and recommend actions required of regulators, financial institutions and industry associations.

The draft Technical Paper regards "sustainable finance" as an overarching concept that incorporates ESG and contains a number of ESG-related recommendations relevant to the financial sector and to specific participants within it, which recommendations indicate the potential future direction of law and regulation affecting the sector insofar as ESG is concerned. Pursuant to one of the recommendations, to "develop or adopt a taxonomy for green, social and sustainable finance initiatives, consistent with international developments, to build credibility, foster investment and enable effective monitoring and disclosure of performance", a draft taxonomy for green, social and sustainable finance initiatives for the South Africa financial services industry has been developed and in June 2021 was circulated for commentary. An updated draft is expected to be released in the fourth quarter of 2021.

The draft Technical Paper was developed by a working group involving around 50 stakeholders, including regulatory agencies and industry associations: the South African Reserve Bank

(**SARB**); the FSCA; the PA; the Department of Environmental Affairs (**DEA**); the South African Insurance Association (**SAIA**); the Banking Association of South Africa (**BASA**); the Association for Saving and Investment South Africa (**ASISA**); the JSE; and Batseta – Council of Retirement Funds (**Batseta**).

1.5 What significant private sector initiatives relating to ESG are there?

CRISA is a significant private sector initiative for advancing ESG and sound stewardship practices in South Africa, particularly given its broad and influential membership. The revised draft CRISA code mentioned above retains similar core concepts to the first code but has introduced some shifts to align with global and local developments.

In 2011, Batseta launched the Sustainable Returns for Pensions and Society project, which set out to empower South African retirement funds to comply with Regulation 28 of the Pension Funds Act and CRISA. The project featured extensive consultation with the South African retirement investment industry over a two-year period and culminated in the release in 2013 of Responsible Investment and Ownership – A Guide for Pension Funds in South Africa. The Responsible Investment and Ownership Guide seeks to promote responsible investment by supporting South African retirement funds with the integration of ESG considerations into their investment processes. It provides guidance on the development of the policies, procedures and protocols necessary to meet the requirements of best practice, including those set out in Regulation 28 of the Pension Funds Act.

The JSE was the first stock exchange globally to introduce a sustainability index measuring companies on indicators related to ESG. Since 2015, the JSE has partnered with FTSE Russell, the global index provider, to establish the FTSE/JSE Responsible Investment Index Series. It has adopted the FTSE ESG Ratings methodology, and aligned with FTSE Russell's ESG criteria and assessment process. This enables eligible JSE-listed companies to form part of a global group of corporates whose disclosure practices are assessed against ESG factors. The comprehensive methodology and expanded access to data provide investors with increased opportunities to integrate ESG considerations into their investments. The JSE also runs an annual Responsible Investment/ESG Investor Briefing to enable investor engagement on ESG issues.

In the growing impact investing space, which is investing with the intention to generate social and/or environmental impact in addition to financial return, the recently established National Task Force for Impact Investing South Africa is a coalition of public and private sector high-level decision makers whose role is to identify gaps on the supply and demand sides of the impact investing market in South Africa and work together to address those. The Task Force's mission is to accelerate and "increase the deployment of capital that optimises financial, social and environmental returns".

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Due to its role in capital distribution, the financial services sector is integral to achieving sustainable development. Generally speaking, institutional investors and asset managers in South Africa recognise the importance of ESG and are taking steps to improve integration of ESG into their operations. As noted above, pension funds, insurers and the PIC are obliged by regulation to take account of ESG factors in their investment activities. Trade associations and industry bodies in the financial sector have been influential in promoting ESG in South Africa, through the development and adoption of industry standards and guidelines (for example, through participation in the National Treasury's Sustainable Finance initiative described above).

In line with international trends, university endowment funds are under increasing pressure to become more sustainable. The University of Cape Town established a University Panel for Responsible Investment (**UPRI**) committee to oversee the institution's approach to responsible investment as it relates to its endowment fund. The UPRI recently developed a Responsible and Sustainable Investment Policy. Additionally, the UCT Retirement Fund also surveyed its members for their opinions on responsible investment and sustainability issues, which led to the appointment of a new investment advisor with a strong ESG advisory and implementation track record. The Fund is also in the process of amending its investment policy. As thought leaders with considerable endowments, universities can exert influence through integrating ESG into their investment practices.

Investors are able to influence ESG conduct through their investment mandates and investment management agreements concluded with investment managers.

The majority of investors and asset managers support CRISA and apply its principles, though the manner in which they do so varies considerably. As mentioned previously, many institutional investors will regularly publish ESG policies and sustainability reports dealing with ESG issues. There is also a growing number of ESG-related products being provided by the various asset managers.

Active ownership is encouraged by King IV and CRISA. The draft CRISA recommends institutional investors to: (i) demonstrate the acceptance of ownership responsibilities and enable diligent discharge of stewardship duties through purposeful engagement and voting; and (ii) adopt a collaborative approach where appropriate to promote acceptance and implementation of the principles of CRISA and other relevant codes and standards, to support the building of capacity throughout the investment industry and enhance sound governance practices.

Institutional investors have shown a willingness to engage collaboratively with companies and can exert considerable influence in driving change on ESG issues.

As regards pension funds, FSCA Guidance Notice 1 recommends that a fund's investment policy statement (**IPS**) and investment mandate reflects, among other things: (i) how the fund intends to monitor and evaluate the ongoing sustainability of the asset that it owns (or that it intends to acquire), including the extent to which ESG factors have been considered by the fund, and the potential impact thereof on the assets of the fund; and (ii) the fund's active ownership policy. It defines "active ownership" as the prudent fulfilment of responsibilities relating to the ownership of, or an interest in, an asset. These responsibilities include, but are not limited to:

- guidelines to be applied for the identification of sustainability concerns in that asset;
- mechanisms of intervention and engagement with the responsible persons in respect of the asset when concerns have been identified, and the means of escalation of activities as a holder or owner of that asset if these concerns cannot be resolved; and
- voting at meetings of shareholders, owners or holders of an asset, including the criteria that are used to reach voting decisions and the methodology for recording voting.

Where a fund holds assets that limit the application of ESG factors, sustainability criteria or the full application of an active ownership policy, the IPS should state the reasons why the limitation is advantageous to the fund and its members. Alternatively, the IPS should set out the remedial action the fund has taken (or intends to take) to rectify the position. If no such remedial action is being considered or taken, the fund may set out the reasons for that.

As of November 2021, there were 64 South African-headquartered signatories to the UN Principles for Responsible Investment (**PRI**). The PRI provides a framework for its international network of investor signatories to incorporate ESG factors into their investment and ownership decisions. In order for the financial services industry to effect significant change, a large part of the industry needs to subscribe to the same vision and the PRI framework is useful in achieving this.

Stewardship activities are relatively common, with King IV, and the principles in CRISA and the PRI, setting best practice. The draft CRISA has placed significant emphasis on stewardship activities. In practice, asset owners will often outsource stewardship activities, and sometimes the specific philosophy and approach for stewardship, to an investment manager to deal with pursuant to its contracted stewardship and ESG undertakings.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

A number of non-profit and public benefit organisations are involved in advocacy, engagement, stewardship activities and shareholder activism with a view to promoting ESG and exerting influence on institutional investors (such as pension funds, insurers and mutual funds) and asset managers.

The RAITH Foundation and Just Share seek to use "advocacy, engagement and activism to support active ownership and responsible investment", and regularly propose resolutions on various ESG issues. Recent campaigns have sought to have resolutions tabled at listed companies' annual general meetings (**AGMs**), which would require the companies to disclose and/or report to shareholders on: climate risk; plans to address climate-related transition risks; assessments of greenhouse gas emissions in financing portfolios; and policies on lending to coal-fired power projects and coal mining operations, oil & gas, or carbon-intensive fossil fuel activities, and commit to a hard deadline for enhanced disclosures related to climate risk. These activities have been particularly successful in pushing climate-related and coal-lending policies and disclosures in the South African banking sector.

The Centre for Environmental Rights (**CER**) has a corporate accountability team that seeks to engage with companies, investors and industry associations to improve disclosures and transparency on the environmental impact of their activities, expose corporate failures to comply with environmental laws, and promote shareholder activism to compel compliance with environmental laws and disclosures It also engages in litigation on environmental matters.

King IV requires a company to have a stakeholder engagement policy, and with increasing awareness of ESG issues, companies can expect greater engagement from other stakeholders on these issues. Because there is an interdependent relationship between an organisation, its stakeholders, and the organisation's ability to create value, King IV advocates a stakeholder-inclusive approach "in which the governing body takes account of the legitimate and reasonable needs, interests and expectations of all material stakeholders in the execution of its duties in the best interests of the organisation over time".

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The National Treasury, which is overseen by the Ministry of Finance, is responsible for policy creation for private and public sector investment and as it relates to ESG. The SARB is responsible for developing appropriate monetary policy and overseeing the banking sector.

The Financial Sector Regulation Act, 2017 introduced a "twin peaks" model of financial sector regulation in South Africa, with the object of achieving a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in South Africa. It established two regulators: (i) the PA, within the SARB, tasked with prudential regulation; and (ii) the FSCA, tasked with market conduct regulation.

The PA is responsible for the prudential regulation of insurers. The FSCA's functions include regulating and supervising the conduct of various financial institutions (particularly in relation to the provision of financial services), including pension funds, insurers and collective investment schemes, in accordance with applicable "financial sector laws", including: the Pension Funds Act, 1956; the Long-term Insurance Act, 1998; the Short-term Insurance Act, 1998; the Financial Advisory and Intermediary Services Act, 2002; the Collective Investment Schemes Control Act, 2002; the Financial Markets Act, 2012; and the Insurance Act, 2017.

In order to achieve their respective objectives, the PA and the FSCA are empowered to make prudential standards and conduct standards, respectively, or joint standards, in respect of financial institutions. These standards relate to various matters including the governance and operation of financial institutions, and investment activities, including ESG. One such standard is the abovementioned Prudential Standard GOI 3, which requires an insurer's investment policy to consider ESG factors.

The JSE – which is a PRI signatory and a founding signatory of the Sustainable Stock Exchanges Initiative – is also a significant regulator insofar as listed companies are concerned, and has been very influential in promoting the adoption of King IV's recommended practices, and enhancing corporate transparency and performance regarding ESG and sustainability practices in South Africa.

All of the above regulators are taking part in the National Treasury's Sustainable Finance initiative described at question 1.4 above, and we expect the recommendations in the draft Technical Paper to be pushed by the regulators in the coming years.

2.4 Have there been material enforcement actions with respect to ESG issues?

There has been no material enforcement action with respect to ESG issues in the past year. However, with the increasing emphasis on ESG in South Africa, enforcement risk is expected to increase.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The principal ESG-related litigation risks concern inaccurate or misleading ESG reporting and disclosures, including in respect of climate change. From a securities law perspective, the

Financial Markets Act, 2012 makes it an offence to publish, in respect of past or future company performance, any statement, promise or forecast that is, at the time, and in the circumstances in which it is made, false, misleading or deceptive in respect of any material fact and that the person knows, or ought reasonably to know, is false, misleading or deceptive. The risk will rise as companies more regularly report to shareholders and stakeholders on their ESG conduct and with ESG concerns gaining increasing prominence in investors' choices.

There is also the potential for litigation in respect of a company's activities or performance, from an ESG perspective. Companies in natural resources and commodities industries are particularly exposed to ESG challenges and potential class actions, as was illustrated in the high-profile silicosis class action brought against more than 30 mining companies in 2015.

2.6 What are current key issues of concern for the proponents of ESG?

The main issue of concern for proponents of ESG is to move beyond virtue signalling and bare minimum compliance to a more proactive approach to ESG.

Different approaches to ESG in different industries and within industries make it difficult to compare ESG performance. Added to this is a lack of capacity and expertise in ESG, requiring training on ESG integration.

The lack of standardised reporting and disclosure on ESG makes achieving quality, comparable, relevant and timely disclosures difficult. Linked to this are difficulties associated with a plethora of different reporting standards. This has led BlackRock, the world's largest asset manager, to call for a single, globally recognised set of sustainability reporting frameworks and standards. In this regard, towards the end of 2020, the International Business Council of the World Economic Forum, in collaboration with the Big Four accounting firms, unveiled jointly developed ESG reporting standards with 21 core metrics and 34 extended metrics, addressing issues ranging from emissions to pay and gender ratios to governance targets.

In South Africa, screening out companies with questionable ESG further reduces an already relatively small investment universe for investors and asset managers.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The board of a company is primarily responsible for the management of the business and affairs of a company, including ESG. It is the board that sets and changes the strategy of a corporate entity with regard to ESG.

Pension funds have a board that is tasked with directing, controlling and overseeing the operations of the fund, including in respect of ESG issues and investment strategy, in accordance with applicable laws and the rules of the fund. Regulation 28 of the Pension Funds Act, 1956 specifically links the board's fiduciary duties with giving adequate consideration to ESG. The board of the fund consists of various subcommittees, including an investment subcommittee that is tasked with addressing the fund's investment activities and its investment strategy.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

As noted above, the board is primarily responsible for management of ESG issues. As to supervision thereof, public companies and those that attract high levels of public interest (measured with reference to a public interest score) are required to have in place a social and ethics committee (**SEC**). The function of the SEC is to monitor and report on various matters, including in respect of ESG-related matters.

The SEC is required to monitor a company's activities, having regard to any relevant legislation, other legal requirements or prevailing codes of best practice, with regard to matters relating to:

- social and economic development, including the company's standing in terms of the goals and purpose of the 10 principles set out in the United Nations Global Compact Principles, the Organisation for Economic Co-operation and Development (**OECD**) recommendations regarding corruption, the Employment Equity Act, 1988, and the Broad-based Black Economic Empowerment Act, 2003;
- good corporate citizenship, including its: (a) promotion of equality, prevention of unfair discrimination, and reduction of corruption; (b) contribution to development of the communities in which its activities are predominantly conducted or within which its products or services are predominantly marketed; and (c) record of sponsorship, donations and charitable giving;
- the environment, health and public safety, including the impact of the company's activities and of its products or services;
- consumer relationships, including the company's advertising, public relations and compliance with consumer protection laws; and
- labour and employment, including the company's standing in terms of the International Labour Organization Protocol on decent work and working conditions, and the company's employment relationships and its contribution towards the educational development of its employees.

The SEC is also required to draw matters within its mandate to the attention of the board as occasion requires. It also reports, through one of its members, to the shareholders at the company's AGM on the matters within its mandate.

ESG conduct and reporting is ultimately undertaken for the benefit of shareholders and stakeholders. Shareholders conceivably have the most significant role to play in holding management accountable with respect to ESG. This is achieved through engagement, stewardship activities and shareholder activism, all of which are gaining prominence. Shareholders also have the ability to elect board members or to ultimately divest. Investors also play an important role through their investment choices.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

The practice within JSE-listed companies of including ESG performance measures governing the vesting of short-term and long-term incentives is gathering momentum, with increased focus by institutional investors and other stakeholders on ESG outcomes. Examples of such ESG-related performance conditions include safety (Long Time Injury Frequency Rate and Fatalities), measures of ESG training and compliance, risk metrics, environmental and safety "near misses", greenhouse gas emissions, water usage, employment of members of nearby communities, and measures of transformation, diversity and inclusion.

When present, the weighting of ESG conditions ranges from 10% to 30% of the full scorecard.

Further explicit adjustments to reflect fatalities are also prevalent within South African listed mining companies.

Further remuneration provisions to address major ESG failures are included in malus (pre-vesting forfeiture) and clawback (post-vesting payback) conditions that are now being included in the variable remuneration policies of many JSE-listed companies. Examples of such malus and clawback ESG-related trigger events include fatalities, major environmental incidents such as spills and emissions, risk and compliance failures, gross negligence and bringing the company into disrepute.

Changes to section 30A of the Companies Act have been proposed that will require the disclosure of the pay gap between the highest-paid and the lowest-paid executives in a similar manner to that required by the US Dodd-Frank Act.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

It is increasingly common for companies (and most of the leading institutional investors) to adopt and publish an ESG policy or responsible investment policy that informs their approach to addressing ESG matters in their corporate and/or investment activities. An element of this is ESG risk management, which is becoming increasingly important, with companies putting in place more sophisticated processes to identify, manage and mitigate ESG risk.

Examples of how some companies integrate ESG into their daily operations are:

- fostering a corporate culture of ethics and appropriate conduct;
- taking ESG into consideration during risk assessments and due diligences of new business partners;
- employee training on ESG; and
- the continued implementation of COVID-19 safety protocols.

As regards the investment process, a 2019 study by the CFA Institute and PRI found that:

- governance issues are systematically incorporated into the investment process for equities and corporate bonds more than 50% of the time, but social and environmental issues are incorporated in similar ways only about 25% of the time. Survey respondents expect that environmental and social factors will be incorporated into equity values and bond yields more than 60% of the time by 2022;
- social factors appear to be incorporated into the investment process in South Africa more than in other markets visited; and
- regulation drives ESG integration in South Arica more than in other markets, as South Africa's listing standards and government regulations are more explicit about ESG disclosure requirements than those in other markets.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

International lending markets have embraced green loans and sustainability-linked loans (**SLLs**). Over the past four years alone, the volume of sustainable finance has grown 15 times. In South Africa, green and ESG initiatives and the related financings are no longer a theoretical aspiration, but are very much at the forefront for governments, banks and corporates. For example, Mediclinic, an international private healthcare services group, recently completed the refinancing of its Southern Africa division's existing debt through a new sustainability-linked banking facility. By achieving pre-agreed sustainability performance targets, Mediclinic Southern Africa will benefit from a reduced facility margin through an incentive-based pricing mechanism. The targets are directly linked to Mediclinic group environmental and social goals of progressing to becoming carbon neutral with zero waste to landfill by 2030 and improving water efficiency and patient experience.

Ultimately, sustainable finance transactions depend on the nature of each key performance indicator or sustainable performance target, and how measurable it is, as agreed between the borrower and lenders. The finance providers will likely look at several factors when assessing potential financings, with reporting and verification being of primary importance.

Thus far, providers of debt and equity finance have relied both on internally and externally developed ESG ratings, depending on the nature of the transaction and the borrower group. There is a growing trend internationally to ensure that there is at least external verification on an annual basis of borrowers' ESG ratings and to move away from self-certification by borrowers. It is likely that South African providers of debt and equity finance will follow this trend.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds and social bonds play a growing role in the South African market. South Africa is recognised as Africa's most-developed green bond market.

With regard to green bonds, local and international investors have increasingly allocated specific portfolio tranches to ESG themes, and the South African market has seen a significant increase in the issuance of green bonds in the last two years. The JSE actively supports the issuance of green and social bonds and has implemented standards for these types of bonds in amended Debt Listings Requirements (Sustainability Segment), which closely follow the International Capital Market Association (**ICMA**) Green Bond Principles. In 2017, the JSE became the first African exchange to launch a Green Bond Segment and Green Listings Rules.

Recently there have been issuances by institutions at various levels, ranging from development finance institutions to municipals, banks and corporates. Nedbank launched an innovative United Nations Sustainable Development Goals-linked bond in 2020, which represented South Africa's first "green" tier-two capital instrument. The proceeds of this bond go towards funding high-potential solar and wind renewable energy projects. The City of Johannesburg and the City of Cape Town have also (and respectively) issued green bonds to fund various green bond projects, such as Cape Town's water infrastructure and Johannesburg's dual-fuel buses. We expect to see more green bond issuances in the next year.

With regard to social bonds, this is still a relatively new area to the South African market, although it continues to develop. The JSE is currently amending its Debt Listings Requirements to accommodate and prescribe regulations for social bond issuances. Due in part to the health crisis caused by COVID-19 and the loss of the sovereign investment-grade rating, the South African government is facing notable funding requirements and recently considered the issuance of a social bond, the proceeds of which would go towards supplies, staff and equipment in order to fight the COVID-19 crisis in South Africa.

4.3 Do sustainability-linked bonds play a significant role in the market?

Yes, the sustainability-linked bond (**SLB**) market is taking off at a rapid rate in South Africa, with many commercial property companies already issuing SLBs this year. As mentioned above, the JSE is currently amending its Debt Listings Requirements to accommodate SLBs – these requirements will closely follow the ICMA Sustainability-Linked Bond Principles.

4.4 What are the major factors impacting the use of these types of financial instruments?

Some of the main factors driving growth include the UN Framework Convention on Climate Change (the Paris Agreement), which reached consensus to combat climate change and intensify all actions and investments needed for a sustainable, low-carbon future. This includes reducing greenhouse gas emissions by 40% by 2030 and becoming carbon neutral by 2050.

The EU Taxonomy has also been a key driver internationally. It effectively operates as a classification system designed, among other things, to:

- create a uniform and harmonised classification system, which determines the activities that can be regarded as environmentally sustainable for investment purposes across the EU; and
- provide all market participants and consumers with a common understanding and language of which economic activities can unambiguously be considered environmentally sustainable/green.

The National Treasury is currently looking to implement similar measures to classify economic activities in South Africa. The South African working group advising the National Treasury recently released a draft Green Finance Taxonomy.

Furthermore, key loan organisations such as the LMA, APLMA and LSTA have jointly produced the Sustainability Linked Loan Principles and the Green Loan Principles. These are high-level market standards to promote the development and integrity of these loans by encouraging a consistent approach, while recognising, in particular for SLLs, the need for flexibility across sectors. These standards have had and continue to have an impact in the South African context.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

It depends on which green bond compliance framework the issuer is using. According to the ICMA Green Bond Principles (which have been endorsed by the JSE), it is required for issuers to confirm green eligibility criteria and use of proceeds in order to "qualify" for the Green Segment.

It is usual for the issuer to appoint an external reviewer (known as an "independent sustainability advisor") who provides an external review with regard to the issuer's compliance with the Green Bond Principles. The independent sustainability advisor will check and verify the issuer's green bond against the Green Bond Principles and provide certification under the Climate Bond Standards (as appropriate). It is also common practice for the independent sustainability advisor to verify that the green bond has been approved in accordance with respective national and/or regional government regulations.

Currently, South Africa does not have specific green bond regulations at the government level.

It is also worth noting that for sustainability-linked instruments, self-verification of the borrower's performance post-signing is no longer recommended as an option under the revised (and internationally recognised) Sustainability Linked Loan Principles, which means that independent and external verification is required.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

There is a general sense that stakeholders and investors are paying more and closer attention to ESG and questions of sustainability in the light of the unprecedented systemic shock inflicted by the pandemic.

COVID-19 has highlighted the inequality that is prevalent in South African society and as ever, poorer citizens have been impacted disproportionately. This has led people to change their approach to social issues and the impending climate crises, the next systemic shock.

The onset of the pandemic and the uncertainties associated with it, have, in many instances, prompted companies to change how they manage their human capital and to prioritise employee health and well-being.

Crises tend to accelerate change and it appears that the take-up of ESG and sustainability issues has accelerated as a result of the pandemic.

6 Trends

6.1 What are the material trends related to ESG?

ESG will become a core strategic concern for corporates, driven by exogenous and endogenous factors and pressures, including a shift towards a more stakeholder-inclusive capitalism.

Climate change is the key ESG challenge of the coming decades, which we expect will be a dominant theme as governments, investors, regulators and pressure groups increase engagements around climate change.

The trend of increasing pressure on companies and institutional investors to tackle ESG issues is likely to continue. Stakeholders are becoming increasingly proactive in engaging with institutional investors and asset managers on the integration of ESG factors into their decision making and are facing increasing scrutiny of their investment activities and AGM voting records. They in turn are taking a more proactive stance on ESG and in holding management to account on ESG issues.

The EU is intending to launch a carbon border tax adjustment, which will see carbon import taxes imposed on carbon intensive goods. South Africa is particularly at risk of such import levies due to its heavy reliance on coal-generated power. South Africa can expect similar future exogenous pressures as countries attempt to meet their climate change goals. Investment firms will accordingly gravitate towards less-carbon-intensive investments.

ESG-related shareholder activism, which has picked up in recent years, is likely to become more prevalent and sophisticated. Economic activists will also leverage poor performance on ESG to bolster activist campaigns.

ESG and sustainability disclosures and reporting will continue to remain an area of focus, with a gradual shift towards more standardised reporting expected to take place. Linked to this, demand for ESG data, assurance and verification is likely to increase, with improved technology and AI enhancing our ability to interrogate and draw insights from data on ESG factors.

Banks and lenders will take ESG risk into account more than has historically been the case. The shift is already under way in the South African banking sector.

There has been a significant growth in green bonds, green loans, SLLs and bonds. This is due to a number of factors, including the regulatory regime, investor-driven sentiment and the harmonising of market standards, with SLLs being particularly popular because of their flexible nature – we have therefore seen a significant increase of SLLs and SLBs already since the start of 2021.

Recently, several of South Africa's largest institutional investors have committed to using ESG metrics in screening potential investments. Ninety One, South Africa's largest listed asset manager, has also recently become signatory to the Net Zero Asset Managers Initiative, which aligns institutional investing with the global goal of achieving net zero carbon emissions by 2050.

More ESG products are likely to be developed (for example, Old Mutual launched South Africa's first ESG equity fund in June 2020), and more capital is expected to flow towards such products as demand for ESG-friendly assets grows, particularly as millennial investors begin to drive investment activity.

With ESG coming to the fore, executive compensation will be linked, at least partly, to ESG-related metrics.

6.2 What will be the longer-term impact of COVID-19 on ESG?

It is too early to tell what the longer-term impact of COVID-19 on ESG will be.

A poll conducted by JP Morgan of investors from 50 global institutions revealed that the vast majority of investors believe that the pandemic will increase awareness and actions globally to tackle climate change.

In South Africa, there is a general sense that we need to do things better going forward, to shift towards a more environmentally and socially responsible transition from currently unsustainable business models. ESG and sustainability have, rather than fall by the wayside, gained momentum as a result of the pandemic.

As mentioned, COVID-19 has had a devastating impact on society and particularly on those most vulnerable in our societies. Going forward, it is likely that there will be increased awareness around social issues as more people recognise the importance of the social aspect in ESG. Businesses' approach to ESG will be more holistic as they realise that uplifting communities is equally vital to business success as the reduction of carbon emissions.

Acknowledgments

The authors would like to thank Martin Hopkins, a partner at Bowmans, for his input on questions 3.3 and 3.4, Jason Wilkinson, a partner at Bowmans, for his input on questions 4.1–4.5 and 6.1, and Joshua Peebles, a candidate attorney at Bowmans, for helpful research assistance.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In Spain, the main substantive ESG-related regulations are:

- Law 11/2018, of 28 December, approving the Code of Commerce, the revised text of the Capital Companies Act approved by Royal Legislative Decree 1/2010, of 2 July, and Act 22/2015, of 20 July, on the Audit of Accounts, in relation to the non-financial information and diversity aspects that companies must include in the non-financial information report ("EINF") (hereinafter, "Law 11/2018").
  - Law 11/2018 transposes the Non-Financial Reporting Directive (Directive 2014/95/EU) of the European Parliament and the Council. The law introduced a series of changes in the Spanish Commercial Code (*Código de Comercio*) relating to non-financial information and the different documentation that must be included in the EINF.
  - The Corporate Enterprises Act (*Ley de Sociedades de Capital*, or "LSC") is also modified by Law 11/2018, stating that company directors shall be obliged to include the EINF in the annual accounts in addition to the management report, where appropriate.
  - Article 262 of the LSC specifies that Law 11/2018 applies regarding compliance with the EINF to entities considering the number of employees, turnover, and assets.
- Law 9/2017, of 8 November, on Public Sector Contracts, which contemplates the incorporation of social and environmental criteria in a cross-cutting and mandatory manner in the public procurement process.
- Regarding Governance:
  - Royal Legislative Decree 1/2020, of 2 July, approving the consolidated text of the LSC, which has been recently amended to include some issues regarding good governance principles in the governing bodies of corporate enterprises.
- Regarding Environment:
  - Law 7/2021, of 20 May, on Climate Change and Energy Transition (*Ley Cambio Climático*) (hereinafter, "Law 7/2021").
  - Royal Decree-Law 15/2018, of 5 October, on urgent measures for Energy Transition and Consumer Protection. A statute that promotes the integration of renewable energy and energy efficiency in Spain, in part through providing fiscal incentives for energy generation, and allows citizens to produce their own energy without charges or registration.
  - Royal Decree 617/2017, of 16 June, regarding alternative energy vehicles. A law that regulates how the Spanish government grants aid to consumers who purchase alternative energy vehicles. The law also expands electric vehicle charging sites.
  - Royal Decree 564/2017, of 2 June, on the certification of energy efficiency in buildings. A law that sets energy efficiency standards for new buildings and provides for certification of energy efficiency in new and existing buildings.
  - Law 22/2011, of 28 July, on Waste and Contaminated Soils.
  - Law 26/2007, of 23 October, on Environmental Responsibility.
- Regarding Social:
  - Royal Decree-Law 28/2020, of 22 September, on Remote Work.
  - Royal Decree-Law 6/2019, of 1 March, on urgent measures to guarantee equal treatment and opportunities between women and men in employment and occupation.
  - Royal Decree 901/2020, of 13 October, regulating equality plans and their registration.
  - Royal Decree 902/2020, of 13 October, on Equal Pay for Women and Men.

1.2 What are the main ESG disclosure regulations?

As mentioned above, Law 11/2018 is the ESG disclosure regulation.

The transitional provision regulates that three years from the entry into force of Law 11/2018, ESG reporting shall be applicable to all companies with more than 250 employees that either have the consideration of public interest entities in accordance with legislation on the auditing of accounts, or, for two consecutive financial years, meet, at the closing date of each of them, at least one of the following circumstances: (i) the asset total exceeds EUR 20,000,000; or (ii) the net amount of annual turnover exceeds EUR 40,000,000. Given that the law came into force in 2018, companies that meet the above requirements for the current fiscal year, 2021, will have to submit their EINF, which means that, in Spain, approximately another 3,000 companies (in addition to those obliged to do so since 2018) should start reporting their non-financial information by the end of June 2022.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

Law 11/2018 is sufficiently broad to cover almost all ESG criteria commonly used in the market. From the review of EINFs of listed companies, the following advantages of good non-financial reporting stand out: (i) cost savings by implementing environmental measures; (ii) improved reputation; (iii) employee pride in the company; (iv) ease of public procurement; (v) easier access to large companies; (vi) access to new markets; and (vii) anticipation of new regulations. Some of the ESG voluntary disclosures that are made beyond those required by law are:

- concern for sustainability;
- collaboration with Médecins Sans Frontières ("MSF");
- increasing use of renewable energy;
- approval of new and more ambitious decarbonisation targets;
- an increase in digitalisation to achieve a more sustainable, circular and decarbonised world;
- a reduction in the waste produced;
- defence of the rights of children through associations such as MSF;
- advocacy for children's rights through associations such as UNICEF; and
- establishing a 360° vision of sustainability, and anti-corruption policies.

1.4 Are there significant laws or regulations currently in the proposal process?

In relation to the EU, there are a number of proposals for ESG regulations in the short term that will be applicable in Spain.

The European Commission has carried out a series of consultations on the EU Taxonomy, including an EU Sustainable Finance Platform Consultation on Taxonomy (until 6 September 2021) and a Public Consultation on the Draft Report of the Sustainable Finance Platform GTT on the preliminary recommendations of the technical screening criteria for the remaining four environmental targets and some additional activities according to the criteria for the climate targets of the Taxonomy.

The European Commission believes that, by the end of 2021, it will adopt a decision extending the regulatory framework for ecolabels to financial products.

In July, the European Commission published a proposal for a regulation for the establishment of a voluntary European Green Bond Standard ("EUGBS").

On 2 August 2021, the European Commission published, in the Official Journal of the European Union, the following delegated acts for the integration of sustainability considerations in:

- Undertakings for Collective Investment in Transferable Securities ("UCITS");
- the Alternative Investment Managers Directive; and
- the Markets in Financial Instruments Directive, which includes: Delegated Regulation (EU) 2021/1255, of 21 April, amending Delegated Regulation (EU) 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers; Delegated Directive (EU) 2021/1270, of 21 April, amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for UCITS; Delegated Directive (EU) 2021/1269, of 21 April, amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations; and Delegated Regulation (EU) 2021/1253, of 21 April, amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.

Furthermore, the International Organization of Securities Commissions held a consultation in July on ESG ratings and data product providers.

In Spain, in June 2021, the National Securities Market Commission (*Comisión Nacional del Mercado de Valores*, or "CNMV") issued a statement on the application of Regulation (EU) 2019/2088, of 27 November, on sustainability disclosures in the financial services sector ("SFDR"). Because of this Regulation, the CNMV made available a Q&A document on the sustainability regulation applicable to financial products, clearly stating that the SFDR does not define sustainable economic activities (competence of the Taxonomy Regulation) but rather sustainable investments.

A significant change in the SFDR will be made by the revision of the Non-Financial Reporting Directive, where there is a proposed change in name to the Corporate Sustainability Reporting Directive; no doubt that all stakeholders have an interest in ensuring that ESG reporting must be globally comparable.

In April, the state official newsletter, the *Boletin Oficial del Estado*, published Law 5/2021, of 12 April, amending the LSC, regarding the promotion of long-term shareholder involvement in listed companies.

1.5 What significant private sector initiatives relating to ESG are there?

Significant private sector initiatives relating to ESG include:

1. The Transparency, Good Governance, and Integrity Cluster (*Clúster de Transparencia, Buen Gobierno e Integridad*), which is established as a business platform coordinated by Forética (https://foretica.org/) with the aim of promoting a sustainable corporate governance model and addressing different issues related to the management of ESG aspects.
2. *Cámara de Comercio de España* (https://www.camara.es/), which offers sustainability as a transformation lever for small and medium-sized enterprises.
3. The Sustainable Financial Institutions Programme (*Programa de Entidades Financieras Sostenibles*), the aim of which is to provide specialised knowledge to prepare for regulatory changes and to integrate them into the financial entity in an effective way, to direct capital flow towards green transformation and to understand the role of the financial industry in the financing of the green economy.
4. The Spanish Group for Green Growth (https://grupocrecimientoverde.org/), which is an association created to promote public-private collaboration and jointly advance in environmental challenges. The solutions for mitigating and adapting to climate change, the decarbonisation of the economy and the promotion of a circular economy will undoubtedly come from the business sector and are key to a prosperous society.
5. Orkestra, which is an initiative of the University of Deusto for the study of competitiveness and regional development through different lines of research. Among its goals is promotion of the improvement of citizens' wellbeing through transformative research that has become an international model in the analysis of regional competitiveness in a global environment (https://www.orkestra.deusto.es/es/).
6. The Spanish forum "Spainsif", created by various Spanish companies to promote socially responsible investment in Spain (https://www.spainsif.es/).

7. Ship2B Foundation, whose aim is to boost the impact economy, with the main purpose of helping start-ups, businesses, investors and organisations to maximise profitability while improving their social and environmental impact (https://www.ship2b.org/).

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors have widely integrated ESG aspects into their decision-making.

Sustainability is a determining factor in the investment thesis for asset managers through three fundamental channels that form the fundamental axes of action for investors: (i) asset selection under sustainability criteria; (ii) the search for ESG impacts; and (iii) stewardship.

The five steps of stewardship for investors, through which they exert influence are: voting at shareholder meetings; engagement in investee companies; presence on boards of directors; taking part in activist campaigns; and participation in litigation.

In addition, investors will coordinate their ESG policies as a lever for change in companies through collaboration.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Other stakeholders' views on ESG are that: (i) companies should be encouraged to create specific sustainability committees to oversee the non-financial aspects of companies; (ii) sustainability should be an objective competence included in the competencies of the board of directors and those members of the board who have been attributed sustainability functions should have experience in this area; (iii) the board of directors is ultimately responsible for the management and reporting of climate-related and non-financial information; (iv) the governing body should ensure that policies and procedures comply with ESG criteria in the long term; and (v) the board should be responsible for approving the sustainability strategy in line with the Sustainable Finance Action Plan.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In this case, the main regulator in Spain in relation to ESG issues is the EU.

Currently, the most relevant issue is the revision of the Non-Financial Reporting Directive as all stakeholders have an interest in ensuring that ESG reporting is globally comparable, and in the impact that the new Corporate Sustainability Reporting Directive will have on Law 11/2018.

It is also worth mentioning that Law 7/2021 and the National Integrated Energy and Climate Plan (2021–2030) (*Plan Nacional Integrado de Energía y Clima*, or "PNIEC") define the objectives for the reduction of greenhouse gas emissions, the penetration of renewable energies and energy efficiency. Law 7/2021 also defines the most appropriate and efficient course of action, as well as ESG reporting.

2.4 Have there been material enforcement actions with respect to ESG issues?

An EINF must be filed, by certain companies, in the Commercial Registry, jointly with the annual management report. Failure to file by the established deadline will result in the imposition of a fine on the defaulting company.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

The principal ESG-related litigation risk, as indicated in question 1.1 by the list of regulations in force in Spain, is non-compliance with any of their provisions, e.g., failure to comply with the workers' equality plan, failure to comply with the reporting obligation, etc., which can be grounds for a claim by the person concerned.

As far as we know, there has been no material litigation with respect to ESG issues, although there have been some ESG-related disputes:

- In September 2020, the Supreme Court admitted the administrative appeal filed by non-governmental organisations Greenpeace, *Ecologistas en Acción* and *Oxfam Intermón* against the Spanish government for not complying with the Paris Agreement. The claimants alleged that the Spanish government was in infringement of Regulation (EU) 2018/1999, of 11 December, on the governance of the Union and Energy and Climate Action, which established that the Spanish government should have approved the PNIEC and a long-term strategy with definitive character in December 2019.
- In March 2021, the European Court of Human Rights sentenced Spain for the police action in "*Rodea el Congreso*", which took place on 12 May 2012, for a violation of Article 3 of the European Convention on Human Rights. The lawsuit is based on the complaint of a protester who stated that she had been forcibly and humiliatingly removed from a bar where she had taken refuge from the disturbances.

In conclusion, it is worth noting that the risks that a company may face if it does not have a sustainability policy include a private person claiming damages for not having an EINF that includes all the information related to ESG criteria. It may also face sanctions from the Spanish state for not fulfilling the provisions of the law relating to sustainability and social issues.

2.6 What are current key issues of concern for the proponents of ESG?

One issue of concern for ESG proponents is the lack of comparability in reporting; i.e., there is no comparable reporting between the different companies that carry out non-financial reporting.

Another issue of concern is related to greenwashing, which is the misleading or misperception of the public by emphasising the environmental credentials of a company, person, or product when these are irrelevant or unfounded. Many companies today take advantage of this situation by trying to exploit certain buzzwords in society and on their product labels, such as "sustainable", "ecological" or "natural", in order to sell more, even if their activities continue to pollute in the same way as they always have done.

Law 11/2018 regulates that the State Council on Corporate Social Responsibility (*Consejo Estatal de Responsabilidad Social de las Empresas*, or "CERSE") (https://www.mites.gob.es/es/rse/cerse/index.htm) will issue an annual report on the quality of the relevance, neutrality, materiality, completeness, sustainability context, accuracy, clarity, comparability, and reliability of the information disclosed in the ESG reports. Among CERSE objectives is the search for the greatest possible homogeneity in the reports on social responsibility and sustainability that companies and organisations make public.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The principal responsibility for addressing ESG issues lies with the company administration (the management body).

Ultimately, addressing ESG issues is nothing more than the application of common sense in the business world, meaning: taking care of resources, which are finite (i.e., making conscious use of them that does not compromise future generations); taking care of people, because they are the differential asset of a company as proven in particular by the pandemic; and taking care of organisations, because the better we govern them, complying with the rules and being transparent, the more efficient they will be.

Spanish companies must comply with the law regarding EINFs, which is a management body task. As discussed, companies with an average number of employees exceeding 250 in the fiscal year 2021 must prepare an EINF. EINFs have been included in the obligations of all companies to disclose their financial information, through the annual accounts, regulated in Title VII of the LSC. Three months after the end of the financial year, the directors, in addition to preparing the annual accounts, must also prepare an EINF or ESG report, so they should address those issues in order to be ready for such disclosure.

To disclose the information required by the law, the management body should provide information regarding the evolution, results, and situation of the company, the impact of its activity with respect to environmental and social issues, how human rights are respected and how it fights against corruption and bribery, as well as what impact its activity generates with respect to personnel, including the measures that have been adopted to favour equal treatment and opportunities between women and men, non-discrimination and inclusion of people with disabilities and universal accessibility.

Furthermore, the EINF should respond to the following issues:

- environmental (pollution, circular economy, use of resources, climate change, and protection of biodiversity);
- social and personnel (distribution of employment, work organisation, health and safety, social relations, training, accessibility, and equality);
- issues in respect of human rights;
- issues on the fight against corruption and bribery; and
- in a sort of "catch-all", information on issues of society, ending with the devastating phrase: "Any other information that is significant."

So, the role of the management body regarding ESG should be:

- to nominate a specialised committee;
- the supervision of compliance with the company's ESG policies and rules;
- to develop internal codes of conduct;
- to communicate internally as well as with shareholders and investors, proxy advisors and other stakeholders;
- periodic evaluation and review through a monitoring process; and
- supervision and evaluation of stakeholder engagement processes.

Overall, the goal must be to improve decision-making and external disclosure. A crucial element of this transformation is to have understandable, comparable, and relevant ESG information.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

The boards of directors of listed companies will have to ensure an adequate policy of sustainability in environmental and social matters as a non-delegable power of the company administration and provide transparent information on its development, application, and results.

In this regard, it is advisable to develop the recommended minimum content of the social responsibility or sustainability policy on environmental and social matters, whose approval corresponds to the board of directors (Article 529 *ter* of the LSC), and to establish the principle of maintaining transparent communication based on the need to report on both financial and non-financial aspects of the business.

It is also recommended that companies' oversight of sustainability should be assigned to an existing or new board committee, which should address sustainability on a regular basis, linked to the board's current oversight of risk management.

Sustainability policies in environmental and social matters should include at least:

- The principles, commitments, objectives and strategy regarding shareholders, employees, customers, suppliers, social issues, environment, diversity, fiscal responsibility, respect for human rights, and prevention of corruption and any other illegal conduct.
- Methods or systems for monitoring compliance with policies, associated risks and their management.
- The mechanisms for monitoring non-financial risk, including those related to ethical aspects and business conduct.
- Channels of communication, participation and dialogue with stakeholders.
- Responsible communication practices that avoid manipulation of information and protect integrity and honour.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Law 5/2021, as mentioned above in question 1.4, redefines the contents of remuneration policies and requires that all remuneration systems for all tasks performed by directors are reflected in the bylaws. Investors have placed special emphasis on wage moderation and on the discretion of the remuneration committee to grant incentives to executives.

Some companies are incorporating ESG performance goals into their short-term (annual) incentive and long-term incentive compensation programmes, not only for members of the ESG team, but also for executive officers and other senior management.

Some of the approaches used include:

- Obtaining a certain percentage of the company's financing from sustainably sourced loans (green loans).

- Reducing carbon emissions compared to the previous year's figure.
- Reducing annual water consumption compared to the previous year's figure.
- Increasing the number of women among senior managers.
- Helping to increase carbon sinks, for example, by planting trees (each employee must plant at least one tree per fiscal year).
- Equal salaries between women and men.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Some common examples of day-to-day operations are:

- Reduction and reuse of paper used in offices, such as printing only when necessary, printing in black and white to reduce the use of toner in printers, and recycling paper that is no longer used in specialised companies.
- Use of courier services provided by bicycle or electric vehicles only.
- Rejecting the use of single-use plastics.
- Food donations to attend the needs of the most disadvantaged people.
- *Pro bono* services to provide legal assistance to the most disadvantaged people.
- Numerous measures in energy efficiency: water reuse; flow sensors; double push button toilets; renewable energy; efficient lighting with auto shut-off systems and motion sensors; and use of reusable and recyclable items.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

One of the main challenges in this area is the development of generally accepted ESG methodologies that allow institutions, independently of their size, to find the right mix between internal and external analysis, between in-house capacity building and recourse to external providers, which methodologies are comparable and of high quality.

A Spanish financial institution has created a survey on the methodologies used by fund managers so as to incorporate ESG factors into their portfolios. The results show a mixed approach:

- Using proprietary approaches to analyse a fund's positions and estimate the degree to which it is sustainable or achieves various ESG metrics: 38%.
- Using third-party approaches to analyse a fund's positions and estimate the extent to which it is sustainable or achieves various ESG metrics: 75%.
- Prioritising qualitative factors: 25%.
- Priming quantitative factors: 34%.

4.2 Do green bonds or social bonds play a significant role in the market?

Both green and social bonds play an important role in the market; however, green bonds are experiencing higher issuance volumes compared to social bonds.

The demand for green bonds in Spain multiplies the existing supply of bonds by 12, which has led to oversubscriptions. Spain joins countries such as Italy, France and Germany that have already issued green bonds.

It is worth highlighting the words of Chris Iggo, head of investment at AXA IM, that "*there is a very strong demand for sovereign green assets*". Iggo explains that there are already many green corporate bonds on the market, but investors "*need diversification*", and that natural purchasers of this issue by the Kingdom of Spain will include "*dedicated green bond funds, broader sustainable bond funds, pension funds and insurance companies*".

Finally, in relation to green bonds, the high interest in them is a major concern, as the combination of high demand and low supply could have a detrimental effect on proper price formation.

As for social bonds, their function is to finance social projects, those whose direct objective is either to solve or mitigate a certain social problem or to achieve positive results for certain population groups.

Their current trend is still much lower compared to green bonds and sustainable bonds, but their issuance volume is nevertheless increasing. Social bonds are becoming more and more important in society, and companies are using them more frequently and increasingly including them in their action plans.

4.3 Do sustainability-linked bonds play a significant role in the market?

The main characteristic of sustainability-linked bonds is that they focus on the achievement of ESG objectives rather than on the use of the proceeds raised in the issuance. This feature has allowed more structurally carbon-intensive sectors to enter into the sustainable bond market.

Sustainability-linked bonds are becoming more and more prevalent in the market and may provide an alternative to green bonds in view of the high market demand for green bonds.

4.4 What are the major factors impacting the use of these types of financial instruments?

The two major factors impacting the use of these types of financial instruments are, on the one hand, the commitment of institutions to develop an ESG strategy, which is growing, and on the other hand, the increasing demand from investors.

Not only has this demand already seen considerable growth, but expectations are rising as a result of the incorporation of ESG preferences in the suitability test to be carried out on investors for the provision of discretionary portfolio management and advisory services from August 2022 (as set out in Commission Delegated Regulation (EU) 2021/1253, of 21 April, modifying Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions of investment firms).

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

For this response, we refer to the framework of the Tesoro Español (the Spanish Treasury), which published a framework last September regarding a Spanish sovereign green bond issuance programme.

The Spanish framework has received the highest possible rating and the highest obtained by a European issuer to date from the independent entity Vigeo Eiris, which highlighted Spain's commitment to sustainability and the strong environmental impact of the projects to be financed.

The sovereign green bond programme will allow the Treasury of the Kingdom of Spain to continue to diversify the investor base in government debt, maintain low funding costs and further lengthen the average maturity of the debt.

The Green Bond Framework is the document that defines the essential elements of the issuance programme and details what the funds raised will be used for, how the process of evaluation and selection of projects and investments will be carried out and how the resources will be managed, as well as the information that will be made available to investors.

The Spanish green bond programme is aligned with international best practices, will become a structural element in the Treasury's financing policy, and will contribute to the mobilisation of investments aimed at transforming Spain's economic structure.

Vigeo Eiris also includes Spain as one of the most advanced countries in terms of sustainability (ranked 14th out of 178 countries evaluated), not only in the environmental dimension, but also in the social and good governance dimensions.

In financial terms, the launch of green sovereign bonds will allow the Spanish Treasury to continue to diversify its investment base in government debt, keep financing costs low and lengthen the average maturity of debt.

From a more regulatory point of view, the status of the EUGBS included in the European Commission's Action Plan is as follows: on 6 July 2021, the Commission made a proposal for a regulation for the establishment of a voluntary EUGBS.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

The COVID-19 pandemic has caused unprecedented disruption to our daily lives and to the world at large, which has had a significant impact on ESG practices and has helped companies to take more clearly into account the importance of non-financial issues for social purposes. The pandemic has shown us the importance of taking care of our people as they are the key asset of any company. Further, the pandemic has exacerbated underlying and longstanding failures regarding equality and access to economic opportunities.

6 Trends

6.1 What are the material trends related to ESG?

The main trend continues to be climate change. After last summer, the IPCC (Intergovernmental Panel on Climate Change) assessment report stated unequivocally that human influence has warmed the atmosphere, oceans, and land, and it is therefore time to limit human-induced global warming to reach net zero CO_2 emissions, along with strong reductions in other greenhouse gas emissions.

The International Monetary Fund ("IMF") and the World Bank's biannual meeting held recently in Washington moved ESG issues from the section on risks or future challenges to the second item in Gita Gopinath's speech on forecasts for 2022, just behind the call for a global vaccination against COVID-19. Curbing climate change is the urgent priority.

We predict a trend in environmental sustainability, even more so after COP26 (the UN Climate Change Conference held in November 2021 in the Scottish Event Campus in Glasgow, UK), with companies focusing on reducing energy usage, controlling greenhouse gas emissions, controlling waste, sustainable land use, restoration of forests and increasing recycling.

Another trend that we anticipate relates to human capital, in particular gender and ethnic diversity (Black Lives Matter), gender equality and racial inclusion, as well as health and safety, employee attraction, retention, and satisfaction as well as labour management relations.

6.2 What will be the longer-term impact of COVID-19 on ESG?

The IMF says that global economic recovery is continuing, even as the pandemic resurges. The rapid spread of the Delta variant of COVID-19 and the threat of new viruses and/or variants have increased uncertainty about how quickly the pandemic can be overcome.

It seems that we are going to have to get used to living with the virus (whether it is coronavirus or another one that may appear in the future), which should make us all more aware of the importance of taking care of the planet and moving towards a sustainable economy, leaving no one behind, in order to achieve a fairer and more inclusive society.

Acknowledgment

Special thanks are reserved for Ms Elisa Ricón, the General Manager of INVERCO (https://www.inverco.es/), a Spanish Association of Collective Investment Undertakings and Pension Funds, for her assistance with section 4 of this chapter.

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RocaJunyent is an international legal services provider. We understand companies as projects that are led and worked by people. This is precisely the main value that distinguishes us as an office – our human dimension. We want to be strategic partners for our clients.

Our ESG unit is focused on advising our clients on their adaptation to ESG criteria in order to improve the services/products they provide through a more efficient and responsible use of their resources.

Our methodology begins with the completion of a basic questionnaire in order to highlight those issues related to ESG criteria in which the company has already gone part of the way. With the result of the preliminary questionnaire and after appointing a sustainability manager, we proceed to helping the client by drafting a commitment declaration and obtaining approval of the corporate sustainability action plan.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

The broad range of issues that fall under the term ESG are subject to a patchwork of laws and regulations, some of which are briefly addressed below.

The main source of environmental legislation is the Swedish Environmental Code, which transposes a number of EU directives and is supplemented by a number of EU regulations. The Environmental Code regulates, amongst other things, the management of land and water, environmentally hazardous activities, water operations, chemical products and waste management.

Substantive social legislation includes the Swedish Anti-Discrimination Act – the purpose of which is to combat discrimination and promote equal rights and opportunities regardless of gender, transgender identity or expression, ethnicity, religion or other religious belief, disability, sexual orientation or age – the Swedish Work Environment Act, the Swedish Employment Protection Act, the Swedish Act on Co-determination in the Workplace, and the Swedish Act on Board Representation for Employees.

As to data protection, the main source of regulation is the EU General Data Protection Regulation (the GDPR), the purpose of which is to protect individuals' fundamental rights and freedoms, particularly their right to protection of their personal data.

The Swedish Penal Code criminalises the activity of giving, offering and accepting bribes. The non-profit organisation, the Swedish Anti-Corruption Institute, has issued a widely acknowledged anti-corruption code, which is partly intended to supplement the Penal Code by offering guidance on anti-corruption provisions of said Code (please see question 1.5 below).

The main sources of anti-money laundering regulation are the Swedish Money Laundering and Terrorist Financing Prevention Act and the Swedish Act on Penalties for Money Laundering Offences, both of which implement EU directives to combat money laundering and terrorist financing.

As to governance, companies whose shares have been admitted to trading on a regulated market are subject to a combination of legislation, self-regulation and generally accepted practices. The main source of corporate legislation is the Swedish Companies Act, which sets out, amongst other things, the duties of the Board and the CEO, shareholders' rights, and requirements for general meetings and for guidelines in respect of director remuneration. Other sources include the Swedish Corporate Governance Code, the regulated markets' listing rules as well as statements and rulings by the self-regulatory body – the Securities Council – on what constitutes good practice in the Swedish securities market. Under the Corporate Governance Code, the Board is required to adopt guidelines concerning the company's conduct in society, with the aim of ensuring the company's long-term value creation capability, and to identify how sustainability issues impact risks to, and business opportunities for, the company. The Board is also responsible for putting in place appropriate procedures to ensure the company's compliance with its disclosure obligations, including ESG disclosure obligations.

The amended EU Shareholder Rights Directive (SRD II), which was transposed into Swedish law in 2019, requires the Boards of listed companies to prepare, at least every four years, a proposal for a remuneration policy to be voted on at the annual general meeting. The remuneration policy must include an explanation of how the policy contributes to the company's business strategy, long-term interests and sustainability.

1.2 What are the main ESG disclosure regulations?

As with substantive ESG-related regulations, ESG disclosure is subject to a patchwork of laws, regulations, standards and practices, some of which are briefly addressed below.

The Swedish Annual Accounts Act, which implements, amongst other things, the EU Accounting Directive (2013/34/EU), including Directive (2014/95/EU) on disclosure of non-financial and diversity information (the NFRD), requires that Swedish companies prepare an annual report. The annual report must, amongst other things, include a directors' report that sets out information on sustainability that is necessary to understand the company's development, financial position and results, including information regarding environmental and employment issues. Companies that conduct operations that require a licence or are notifiable under the Environmental Code must also set out information on the environmental impact of the operations in the directors' report.

The Annual Accounts Act requires larger companies to prepare a sustainability report and to address ESG matters in the report. A company is required to prepare a sustainability report if the company satisfies more than one of the three following requirements for each of the two most recent financial years: (i) the average number of employees exceeds 250; (ii) a balance-sheet total exceeding SEK 175 million; and (iii) net turnover exceeding SEK 350 million. The report must set out, amongst other things, information on the policies the company implements in relation to environmental protection, social responsibility and treatment of employees, respect for human rights and anti-corruption, and the material risks related to these issues.

As from 2022, large companies that are public-interest entities, with an average number of employees exceeding 500 during the most recent financial year, must also provide additional disclosure in their sustainability reports under Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the Taxonomy Regulation). A company meeting the above criteria must include in its sustainability report information on how and to what extent the company's activities are associated with economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. The reports to be published in 2022 (for financial year 2021) must address the objectives related to climate change mitigation and adaptation. Starting with the reports due in 2023 (covering financial year 2022), the reports should cover all environmental objectives in the Taxonomy Regulation.

Under the Annual Accounts Act, companies whose shares are admitted to trading on a regulated market must also prepare a corporate governance report. The report must include information regarding, amongst other things, the principles for corporate governance that are applied in the company, the most important elements of the company's system for internal control and risk management in respect of financial reporting, major shareholders and information on specific shareholders' rights. Moreover, if such companies are required to prepare a sustainability report, they must also include in their corporate governance report information on the diversity policy that is applied in respect of the Board as well as the aim of the policy, how the policy has been applied during the financial year, and the result thereof.

Under the Corporate Governance Code, the nomination committee must, when nominating directors to the Board for election by the general meeting of shareholders, issue a statement on the company's website explaining its proposals and describing, amongst other things, the diversity policy applied by the nomination committee in its work. Under the Corporate Governance Code, the composition of the Board must be appropriate to the company's operations, phase of development and other relevant circumstances; the composition of the Board must reflect diversity and breadth of qualifications, experience and background; and the company must seek gender balance on the Board. In our experience, Swedish listed companies invariably apply this Corporate Governance Code rule as their diversity policy.

Companies whose shares are listed on a regulated market must prepare a directors' remuneration report, which is subject to approval by the annual general meeting. The report must set out, amongst other things, the remuneration received by the CEO and any deputy CEO, shown by each pay component as well as changes in remuneration and company performance over five years, compared to the average employee.

It is worth noting that SRD II sets out requirements in relation to the investment strategy of institutional investors. These requirements include institutional investors publicly disclosing how the main elements of their equity investment strategy are consistent with their liability profile and duration (and, in particular, their long-term liabilities) and how they contribute to the medium- to long-term performance of their assets. Where an asset manager invests on behalf of an institutional investor (either on a segregated mandate basis or through a collective investment undertaking), the institutional investor must publicly disclose information about its arrangement with the asset manager. Asset managers are required to adopt an "engagement policy" on a "comply or explain" basis. The policy should describe how an asset manager integrates shareholder engagement into its investment strategy when it or its funds under management are shareholders in EU investee companies.

In addition, Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the Disclosure Regulation) aims to increase transparency about how financial market participants and financial advisers integrate sustainability risks in their investment decisions and investment or insurance advice. The Disclosure Regulation requires financial market participants and financial advisers to disclose information about how sustainability risks are integrated into their investment decision processes, with particular requirements for products that "promote environmental or social characteristics" or have "sustainable investment" as their objective.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

In addition to mandatory disclosure requirements, there are several voluntary disclosure frameworks relating to ESG issues that are applied by Swedish companies.

Many Swedish companies across industries use the standards established by the Global Reporting Initiative (the GRI). Already in 2007, the Swedish Government stated in its ownership policy that all state-owned companies were expected to report on ESG issues in accordance with the guidelines established by the GRI. As a result, the use of GRI standards has become widespread in the Swedish market.

In addition, an increasing number of Swedish companies across industries report on climate-related risks and opportunities in accordance with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

The European Commission has issued non-binding guidelines on non-financial reporting to help companies disclose non-financial information under the NFRD in a relevant, useful, consistent and more comparable manner. The guidelines incorporate the TCFD recommendations.

An increasing number of Swedish companies across industries are joining the UN Global Compact, and an increasing number of investors and asset managers are becoming signatories to the UN Principles for Responsible Investment and filing reports on their progress. Many companies also support the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, and the UN Sustainable Development Goals. The large Swedish banks have also adopted the Equator Principles and committed to comply with the Principles for Responsible Banking.

1.4 Are there significant laws or regulations currently in the proposal process?

In recent years, several initiatives have been launched by the EU as part of the European Commission's Action Plan on Financing Sustainable Growth and the European Green Deal, which form part of the European Commission's strategy to implement the UN's 2030 Agenda and Sustainable Development Goals, as well as to meet the objectives of the Paris Agreement. In addition to the legislation already adopted, including the Taxonomy Regulation and the Disclosure Regulation mentioned above, the European Commission has announced a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD. The proposed CSRD would extend the sustainability reporting requirements to all large companies and all listed companies, and set out more specific sustainability reporting elements. The European Commission has also proposed that EU sustainability reporting standards be developed and adopted by the Commission. It is proposed that the European Financial Reporting Advisory Group (EFRAG) be responsible for developing these standards. In parallel, the IFRS Foundation has announced a proposal for the creation of an International Sustainability Standards Board and the development of IFRS Sustainability Standards.

Another important initiative taken by the European Commission is its initiative for Sustainable Corporate Governance, including mandatory due diligence requirements across supply chains. The Commission is expected to publish its legislative proposal by the end of 2021. The European Commission is also expected to publish a proposal for a social taxonomy by the end of 2021.

In July 2021, the European Commission announced a proposal for a voluntary European Green Bond Standard (EUGBS). The funds raised under the proposed EUGBS must be allocated fully to projects that are aligned with the Taxonomy Regulation.

As part of the action plan to promote a circular economy within the EU, the European Commission has adopted, and is expected to adopt, several revised legislative proposals on waste and waste management.

The Swedish Government has appointed a committee to undertake a comprehensive review of all environmental legislation to ensure that this legislation effectively contributes to achieving Sweden's climate goals. This review has resulted in, amongst other things, proposals to revise the Swedish Environmental Code to ensure that the climate perspective is given increased consideration in license procedures.

1.5 What significant private sector initiatives relating to ESG are there?

There are a number of private sector initiatives relating to ESG, including the following.

The Swedish Corporate Governance Board is a self-regulatory body promoting good corporate governance. It oversees the Corporate Governance Code and keeps it under review. The Corporate Governance Code includes, amongst other things, requirements relating to Board composition, including a requirement that the Board composition should reflect appropriate diversity, breadth of qualifications, experience and background and that nomination committees are expected to strive to achieve gender balance. The Corporate Governance Board has adopted gender balance goals in respect of Board composition. Furthermore, under the Corporate Governance Code, the Board is required to adopt guidelines concerning the company's conduct in society, with the aim of ensuring the company's long-term value creation capability, and to identify how sustainability issues impact risks to and business opportunities for the company.

The Swedish Anti-Corruption Institute is a non-profit organisation that promotes self-regulation as a means of combatting corruption. In August 2020, the Institute published a revised version of its widely acknowledged anti-corruption code, which is partly intended to supplement the Penal Code by offering guidance on the Penal Code's anti-corruption provisions and by setting out stricter requirements. In addition, the Institute's Ethics Committee makes rulings on points of interpretation of the anti-corruption code.

The Fossil Free Sweden initiative was taken by the Swedish Government ahead of the climate change conference in Paris in 2015. The initiative is a platform for dialogue and collaboration between companies, municipalities and various organisations. The initiative aims to accelerate the transition to a fossil-free society.

Nasdaq has issued an ESG Reporting Guide, which, amongst other things, contains ESG metrics that companies listed on Nasdaq Stockholm, the main regulated market in Sweden, may choose to report on.

ISO 26000 is a voluntary guidance standard for corporate social responsibility drawn up by the International Organization for Standardization (ISO) under the leadership of the Swedish Institute for Standards (SIS) and the Brazilian Association of Technical Standards (ABNT).

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

ESG has become a strategic priority to many investors and asset managers. Investors and asset managers may, on occasion, work together in respect of ESG issues and may exert influence in support of their views, not only on matters that require shareholder approval, but also through interactions with the Board. Large shareholders will generally be able to exercise a great deal of *de facto* influence on the strategic direction of the company outside a general meeting as well as through influencing the composition of the Board. Investors and asset managers may also exert influence by raising awareness of certain ESG issues at an industry level rather than *vis-à-vis* a particular company.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

There is an ever-increasing awareness of ESG matters among non-shareholder stakeholders, including the wider community. However, other than employee Board representation, non-shareholder stakeholders do not have any formal role in corporate governance. The Board will, however, need to have regard to responsibilities to employees, customers, suppliers and other stakeholders, including the wider community, as a matter of sustainable long-term value creation and sound corporate governance.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

There are several regulators whose authority overlaps with or includes ESG issues. These include the Swedish Environmental Protection Agency, the County Administrative Boards, the Swedish Work Environment Authority, the Swedish Data Protection Authority, and the Swedish Financial Supervisory Authority (the FSA).

Under the Environmental Code, there are several authorities that exercise supervisory functions, including the Swedish Environmental Protection Agency. With some exceptions, inspections and enforcement actions are carried out by the respective County Administrative Boards or the Environmental and Public Health Committees.

The Swedish Work Environment Authority exercises supervisory functions in respect of work environment-related issues.

The Swedish Data Protection Authority supervises compliance with the GDPR.

The FSA supervises the financial markets, including entities providing regulated financial services and listed companies. The FSA is responsible for, among many other things, the supervision of financial reporting by listed companies, but has delegated part of this authority to the self-regulatory organisation, the Council for Swedish Financial Reporting Supervision.

2.4 Have there been material enforcement actions with respect to ESG issues?

There have been few examples of enforcement actions in respect of non-compliance with ESG reporting by listed companies. There have been, however, and continue to be, enforcement actions in respect of non-compliance with ESG matters, including in particular non-compliance with environmental, anti-money laundering and anti-corruption regulations. Highly publicised cases include the imposition of hefty administrative fines on certain Swedish banks in respect of material deficiencies in their anti-money laundering procedures.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Principal ESG-related litigation risks are related to environmental harm and, in particular, liability to clean up and restore polluted areas. Under the Environmental Code, the operator of a business that has polluted an area or building is generally liable for the clean-up and restoration of such areas or buildings. The liability lies with the operator and if the operator is a company, the liability will remain within the company after a change of ownership. However, should the operator not be able to carry out or pay for the after-treatment, the liability may be transferred to an acquirer of the property upon which the business that caused the pollution is or was conducted.

A recent, highly publicised litigation concerned a claim for damages from a Swedish listed mining company, which, in the mid-1980s, delivered smelter sludge to a company in Chile. The claimant, representing people living in residential areas next to the Chilean company's facility, argued that they were caused harm by exposure to arsenic. The mining company was ultimately not held liable.

2.6 What are current key issues of concern for the proponents of ESG?

While ESG issues are high on the agendas of investors, companies and the media, many proponents of ESG are concerned that the purpose of a for-profit corporation is not sufficiently clear under the Companies Act and that it may not be possible to align sustainable value creation over the long term with this purpose. In an attempt to address this lack of clarity, the Swedish Corporate Governance Board has stated in the foreword of the revised Corporate Governance Code that it "wishes to emphasize that, unless otherwise specified in its articles of association, the purpose of a company is to generate profit for distribution among its shareholders. However, in order for a company to have the freedom to conduct its business in the best possible way for long-term sustainable value creation, it is that company's responsibility to ensure that society continues to have confidence and trust in its business and operations". This statement arguably confirms that, in the opinion of the Swedish Corporate Governance Board, the purpose of a for-profit corporation is "long-term sustainable value creation".

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Under the Companies Act, the Board is, amongst other things, responsible for the organisation of the company and the management of the company's affairs. As a result, the Board is responsible for setting and changing the strategy of the company, including with respect to ESG issues. Under the Corporate Governance Code, the Board is expected to adopt guidelines concerning the company's conduct in society, with the aim of ensuring long-term value creation capability and identifying how sustainability issues impact risks to, and business opportunities for, the company. With increasing awareness of ESG risks, it is becoming increasingly important for Boards to identify the risks most relevant to the business and consider how these risks affect business strategy and performance in both the short and long term. Against this backdrop, and since the materialisation of ESG risks could cause material operational, financial and reputational harm, ESG risk oversight has become a priority for many Boards.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Boards are expected to exercise risk oversight, whereas the day-to-day risk management is carried out at management level. Risk oversight should include both being engaged in monitoring risk factors, including through Board committees, and actively working with management to identify ESG issues and adopting appropriate procedures for monitoring and managing such risks. Boards are also expected to put in place reporting channels to ensure that they receive regular progress updates on risk management and regular briefings on ESG issues relevant to the business and how these issues could pose risks to the company.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Under the Companies Act, implementing SRD II, the Boards of listed companies must prepare, at least every four years, a proposal for a remuneration policy to be voted on at the annual general meeting. The remuneration policy must include an explanation of how the policy contributes to the company's business strategy, long-term interests, and sustainability. The policy should set out financial and non-financial criteria (including, where appropriate, ESG criteria) for variable remuneration and how they contribute to the company's strategy, long-term interests, and sustainability. The implementing legislation does not require variable remuneration to be linked to ESG criteria, and to date, criteria for payment of variable remuneration have largely been linked to financial targets. There is, however, increasing pressure from investors and other stakeholders that variable remuneration should, to a greater extent, be linked to prioritised ESG metrics. In this context, it should be noted that, in its report on "Undue short-term pressure on corporations", the European Securities and Markets Authority (ESMA) emphasises the importance of ESG criteria as performance measures for payment of variable remuneration, and recommends that the European Commission, in its yet-to-be-adopted guidelines on the standardised presentation of the remuneration report, should require companies to explain, where applicable, why variable remuneration is not linked to ESG criteria.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Companies are increasingly managing ESG-related risks as part of their day-to-day operations, by identifying and mitigating risks concerning, for example, environmental liabilities, consumer and product safety, workplace safety, employee health, supply chains, and alternative energy sources. ESG compliance has also become a due diligence item both for institutional investors and for companies in the context of mergers and acquisitions. Other common examples of where ESG is incorporated as part of the management of the business include procurement processes, business and product development as well as requiring new or existing business partners to sign or comply with codes of conduct. As set out above, there is also increasing pressure on companies to use non-financial metrics for payment of variable remuneration.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

To the extent that finance providers rely on ESG ratings, such ratings tend to be externally developed.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds play a significant role in the Swedish SEK-denominated bond market. Their role has increased ever since the first green bond was issued by the World Bank in 2007. Real estate companies are well represented among issuers of green bonds, alongside the public sector, including municipalities. Other sectors are, however, catching up. Recently, state-owned energy company Vattenfall issued two green bonds at a combined nominal amount exceeding SEK 5 billion, the proceeds of which will be used for, amongst other things, renewable energy and related infrastructure, energy efficiency, electrification of transport, and heat.

While the social bond market is behind the green bond market in terms of maturity and liquidity, it is starting to gain traction. A number of real estate companies have issued social bonds to finance the renovation and construction of low-income housing in socioeconomically disadvantaged areas, and Kommuninvest, a Swedish local government funding agency, adopted a framework for social bonds in early 2021. Other types of issuers are also showing interest in social bonds, with medtech company Getinge issuing its first social bond in 2021.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds have so far not played a significant role in the Swedish debt capital market, but they have recently been gaining traction with steel company SSAB and clothing company H&M both adopting sustainability-linked bond frameworks and listed private equity firm EQT issuing a sustainability-linked bond in May 2021.

4.4 What are the major factors impacting the use of these types of financial instruments?

Sustainable financing is mainly driven by increased investor demand for sustainable investment solutions. Furthermore, there is mounting evidence that addressing ESG issues does not hurt financial performance.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

There is currently no statutory verification process for green bonds. The issuance of green bonds tends to be based on the voluntary process guidelines, the "Green Bond Principles", issued by the International Capital Market Association (ICMA).

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

While COVID-19, in the short term and to some extent, resulted in ESG issues being given lower priority and some ESG initiatives being put on hold to enable Boards and management to focus on immediate financial difficulties, we expect that, in the medium and long term, ESG practices as well as Government ESG policies may be reshaped in a number of ways (please see question 6.2 below).

6 Trends

6.1 What are the material trends related to ESG?

For a long time, the "E" and "G" of ESG have attracted most of the attention and this is likely to continue to hold true in the near future, considering, amongst other things, recent initiatives in the context of the European Commission's Action Plan on Financing Sustainable Growth and the European Green Deal. There are also similar Swedish initiatives. For example, in July 2020, the Government adopted a national strategy for a circular economy that sets out the direction and ambition for a long-term and sustainable transition of Swedish society and, in January 2021, the Government also adopted an action plan towards a circular economy.

Climate change continues to be the principal ESG-related issue. However, in recent years, there has been increased focus on the effect of climate change on other ESG issues, such as human rights and governance practices, entailing a more holistic approach to ESG-related issues, and an increased focus on the interaction between different ESG issues.

Following COVID-19 and the Black Lives Matter movement, social issues have received increased attention. In the past, social policies for Swedish businesses have, to a great extent, focused on gender discrimination (equal pay and Board diversity), but more recently there have been calls for expanding social policies to cover broader issues.

6.2 What will be the longer-term impact of COVID-19 on ESG?

While the full effects of COVID-19 are yet to be seen, we expect that ESG practices will be impacted in a number of ways in the medium and long term. We expect increased focus on workplace safety and employee health, physical risks, such as physical assets and supply chain risks, business continuity and broadened contingency planning and risk governance. Some commentators also expect reinforced efforts to decarbonise the economy, driven by social forces on the back of the decrease in emissions that COVID-19 resulted in.

We also expect that sustainability measures will be built into recovery programmes that are launched to address the economic impact of COVID-19. The Stockholm Chamber of Commerce has established a Commission (Sw: *Omstartskommissionen*) – an initiative to reboot and strengthen Sweden after the COVID-19 crisis. In its report, the Commission advocates that the strategy for growth and transformation must support the development of a socially and environmentally sustainable society, mobilising resources to address threats caused by global warming and to reduce exclusion and segregation. On the same note, the European Commission has encouraged governments to impose green conditions on state aid granted to support businesses affected by COVID-19.

The COVID-19 crisis has shown that some problems need industry solutions. For example, a single company, working alone, is unlikely to be able to effectively address nationwide medical supply shortages. However, companies often hesitate to cooperate on initiatives involving competitors because of actual or perceived anti-trust risks. In some instances, competition authorities showed flexibility during the pandemic to discuss and provide comfort to proceed with collaboration projects to address urgent needs. This could potentially pave the way for a similar latitude when it comes to ESG goals. Sweden is part of the ongoing and lively debate in Europe about the extent to which achieving ESG targets, in particular in relation to the Green Deal, may justify cooperation that may otherwise be questionable under competition law. COVID-19 may have provided a renewed recognition that so-called "coopetition" on ESG may be valid, and we expect developments in this area.

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Our specialist practice groups cover a wide range of ESG matters including Corporate Investigations and Corporate Crime, Corporate Sustainability and Risk Management, Data Privacy, Environment and Trade. Our lawyers handle all our clients' needs around climate change including: green investments, green bonds, climate-related litigation, emissions, and renewable energy; human rights; data privacy; anti-corruption and compliance; trade, sanctions and anti-trust; and sustainable finance, sustainable corporate governance and sustainability in M&A transactions.

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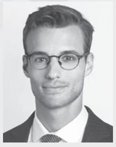
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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

The Swiss legislature and government's focus on ESG has intensified over the recent past:

Environment/Climate Change

- ***Swiss CO_2 Act***: Switzerland ratified the Paris Accord on climate change on October 6, 2017. In the wake of the ratification, the Swiss parliament revised the Swiss Act on greenhouse gas of December 23, 2011 ("Swiss CO_2 Act"). The revision was adopted by the Swiss parliament in September 2020 with the primary objective of laying the foundation for Swiss climate policy for the next decades. While one of the goals of the new law was to make finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient developments, it did not integrate sustainability-related disclosures and regulations for climate-compatible investments. The parliament-adopted revision was rejected by the Swiss population in June 2021. In September 2021, the Swiss government announced that it planned to release a new bill by the end of 2021. In parallel, it initiated the preparation of binding disclosure requirements in line with the Task Force on Climate-related Financial Disclosures ("TCFD"). The elaboration of these binding disclosure requirements is further discussed in question 1.4 below.
- ***Climate Change and Prudential Supervision***: The Swiss prudential regulator – the Financial Market Supervisory Authority ("FINMA") – monitors climate-related financial risks to which regulated financial institutions are exposed as part of its supervisory remit. Under the Swiss Federal Act on Banks and Savings Banks of November 8, 1934, regulated financial institutions are required to identify, assess and adequately deal with risks, including significant climate-related financial risks and, where necessary, to develop instruments and processes to address these risks. In May 2021, FINMA updated the reporting obligations of supervised financial institutions by amending its "Disclosure – banks" and "Disclosure – insurers" circulars in line with the TCFD. Please see question 1.2 below.
- ***Consumer Protection***: On the basis of the recently enacted Swiss Financial Services Act of June 15, 2018 ("FinSA") and the Swiss Code of Obligations governing advisory and asset management contracts, assets managers are duty-bound to inform their clients about financial risks, conduct a suitability analysis and manage the assets of their clients with due care. While FinSA is still in its infancy, legal commentators consider that such duties encompass an obligation to explain climate-related risks to clients (the scope of that obligation depends on the sophistication of the client) and to consider climate-related risks in the investment-making process, with potential liability exposure in case of negligent management. However, Swiss legal commentators generally do not yet recognise a duty of financial services providers to explore the client's preference in terms of sustainable investments.
- ***Public Pension Funds Investment Mandates***: A number of Swiss Cantons require their public pension funds to integrate ESG criteria in their investment decision-making. At the federal level, it is now admitted that the scope of the fiduciary duties set out in the Federal Law on Occupational Old Age, Survivors' and Invalidity Pension Provision of December 20, 1946 allows for consideration of ESG factors.

Corporate Responsibility

- ***Due Diligence Duties and Corporate Responsibility of Multinationals***: Switzerland signed up to the UN Guiding Principles on Business and Human Rights in 2011. This led the Swiss government to adopt a four-year "National Action Plan" in 2016, a set of guiding principles on business and human rights, which was most recently updated in January 2020. The plan was heavily criticised by a coalition of non-governmental organisations, which submitted a popular initiative on corporate responsibility. This initiative was rejected by the Swiss people in November 2020, paving the way for the counterproject adopted by the Swiss parliament to become effective.
- ***New Law on Non-financial Disclosure and Supply Chain Due Diligence***: The counterproject introduced reporting obligations for large, public interest companies on environmental and social matters ("non-financial disclosure") that mirror EU Directive 2014/95/EU. Under the new provisions included in the Swiss Code of Obligations, covered companies are required to publish annual reports on environmental, social and employee matters, respect for human rights and the fight against corruption. Please see question 1.2 below for further details. In addition, the counterproject introduced due diligence and transparency rules applicable to all companies (and not only large public interest entities) (subject to available carve-outs) that import into or smelt, refine, etc., in Switzerland ores or metals containing one of the "3TG" (tin/cassiterite, tantalum/coltan, tungsten/wolframite, and gold) originating from conflict zones or high-risk areas or that offer goods or services for which

it can legitimately be suspected that child labour may have been involved. These due diligence and transparency rules are modelled on the EU Conflict Minerals Regulation (EU 2017/821). Both planks of the counterproject are expected to become effective on January 1, 2022, subject to a one-year conformance period.

Corporate Governance

- ***Executive Compensation***: In 2013, the Swiss people adopted a popular initiative (the so-called "Minder initiative") in an effort to curb the perceived excesses in board and executive compensation. The Swiss government gave effect to the initiative by way of regulation (the Ordinance against Excessive Compensation in Listed Companies, or "OaEC", effective January 1, 2014) pending the adoption of the corporate law reform in June 2020. The provisions of the ordinance will be rolled into the Swiss Code of Obligations without substantial modifications once the corporate reform becomes effective (in 2022 or 2023). These provisions have come to represent the pivot of corporate governance for listed companies in Switzerland. They apply to corporations organised under Swiss law with stock listed on a Swiss or non-Swiss stock exchange. The hallmark of the initiative is a binding say-on-pay regime.
- ***Governance and Electoral Process***: The OaEC regulates many corporate governance aspects of listed companies, setting the maximum term in office of board members and management (board members are up for re-election every year), banning golden parachutes, golden hellos and specified types of transaction bonuses, establishing the authority of the general meeting of the shareholders to elect each director individually (rather than *en bloc*) and to elect the chairman of the board, as well as the members of the compensation committee (displacing the authority of the board in this respect). The OaEC also requires Swiss pension funds to vote on specified corporate governance matters, including the election of directors, and to report annually as to how they exercise their voting rights.
- ***Gender Equality***: In an effort to promote gender equality in large public companies, the corporate law reform adopted in June 2020 introduced minimum target gender quotas under a "comply or explain" model. Specifically, the reform provides that women should account for at least 30% of the board of directors and at least 20% of executive management for large, publicly traded companies. Any such company that does not meet these provisions will be required to state in its remuneration report the reasons for such shortfall, and the actions that are being taken to improve the situation. The introduction of the quotas is subject to multi-year conformance periods. In addition, as further described in question 1.2 below, the Federal Act on Gender Equality of March 24, 1995 has been modified to include statistical reporting obligations on wages.

1.2 What are the main ESG disclosure regulations?

A comprehensive disclosure and transparency framework is emerging in Switzerland:

Corporate Responsibility Transparency

- ***Non-financial Disclosure***: As outlined in question 1.1 above, large firms of public interest will be required to report annually on non-financial matters. Covered companies will be required to report on their business model, policies and due diligence procedures, the measures taken in application of these policies and their evaluation system to assess the efficiency of these measures, the principal risks in relation to non-financial matters, whether arising from the company's own operations or, when relevant and proportionate, those arising from the company's business relationships, products or services, as well as key performance indicators ("KPIs") that are relevant to their particular business. Reports on non-financial questions will have to be approved and signed by the board of directors and submitted to the annual general meeting of the shareholders for approval. The board of directors will then be required to ensure that the reports be published electronically immediately after their approval and remain accessible to the public for 10 years.
- ***Conflict Mineral and Child Labour Transparency***: Companies having due diligence obligations in respect of their supply chain as outlined in question 1.1 will also be required to publish an annual report to ensure proper transparency. This report has to contain information relating to the implementation of the covered company's oversight system and risk management plan and thus compliance with its due diligence obligations. As in the case of non-financial disclosure, this report will have to be approved by the board of directors, be published electronically and remain accessible for 10 years. However, it will not be subject to the approval of the general meeting of the shareholders.
- ***Transparency Obligations for Resources Extraction Companies***: Under the reform of Swiss corporate law adopted in June 2020, Swiss companies that are subject to a full audit and, directly or indirectly, extract minerals, oil, natural gas or primary forest wood, will be required to publish annually a special report disclosing each payment or series of payments made to government authorities (including government-controlled enterprises) in the aggregate amount of CHF 100,000 or more per financial year. This requirement applies for the first time in respect of the financial year starting one year after January 1, 2021.
- ***Wage Equality***: In July 2020, the Federal Act on Gender Equality of March 24, 1995 was modified to include reporting obligations on wage inequality. In broad terms, companies with 100 or more employees are required to complete an equal-pay analysis every four years (the first analysis had to be completed by the end of June 2021). The analysis must be audited by an independent, approved third party (the first analysis has to be audited by the end of June 2022). The results of the analysis must be shared with the workforce and, if the company is listed, with its shareholders (in the appendix to the annual report).
- ***Sustainability Report***: Since 2017, SIX has made available to listed issuers an elective regime for the publication of an annual sustainability report. Issuers that decide to opt in are then required to compile a sustainability report in accordance with an internationally recognised standard. Permissible standards include (i) the Global Reporting Initiative, (ii) the Sustainability Accounting Standards, (iii) the UN Global Compact, and (iv) the European Public Real Estate Sustainability Best Practices Recommendations. SIX reviews the conformance of the annual sustainability reports with the chosen standards. Out of more than 250 listed companies, approximately 30 companies have opted in.

Corporate Governance Disclosure

- ***Corporate Governance Disclosure***: SIX-listed companies must comply with the Directive on Information relating to Corporate Governance ("DCG") and related guidance. The DCG mandates the inclusion of a "corporate governance section" in the annual report containing important information on management and control mechanisms at the highest corporate level.

- ***Executive Compensation Disclosure***: Among other categories of information, the DCG mandates the inclusion of disclosure on compensation of board members and management. The corporate governance section must include basic principles and elements of compensation and shareholding programmes, together with a description of the authorities and procedures for setting board and executive compensation.
- ***Remuneration Report***: The DCG is supplemented by the OaEC, which mandates the annual publication of a remuneration report presenting statistical information on the compensation of board members and management. This disclosure must be verified by an external auditor. Required to be disclosed are not only the aggregate amounts but also the comprehensive compensation packages of each of the board's members, as well as the highest total compensation package among the members of senior management. The DCG extends these disclosure requirements to all issuers with a primary listing on SIX, whether incorporated in Switzerland or not.

General Disclosure Obligations

- ***General Disclosure Obligations***: The recently enacted FinSA and its implementing ordinance regulate the content of prospectuses for primary and secondary offerings, as well as listings in Switzerland. In general terms, ESG risks, which are typically conceived as either physical or transition risks, should be disclosed insofar as they have an effect on the risk profile of an investment.

Transparency for Financial Institutions

- ***Climate-related Financial Disclosure***: In May 2021, FINMA introduced reporting obligations for supervised financial institutions in line with the TCFD by amending its "Disclosure – banks" and "Disclosure – insurers" circulars. The revised circulars became effective on July 1, 2021. In an initial phase, only large banks and insurance companies will be subject to the transparency obligations.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

As indicated above, a comprehensive framework for ESG disclosure is now emerging in Switzerland. Not all aspects of this framework are effective yet, however. As of the date of this publication, SIX-listed companies remain essentially free to omit any ESG disclosure (other than on corporate governance). Alternatively, they may include sustainability topics in their annual report, publish a separate sustainability report on their own without SIX review or opt into the elective SIX regime.

Among the SIX-listed companies that have not opted in, there is a large variance in reporting practice, although the trend points towards a reduction in the number of SIX-listed companies with no reporting on sustainability and an increase in companies reporting on CO_2 reduction objectives and achievements, corporate responsibility or other sustainability topics in their annual report disclosure.

1.4 Are there significant laws or regulations currently in the proposal process?

In June 2020, the Swiss government published a report on sustainable finance in Switzerland taking position on a range of ongoing EU initiatives. In December 2020, the Swiss government then delineated the next steps in its strategy to make the Swiss financial centre more sustainable by adopting a package of measures:

- ***TCFD-based Reporting***: The Swiss government tasked various departments and offices with preparing binding implementation of the TCFD recommendations by Swiss companies across all industries. In August 2021, the Swiss government fleshed out the contours of the new binding disclosure regime:
  - Public companies, banks and insurance companies with 500 or more employees, more than CHF 20 million in total assets or more than CHF 40 million in turnover will be required to report publicly on climate issues (please see question 1.2 above on the TCFD-based transparency requirements already introduced by FINMA for covered financial institutions).
  - Public reporting will not only address the financial risks that a company faces as a result of its climate-related activities, but will also describe the impact of the company's business activities on climate and the environment under a "double materiality" standard (in line with the European Union's approach).
  - The disclosure regime will specify minimum content requirements.
  - Binding implementation of the TCFD recommendations is expected to become effective in 2024 (in respect of the 2023 financial year).
- ***Greenwashing***: The Swiss State Secretariat for International Finance ("SIF"), in close cooperation with the Federal Office for the Environment, has been tasked with proposing, by the third quarter of 2021, recommendations to amend financial market regulation in an effort to prevent greenwashing.
- ***Investment Methodology Transparency***: The Swiss government issued guidance to the effect that asset managers should publish their methodology and strategies for weighing climate and environmental risks when managing their clients' assets, consistent with their duties of loyalty and diligence. The SIF will have to report to the Swiss government by the end of 2022 whether and how the market has adhered to its recommendation on a voluntary basis.

1.5 What significant private sector initiatives relating to ESG are there?

Switzerland has seen a multiplication and acceleration of private sector initiatives, in particular in the financial sector, a key contributor to the Swiss economy:

- ***Support for Sustainable Finance by Industry Groups***: Among other initiatives, in September 2018, the Swiss Bankers Association announced that sustainable finance was one of its strategic priorities. The Swiss Bankers Association published its first ESG position paper in September 2019, which was then updated in June 2020. Together with the members of the Swiss Sustainable Finance ("SSF") working group, the Swiss Bankers Association also developed guidelines for the advisory process for private clients. In parallel, the Swiss Funds & Asset Management Association, together with the SSF, published key messages and recommendations for its members in an effort to actively support asset managers when incorporating sustainability criteria into their investment process. Furthermore, a report published by the Swiss Insurance Association in June 2020 showed that private insurers apply sustainability criteria to an estimated 86% of their capital investments. In mid-2018, the Swiss Pension Fund Association incorporated sustainability factors into its Guidelines for Pension Fund Investments, a voluntary stewardship code.

- ***Voting Guidelines of Proxy Advisors***: Homegrown proxy advisors, such as Ethos, have developed corporate governance and responsibility voting guidelines.
- ***Guidelines for Institutional Investors Governing the Exercise of Shareholder Rights in Swiss Listed Companies***: These guidelines were published in January 2013 by Swiss trade associations and proxy advisers. These non-binding guidelines are aimed at institutional investors and intend to enhance good corporate governance by describing best practices for the exercise of shareholders' rights by institutional investors.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

The Swiss Sustainable Investment Market Study 2021 issued by the SSF reports a rapid growth in sustainable investments and an increased sophistication among investors pursuing sustainable investments:

- ***Substantial Growth in Sustainable Investments***: In 2020, Swiss funds adopting sustainable investment approaches (estimated at CHF 694.5 billion) exceeded conventional investment funds for the first time. Among "asset owners" (*i.e.*, pension funds and insurance companies), sustainable investments represented approximately 33% of total assets in 2020, similarly exhibiting significant growth (estimated at 31%). A similar trend has been identified among private investors (historically less prominently represented in the sustainable investment space), with an estimated growth rate of 72% in 2020.
- ***General Approaches for Sustainable Investments***: The SSF distinguishes among eight different approaches in sustainable investments: (1) best-in-class (*i.e.*, peer comparison among investable companies based on sustainability ratings); (2) ESG engagement (*i.e.*, engagement with management of investee companies); (3) ESG integration (*i.e.*, the explicit inclusion of ESG risks and opportunities into the investor's traditional financial analysis and investment decisions); (4) ESG voting; (5) exclusions (with exclusion criteria referring to product categories, activities or business practices); (6) impact investing (*i.e.*, investment in an effort to generate a measurable, beneficial impact alongside a financial return); (7) norm-based screening (*e.g.*, against the UN Guiding Principles on Business and Human Rights); and (8) sustainable thematic investments (*i.e.*, investments in businesses contributing to sustainable solutions).
- ***Ranking of Sustainable Investment Categories***: In 2020, ESG integration was still the leading approach among Swiss investors. ESG engagement ranked a close second. This represented an inflexion point: previously, investors tended to rely on exclusion when an investee company violated ESG norms (the investor would divest from the company or exclude it from the investment universe). In 2020, asset managers and asset owners, however, resorted to engagement more often than exclusion. In addition, ESG investment practices have become multi-pronged. Most often, investors combine two or more sustainable investment strategies.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

One key stakeholder in Switzerland is the banking industry. As the umbrella organisation of the Swiss banks, the Swiss Bankers Association lobbies for the removal of existing regulatory hurdles in Switzerland and levelling the playing field for sustainable investment products.

In its two-prong strategy, the Swiss banking industry group first encourages its members to sign up to international transparency efforts on risks resulting from ESG factors (which FINMA has now imposed by way of circular; please see question 1.2 above), to integrate sustainability principles into various areas of the banking business (including lending practices), to participate in voluntary climate compatibility tests, and to expand the offering of green, sustainability and other ESG instruments. Second, the Swiss Bankers Association lobbies for framework conditions intended to promote sustainable investments via improved transparency, better market access, up-to-date investment rules for institutional investors, and tax reliefs.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

Impetus for ESG initiatives originates from the Swiss government (please see question 1.4 above), the Swiss population (via popular initiatives) and regulators such as FINMA (please see questions 1.1 and 1.2 above).

FINMA monitors climate-related financial risks as part of its prudential supervisory remit and is imposing climate change transparency obligations on supervised financial institutions. Governance of regulated financial institutions is also subject to strict scrutiny by FINMA from a regulatory perspective.

2.4 Have there been material enforcement actions with respect to ESG issues?

FINMA can open investigations and enforcement proceedings to remedy failings from a regulatory point of view. Enforcement proceedings, however, are confidential unless FINMA determines that public information is necessary from a prudential point of view. There is thus little publicity around enforcement actions.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

In broad terms, Switzerland does not have a litigious culture. Swiss law favours shareholder accountability of the board of directors to address agency issues over liability claims (there are virtually no cases of directors' individual liability claims outside the bankruptcy context). Furthermore, Swiss law does not recognise the concept of class actions, often making it uneconomical for shareholders, clients or other stakeholders to bear the cost of a lawsuit.

By way of example, in 2019, the Zurich commercial court dismissed claims for damages linked to the emissions-rigging scandal initiated by a consumer group against the German car manufacturer Volkswagen and Swiss importer AMAG. The Zurich commercial court had already refused to hear a separate collective action by the same consumer group seeking to establish that Volkswagen and AMAG had misled buyers and violated Swiss law.

2.6 What are current key issues of concern for the proponents of ESG?

Corporate governance has been front and centre of the ESG debate for many years in Switzerland. Over the recent past, climate change has emerged as the next key topic and one of the main areas of concern. The Swiss government is devoting significant time and resources in the preparation of a framework for sustainable investments that is geared towards climate change.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

In the governance framework of Swiss listed companies, the board of directors has the core duty of setting the overall strategy and organisation of the company (fulfilment of that duty cannot be delegated to management), while management have primary responsibility for the day-to-day implementation:

- In practice, given the critical importance of ESG matters, including in terms of reputation, the board's duty to set the overall strategy of the company will often also encompass the duty to develop the long-term ESG strategy of the company. The board is usually responsible for adopting the relevant policies to achieve its strategies, working with management to identify which ESG issues are most pertinent to the company's business and key stakeholders, to oversee the development of appropriate goals, and to monitor the implementation of policies and processes.
- It is not unusual for ESG monitoring and planification tasks to be allocated to a special committee of the board. Such a committee typically ensures that the board is well informed as to ESG considerations and gives advice on sustainability measures and emerging ESG trends. It can also monitor the company's performance against select indices and review material, non-financial issues affecting the company's financial performance, as well as the material interests of the company's shareholder base and other significant stakeholders.
- Management usually set the objectives to be achieved in order to implement the board's overall strategy, monitor their achievement and generally report to the board on these issues. In turn, management of large companies often have their own committees dedicated to overseeing ESG issues (*e.g.*, on global sustainability, roundtable issues, the World Health Organization's code of compliance, and group compliance).

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

Swiss listed companies with a developed ESG policy typically have in place a combination of governance mechanisms. These include bottom-up reporting protocols, clear lines of duties and allocation of responsibilities, as well as tailored KPIs. In line with the Swiss model of corporate governance, the board fulfils a supervisory role, especially concerning material risks that may affect the financial performance of the company, and is often aided by a nomination and governance or sustainability committee in that role.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

There is still a wide variety of approaches. A number of listed companies ostensibly do not take into account ESG achievements when setting executive compensation. At the other end of the spectrum, some companies allocate a numerical weight to ESG topics in the executives' pay-for-performance scorecards (for example, achievement of non-financial strategic goals could represent 40% of overall performance-based compensation and ESG topics could be 20% of that), although what these ESG topics are can be broadly defined. Some other companies report a qualitative approach. For example, a number of companies indicate that ESG topics are considered at various stages of the compensation determination process, whether that is the setting of objectives, the funding of a performance award pool, performance assessment or compensation decisions, or that the compensation committee factors in ESG objectives when proposing bonuses.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Increasingly, companies are setting and disclosing (scope 1, 2 and 3) short- and medium-term CO_2 reduction targets, the concrete initiatives taken to achieve these targets and the aim of becoming carbon neutral or positive by 2050. Companies often seek to set their target emission reductions on a science basis.

Furthermore, common examples of integration of ESG in the day-to-day operations include sensitising employees on sustainability strategy and rewarding employees on good work, due diligencing contracting parties, including suppliers or services providers (across the board), sounding key investors on ESG topics, adopting ESG-related policies, creating internal committees, hiring consultants, and enhancing transparency with key stakeholders.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

Market participants that offer sustainable financial products in Switzerland usually rely on internally developed or external ESG ratings in an effort to evaluate the ESG impact of their financial products or services. However, it should be noted that there are no generally accepted standards or best practice methods in Switzerland for ESG ratings.

An external ESG rating is necessary for bonds listed on SIX to be classified as green or sustainable bonds. The ESG aspects of such bonds have to be reviewed by an external auditor. Furthermore, bonds issued by the Swiss Confederation are externally rated with regard to sustainability aspects.

4.2 Do green bonds or social bonds play a significant role in the market?

There are no official definitions of the terms "green bond", "social bond" or "sustainability bond" in Switzerland. In practice, issuers often adopt the terminology of the International Capital Market Association ("ICMA") Guidelines. Under this terminology, "green bonds" are bonds that (re-)finance environmental projects in accordance with the Green Bond Principles by ICMA, while "social bonds" (re-)finance social projects in accordance with the Social Bond Principles by ICMA. If a bond finances both green and social projects in accordance with the Sustainability Bond Principles by ICMA, it qualifies as a "sustainability bond". Finally, bonds that follow the concept of an issuer commitment in accordance with the Sustainability-Linked Bond Principles by ICMA qualify as a "sustainability-linked bond" (together with green bonds, social bonds and sustainability bonds, "ESG bonds"). Bonds that fall into the categories of green bonds, sustainability bonds and sustainability-linked bonds may be flagged on SIX, the main marketplace for listed bonds in Switzerland.

As of September 21, 2021, a total of 58 green bonds and one sustainability bond were listed on SIX, with aggregate principal value of approximately CHF 19.3 billion.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds do not yet play a significant role in the Swiss market. As of September 21, 2021, there was only one sustainability-linked bond listed on SIX, which had a principal amount of CHF 1.85 billion.

4.4 What are the major factors impacting the use of these types of financial instruments?

The main factors driving volumes of ESG bonds are primarily increased investor demand for sustainable finance instruments on the one hand, and higher issuance costs on the other hand as ESG bonds are associated with additional implementation costs for monitoring the use of proceeds compared to regular bonds (which may be offset by potentially more attractive pricing). Moreover, issuance levels of ESG bonds may be affected by the absence of a binding regulatory framework in Switzerland (please see question 4.5 below), which may create uncertainty for issuers and investors alike. It is noteworthy that the offer and choice of sustainable finance instruments have increased in the last few years in order to meet increased investor demand.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

There is no binding framework regulating the verification of ESG bonds in Switzerland as yet. However, the disclosure requirements for prospectuses pursuant to FinSA require the disclosure of the material risks associated with the financial instruments that are offered to the public or admitted to trading on a Swiss trading venue, including as to verification.

In the absence of binding regulation in Switzerland, issuers of ESG bonds often adhere to non-binding international standards, such as the Green Bond Principles, the Social Bond Principles or the Sustainability-Linked Bond Principles of ICMA, which include, among other things, a recommendation to the issuer to conduct an external audit. Adherence to such international standards is mandatory for listed bonds to be flagged as green, sustainable or sustainability-linked bonds by SIX.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

By and large, COVID-19 has not detracted investors from their focus on ESG considerations, nor have companies abandoned their ESG initiatives. With climate change ever present, ESG considerations kept their top spot in the strategic agenda of investors and companies alike as was evidenced by the considerable expansion of sustainable investments in Switzerland in 2020. Even during strict shelter-at-home orders, many global asset managers intimated that the pandemic would not derail their plan to hold companies accountable on climate change objectives and governance issues.

6 Trends

6.1 What are the material trends related to ESG?

Material trends on the fast-moving ESG scene include:

- ***Climate Change***: The Swiss government and the financial sector have declared that they are committed to a sustainable Swiss financial centre, with a focus on the environment as an immediate priority.
- ***Transparency***: Investors have expressed the concern that the difference in reporting standards, coupled with the fact that they are voluntary, allows companies to cherry-pick data. On September 22, 2020, the International Business Council of the World Economic Forum ("WEF") released a set of universal ESG metrics and disclosures to measure stakeholder capitalism. In addition, the SIF has been tasked with proposing recommendations to amend financial market regulation in an effort to prevent greenwashing.

6.2 What will be the longer-term impact of COVID-19 on ESG?

Echoing the international debate, ESG proponents have been sharpening the social lens. In March 2020, the UN Principles for Responsible Investment exhorted investors to engage with companies that are failing to protect employees' safety or their financial security. Similarly, in April 2020, the WEF endorsed six stakeholder principles for the COVID-19 era, including keeping employees safe, securing shared business continuity with suppliers and customers, ensuring fair prices for essential supplies, offering full support to governments and society, and maintaining the long-term viability of companies for shareholders. As COVID-19 is having a profound impact on how businesses organise their operations and workforce, it is likely that social considerations will continue to garner increased attention.

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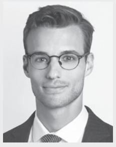

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

There is no single, overarching piece of ESG legislation or regulation in the UK. Rather, the UK's ESG regime comprises a somewhat disparate array of domestic and EU-derived laws and regulations, many of which are not solely ESG-focused. The main legislative sources are the UK Corporate Governance Code 2018 (the "**UKCGC**"), the directors' duties set out in the Companies Act 2006 (the "**Companies Act**"), the Listing Rules, the Disclosure Guidance and Transparency Rules (the "**DTRs**"), the UK Stewardship Code 2020 (the "**UKSC**"), the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the Climate Change Act 2008 (the "**CCA 2008**"), the Bribery Act 2010, the Corporate Manslaughter and Corporate Homicide Act 2007 (the "**CMCHA 2007**"), the Equality Act 2010, and the Modern Slavery Act 2015 (the "**MSA 2015**"). The UK's ESG legal landscape is therefore fragmented (perhaps reflecting the incomplete overlap between the E, the S and the G), with a wide range of different laws and regulations for all businesses (big and small) to be aware of and comply with.

The CCA 2008, which is the UK's principal climate change statute, has set a revised target of at least a 100% reduction of UK greenhouse gas emissions by 2050 compared with 1990 levels. The bulk of the obligations under the statute are placed on the UK government rather than individual organisations, and the statute also provides for carbon trading for larger organisations.

The UKCGC and the UKSC are both key parts of the UK's corporate governance regime and are administered by the UK's Financial Reporting Council (the "**FRC**"). Generally, the UKCGC applies to listed companies, and the UKSC applies to institutional investors. The FRC was due to be replaced in January 2021 by a new administrative body called the Audit, Reporting and Governance Authority ("**ARGA**"), which will have wider powers than the FRC and is expected, among other things, to scrutinise audit practices more closely, following several recent scandals where companies had been given a clean audit shortly before significant financial difficulties became public. It is not, however, clear when legislation to create the stronger regulator will be introduced.

Pension funds are also subject to additional requirements under pension legislation, including the Occupational Pension Schemes (Investment) Regulations 2005, the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013, and the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (the "**Pensions Regulations**"). There are multiple sources of guidelines that supplement the Pensions Regulations, including guidance issued by the Pensions Regulator and organisations such as the Pensions and Lifetime Savings Association and the Pensions Climate Risk Industry Group.

1.2 What are the main ESG disclosure regulations?

The UK's main ESG disclosure regulations are set out in the Companies Act, the UKCGC and the DTRs.

In particular, section 172 of the Companies Act requires directors of UK companies to have regard (in discharging their duties) to, among other things, the interests of the company's employees, the need to foster business relationships, the impact of the company's operations on the community, the environment and its reputation for high standards of business conduct. The director's primary duty, however, is to promote the success of the company for the benefit of the shareholders. The aforementioned matters are secondary to this primary duty. In other words, the UK is currently a jurisdiction that effectively mandates shareholder primacy in directors' discharge of their duties, albeit in parallel with a need to consider other stakeholders.

The Companies Act requires large and medium-sized companies (measured by reference to turnover, balance sheet total and number of employees) to publish an annual strategic report. The report must set out information on various ESG-related items, such as the impact of the business on the environment, disclosures around the company's employees, social, community and human rights issues, and the company's policies in relation to each of those matters. If the company's securities are traded on a particular securities exchange (for example, the Main Market of the London Stock Exchange plc (the "**LSE**")) or if it is a "public interest entity", the Companies Act requires the report to contain a "non-financial information statement". This requirement overlaps with the content requirements already described, but additionally covers respect for human rights, together with anti-corruption and anti-bribery matters. Finally, the legislation requires large companies to include a separate statement in their report explaining how, in the financial year in question, the directors took the matters described above into account when fulfilling their duties under section 172 of the Companies Act.

In addition, all companies (except the very small) must prepare an annual directors' report for the financial year in question. Large companies must include information in their directors' report on how the directors had regard to the need to foster the company's business relationships with suppliers, customers and others and, if the company had more than 250 UK employees in the year, how the directors engaged with those employees. Large companies must typically also include information in their directors' report on the company's greenhouse gas emissions and energy consumption.

Companies with a premium listing of equity shares (on the Main Market) are required by the Listing Rules to comply with the UKCGC or explain in what respects they have diverged from it (known as the "comply or explain" regime). In particular, Provision 5 of the UKCGC requires companies to describe in their annual report how their interests and the directors' duties factors have been considered in board discussions and decision making.

The UKCGC also requires a company to:

- employ one or a combination of the following methods to engage with its workforce:
  - a director appointed from the workforce;
  - a formal workforce advisory panel; or
  - a designated non-executive director; or
- explain what alternative arrangements it put in place and why it considers that they are effective.

Although other publicly traded companies (for example, those traded on AIM, formerly known as the Alternative Investment Market) are not subject to the Listing Rules, the rules of the securities exchange to which they are admitted will likely contain a requirement to report against a recognised corporate governance code. Similarly, very large, non-publicly traded companies (again, measured by reference to turnover, balance sheet total and number of employees) must include a similar "corporate governance statement" in their annual report.

The UKSC sets out good practice for asset owners and managers when engaging with investee companies. In particular, Principle 4 sets out guidelines on how investors should engage on, among other things, environmental risks (if they think the company's own approach is not adequate).

Similar reporting requirements to those for companies apply to UK Limited Liability Partnerships ("**LLPs**").

The MSA 2015 consolidates previous slavery and trafficking legislation and aims to combat modern slavery in the UK and in UK businesses' supply chains. It requires certain organisations with an annual turnover over £36m to publish (and display on a website) an annual statement setting out the steps taken in the previous year to ensure no slavery or human trafficking is taking place in the company's business or supply chains. There is no deadline for publication, so the potential for enforcement action is low, with (as is common in the UK's ESG legislative landscape for now) the main driver to publish being the risk of reputational damage. However, the UK government has recently taken a proactive role in encouraging companies to publish statements, has announced its intention to legislate for a publication deadline, and is reportedly looking at introducing new enforcement powers. Following the "transparency in supply chains" consultation, the government will introduce legislation to bring in measures to strengthen section 54 of the MSA 2015. If an organisation is required to produce a statement, it will be mandatory for it to be added to the registry in the future as part of the proposed changes to strengthen section 54.

The CCA 2008 requires organisations to describe how directors have had regard to the Companies Act directors' duties (listed above) in the context of climate change. The CCA 2008 also makes provision for other ESG-focused measures, such as the use of energy performance certificates on properties, streamlined energy and carbon reporting ("**SECR**"), and minimum energy efficiency standards.

Pension scheme trustees are required to exercise their powers for the proper purpose of the trust. When it comes to pension scheme investment, this usually means acting in the beneficiaries' best financial interests (in a similar vein to company directors' primary duties, as described above). The meaning of "best financial interests" is, however, open to some interpretation. In the company context, ESG factors, if financially material, ought to be considered by pension scheme trustees in their investment decision making.

Under the Pensions Regulations, since October 2019, trustees of most occupational pension schemes have been required to ensure that their statement of investment principles ("**SIPs**") sets out their policies on how financially material considerations (including ESG factors) are taken into account in their investment decision making. Since October 2020, most occupational pension schemes have been required to publish their SIPs on a publicly available website to increase transparency in this area. Furthermore, under rules published by the UK's Financial Conduct Authority (the "**FCA**"), firms that operate workplace personal pension schemes are required to establish and maintain Independent Governance Committees ("**IGCs**"), which requires them, among other things, to report on their firm's ESG policies. From October 2021, trustees of certain occupational pension schemes are required to publish, as part of their annual reports, their compliance with recommendations from the Task Force on Climate-related Financial Disclosures (the "**TCFD**"). The TCFD-aligned disclosures will be phased in on an asset-based threshold. Very broadly:

- schemes with £5bn or more in assets under ownership on the first scheme year end date that falls on or after 1 March 2020 must publish TCFD reports within seven months of the end of the relevant scheme year from 1 October 2021; and
- schemes with £1bn or more in assets under ownership on the first scheme year end date that falls on or after 1 March 2021 must publish TCFD reports within seven months of the end of the relevant scheme year from 1 October 2022.

Notwithstanding the comment above regarding shareholder primacy, the UK's ESG framework (in particular the Companies Act directors' duties, the UKCGC and UKSC) is often cited in other jurisdictions as a good example of legislation that has "moved with the times" regarding corporate governance, stewardship and engagement principles.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

In addition to the UK's laws and regulations, various ESG-related guidelines apply to (or are applied by) UK organisations, including the recommendations of the TCFD, the UN's Sustainable Development Goals (the "**SDGs**"), and the Principles for Responsible Investment (the "**PRIs**").

The LSE has issued guidance that adopts the TCFD recommendations in identifying eight priorities related to climate risk reporting, explaining which ESG issues they see as the most material to the business and explaining how ESG issues may affect their business. The guidance encourages smaller issuers to follow the prescribed criteria, saying "*it is better to start reporting and to improve systems over time than not to report at all*".

UK funds and companies often describe their ESG credentials by reference to the SDGs. The SDGs are a UN initiative that lists 17 development goals that countries can use as a blueprint to "*end poverty, protect the planet and ensure that all people enjoy peace and prosperity by 2030*". The SDGs also refer to 169 associated targets, which are to be measured using 232 indicators of achievement.

In addition, a number of UK investors have signed up to the PRIs, with the bulk of these signatories (74%) being investment managers. The PRIs are six overarching principles to incorporate ESG issues into investment, including at decision-making process level, by disclosing appropriately and by incorporating them into any portfolio companies. The PRIs are described as voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues. The PRIs also explain to organisations how to write a responsible investment policy to assist with improving ESG integration. Organisations are then asked to provide evidence of how the policy is being complied with.

UK asset managers, asset owners and service providers can also sign up to the UKSC, the latest version of which was introduced by the FRC in 2020. Asset managers and service providers were requested to submit a final Stewardship Report to the FRC by 31 March 2021 and asset owners by 30 April 2021, if they wished to be included in the first list of signatories to the UKSC. The UKSC, which is aimed at asset owners and asset managers, as well as "service providers" (investment consultants, proxy advisors, accountants, actuaries, and data and research providers), sets out various principles and reporting guidelines, which differ depending on the category of organisation. FCA-authorised asset managers are required (under the FCA's Conduct of Business Rules) to "comply or explain" against the UKSC. The Pensions Regulator also encourages adherence to the UKSC.

1.4 Are there significant laws or regulations currently in the proposal process?

The Markets in Financial Instruments Directive II ("**MiFID II**") was amended in April 2021 to require financial advisers to incorporate ESG considerations within their suitability requirements for investments. This change was also integrated into the Alternative Investment Fund Managers Directive (the "**AIFMD**") and into the regulatory framework for "Undertakings for the Collective Investment in Transferable Securities" ("**UCITS**") funds. The new measures will apply from 2 August 2022 to UK fund managers that market funds into the EU (but have not yet been adopted by the UK). Under these amendments, firms will need to take account of their clients' ESG preferences in assessing their investment objectives as part of their suitability assessment, which includes the risk of fluctuation in the value of an investment due to ESG factors. Despite the fact that EU laws and regulations have ceased to apply in the UK following Brexit, the FCA has stated that the recent amendments reflecting sustainability concerns are "something which is likely to be looked at, but the timing of any policy proposals emerging from that consideration is not currently known".

The FCA has proposed new requirements for premium-listed Main Market companies to state in their annual report whether they comply with TCFD-aligned disclosures, and to explain any non-compliance.

The pending Environment Bill, which, despite three delays, is expected to become law by the end of 2021, will provide the UK government with powers to create new regulations on air quality, water usage, waste disposal and resource management, biodiversity, and environmental risk from chemical contamination. It will create a new, non-departmental public body (the Office for Environmental Protection) to act as an environment watchdog. The Bill has, however, already been criticised for failing to make the watchdog sufficiently independent of government and for a lack of enforcement powers.

It is proposed that regulatory action or legislative measures will be enacted by 2024–2025 with regard to smaller (>£1bn) occupational pension schemes not already captured by the TCFD reporting obligations set out above.

In addition to the TCFD disclosure requirements, plans have been announced to introduce new Sustainability Disclosure Requirements ("**SDRs**") with an implementation timetable expected to be published ahead of the COP26 Conference in November 2021. It is anticipated that the SDR regime will expand the scope of occupational pension scheme disclosures and require those entities already reporting under the TCFD regime to also report on the ways in which their activities could contribute to climate change.

In June 2021, the FCA published a Consultation Paper in relation to its proposals to introduce a climate-related financial disclosure regime for asset managers, life insurers and FCA-regulated pension providers in keeping with the TCFD recommendations. The FCA also intends to introduce a new ESG sourcebook summarising its proposed rules and guidance on climate-related and wider ESG topics. The FCA is expected to issue a policy statement in late 2021.

The Agriculture Bill, which is designed to replace the EU's Common Agriculture Policy for UK farmers following Brexit, has proposed a new land management system for UK farmers aimed at maximising the potential of land for producing high-quality food in a more sustainable way.

The UK government has not yet adopted the EU Taxonomy or produced its own taxonomy; however, as many investors invest across multiple jurisdictions, many UK fund managers are adopting aspects of the EU Taxonomy to provide investors with consistent use of language, labelling and reporting.

1.5 What significant private sector initiatives relating to ESG are there?

The private sector initiatives relating to ESG are largely those described at question 1.3 above, namely using the PRIs or SDGs to report on ESG in investments.

In addition, the UK Investment Association has devised a Responsible Investment Framework (the "**RIF**"), which was launched in November 2019. The RIF categorises and provides standard definitions for the different components of responsible investment. Investment managers have been encouraged to adopt the RIF to help highlight "the UK's role as a global leader within the areas of sustainability and responsible investment".

The UK Sustainable Investment and Finance Association (the "**UKSIF**") is a membership organisation for firms in the finance industry. The UKSIF describes its role as informing, influencing and connecting UK finance, policymakers and the public to achieve a vision of a fair, inclusive and sustainable financial system that works for the benefit of society and the environment.

Climate Action 100+ is a five-year initiative (from 2018) led by investors to engage larger greenhouse gas emitters and other companies worldwide that have significant opportunities to drive the transition to cleaner energy and to help achieve the goals of the UN 2015 Paris Agreement on climate change.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors and asset managers in the UK are increasingly focusing on ESG, which, in recent years, has become a "hot topic" in the UK. Historically, many larger investors would often state (both publicly and privately) that ESG-focused investments would come at a financial cost.

However, that perception appears to have been displaced in the UK, with a majority of ESG funds reporting parity with or outperformance of the wider market over one-, three-, five- and 10-year periods. A lack of data on ESG-focused funds' performance has previously made many investors nervous, but there are now multiple reports indicating that ESG funds may have outperformed their non-ESG peers, leading to a significant recent increase in the number of ESG funds in the UK. For example, "responsible investment" has grown over 40% from 2014–2020 (the most recently published figures) and this figure seems set to continue to increase.

The Pensions Regulations described in question 1.1 above for pension schemes, which have considerable influence as major investors in the UK markets, have led to an increased provision of more ESG-friendly investments, as fund managers are put under pressure by pension funds to invest in more ESG-conscious investments.

There has been noticeable growth in the UK of entire firms that invest only in ESG or on "impact grounds", as well as specific "sustainable" funds within wider financial institutions. Asset managers are now being trained on how to invest in a more ESG-conscious way and on the upcoming regulations (see question 1.4 above) that will apply to them.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

While it is clearly an over-simplification to divide ESG consciousness purely on grounds of age, the general perception is that younger, "millennial" (and even "Gen Z") investors, consumers and stakeholders are more ESG-conscious than their "baby boomer" and other forebears, and have generated a greater demand for responsible investment. These younger generations of investors and other stakeholders have tended to place greater importance on, for example, climate change, global warming, social justice and other non-financial imperatives than their predecessors. Given the inevitability of wealth transfer to these generations over time (as well as a desire to move – and be seen to move – with the times), organisations have been driven to act competitively in demonstrating their ESG credentials.

The younger, more ESG-conscious generations are also making up an increasing proportion of the workforce in large UK corporates, often encouraging (or forcing) organisations to strengthen their internal ESG measures, such as increased employee engagement, better employee benefits (for example, maternity and paternity leave), improving waste reduction, and more extensive recycling. It is also noteworthy that the "older" generations within (and, generally, at the top of) UK businesses appear, for the most part, to have embraced ESG initiatives and be willing to adapt their organisations and business practices accordingly.

Providers of debt finance have also begun to place a greater emphasis on ESG investments, again particularly in those seeking to reduce or reverse climate change.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In the UK, the principal ESG regulators are the FCA, the European Commission (for EU financial services such as MiFID II, the AIFMD and the UCITS Directive), the UK government, the FRC (to be replaced by ARGA as described in question 1.1 above), regulators of securities exchanges (for example, the LSE), the Registrar of Companies (Companies House), and the Pensions Regulator.

The UK's environmental regulators include the Environment Agency, the Scottish Environment Protection Agency, and Natural Resources Wales (the "**Environmental Regulators**"). The Environmental Regulators are able to issue fines for failure to comply with environmental laws and regulations such as water treatment and discharge, waste disposal, packaging regulations, oil discharge and the management of environmental permits.

In March 2020, the FCA released a Consultation Paper to enhance climate-related disclosures by listed issuers (on a "comply or explain" basis) consistent with the TCFD recommendations. Under the proposal, all commercial companies with a UK premium listing (i.e. Main Market companies subject to the UK's highest regulation and corporate governance standards) are required to include a statement in their annual financial report setting out (1) whether they have made disclosures consistent with the TCFD recommendations, (2) instances where they have not followed the TCFD recommendations (and why), (3) instances where they have included disclosures in a document other than their annual financial report (and why), and (4) where in their annual report (or other relevant documents) the various disclosures can be found. The FCA places particular emphasis on the TCFD's recommended disclosures on risk management and governance, stating that only "on an exceptional basis" should companies not disclose these items. These requirements took effect for accounting periods that begin on or after 1 January 2021, with the first reports published in compliance of the rule being published in 2022. In addition, the FCA is proposing to change its Listing Rules to require companies to disclose annually, on a "comply or explain" basis, whether they meet specific board diversity targets and to publish diversity data on their boards and executive management. The FCA is holding a consultation on this issue with the consolation scheduled to end on 20 October 2021.

2.4 Have there been material enforcement actions with respect to ESG issues?

Much of the UK's regulation in relation to ESG compliance is relatively new, and many of the regimes are "comply or explain" rather than "comply or face sanctions". There have not been many material enforcements to date. As more section 172 statements (described in question 1.2 above) are published and as new regulations come into force, we may see increased regulator action (and abilities to impose sanctions) in relation to non-compliance.

The Environmental Regulators are the most active of the UK's ESG regulators, and are reported to have issued in the region of 1,000 penalties since 2010 totalling over £350m. The largest penalty issued to date was in July 2021: a £92m fine to Southern Water for repeated illegal sewage discharges on the coasts of Kent, Hampshire and Sussex over a five-year period. The Environmental Regulators are also able to issue fines in connection with climate change issues, which often relate to failure to comply with the greenhouse gas emissions trading scheme.

Under the CMCHA 2007, organisations can be found guilty of corporate manslaughter – a criminal offence that results from serious management failures amounting to a gross breach of duty of care. While the suitability of the legislation has recently been questioned as convictions have been relatively rare (there have been fewer than 30 since the regime was introduced in 2007), the criminal sanctions for breach (and the associated reputational damage) mean that organisations are invariably focused on ensuring that adequate measures are in place to ensure compliance with associated health and safety legislation as well as to avoid any possible breach of the CMCHA 2007.

Whilst there has been no material enforcement to date, under the MSA 2015, the UK Home Office has been writing to organisations that have failed to publish their modern slavery statement on time, threatening action. Again, potential reputational damage is currently a greater risk here than legal ramifications. We have encountered companies that have either failed to publish their statement on time and have then been given a grace period within which to publish their statement, or that have been able to explain to the Home Office why the rules are not applicable to them (for example, if the turnover threshold is not met).

The UK Advertising Standards Authority (the "**ASA**") has banned multiple adverts in the UK, often for being misleading in relation to environmental claims. Whilst not a direct ESG enforcement action, this is often described in the media as a "greenwashing" attempt by the company in question (i.e. misleading information being disseminated by an organisation so as to present an (inaccurately) environmentally responsible public image). Again, a ban by the ASA usually leads to negative press and associated investor issues. Examples of businesses that have had adverts banned by the ASA in recent years include Ancol Pet Products, BMW, Fischer Future Heat, Ryanair and Shell.

In 2020, the UKSIF issued a report analysing pension ESG issues, following the introduction of the increased disclosure requirements under the Pensions Regulations (described in question 1.1 above), which found "an appallingly poor rate of compliance with the ESG regulations". Of the SIPs they were able to review, "policies were thin, non-committal and suggest that pension trustees are not adequately interrogating their investment manager's approaches to financially material ESG factors". The UKSIF also flagged that a significant number of pension schemes have failed to comply with their obligations and have not published their SIPs.

Given the lack of major enforcement actions to date, some critics argue that ESG-related litigation, including against governments and public bodies (such as the regulators) for failing to act, as well as against companies to claim damages, may prove in future to be a more effective way of holding businesses to account and forcing them to change their practices.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

ESG litigation has not yet taken off in the UK in the same way as in the US (and is currently very rare), though this could be set to change in the near future.

Investors are increasingly reviewing the ESG credentials of publicly listed companies as part of their decision to invest. This action has led to ESG-related disclosures in annual reports and prospectuses of these entities being put under greater scrutiny, and an increased risk of investor and activist claims if disclosures are inaccurate.

We envisage that there will be an increase in large class actions from investors against companies that inaccurately describe their ESG credentials. Shareholder activism has increased, particularly in the oil and gas and, increasingly, finance sectors. Activist investor groups (such as ShareAction) have given individual or smaller ESG-conscious investors a greater voice and held various firms to account by proposing resolutions, publishing articles on issuer non-compliance with ESG regulations and guidance, and providing rankings for both countries and organisations (such as banks).

For example, at BP's 2019 AGM, two special resolutions in relation to climate change issues were requisitioned by shareholder groups organised by Climate Action 100+ and Follow This. One of these resolutions proposed that BP include, in its annual report from 2019 onwards, a progress report describing how its business strategy is consistent with the objectives of the Paris Agreement on climate change, supported by information relating to relevant capital expenditure, metrics and targets. This resolution was passed at the AGM with the support of 99% of shareholders, evidencing the importance to investors of ESG credentials and their disclosures to the public. Other examples of companies whose shareholders have requisitioned resolutions with respect to environmental matters include Barclays, BHP Group and Royal Dutch Shell. Although not listed in London, the replacement of board members at ExxonMobil by activist investors was widely reported and commented on in the UK as a sign of the rise of global shareholder activism on issues of climate change.

A further risk associated with litigation or regulatory enforcement is the effects of such an intervention, in particular for listed companies given the potential for the effects to cause a rapid drop in the company's share price, in turn prompting shareholders to bring action against the company to recover the losses suffered as a result of the decline in value of the stock. Such "securities litigation" originated in the US but has been on the rise in the UK in recent years, partly due to the increase in third-party litigation funding and insurance, as well as active claimant law firms and claims management companies seeking out these types of claims.

Such claims can be made under section 90A of the Financial Services and Markets Act 2000 ("**FSMA**"), which states that, if an issuer makes an untrue or misleading statement or a dishonest omission in published information (other than listing particulars or prospectuses) – such as in its annual report and accounts – it can be liable to investors who need to prove that they acquired, continued to hold, or disposed of shares in reliance on the relevant statement or omission. As at the date of writing, this section is largely untested in the UK courts in relation to ESG matters, and there are some doubts as to how easy it would be to prove reliance (other than by reference to a sustainable investment's fund or other ESG-conscious investor's documented ESG goals or principles) and then accurately quantify the loss suffered by the investor. Once again, however, the very fact of a claim (rather than damages stemming from one) may be damaging to a company's reputation, so businesses will need to continue to tread carefully in this area.

2.6 What are current key issues of concern for the proponents of ESG?

A key issue for ESG proponents is inconsistency. As a basic example, there is no universally agreed definition for the underlying elements of each component of "E-S-G", which continues to hinder effective ESG legislation and enforcement, both in the UK and more widely. While efforts are being made to improve this situation, the varied requirements under the legislative framework (which, as noted in question 1.1 above, is fragmented), and the differing guidance suggestions on reporting and disclosures, there is often a lack of consistency across companies' ESG disclosures. This can in turn lead to investors inadvertently excluding or even including issuers on the basis of their ESG reporting (especially if an algorithm or program is being used to review ESG disclosures).

Another major concern for proponents of ESG is "greenwashing". Given the lack of consistency across regulations and guidelines and the currently limited number of enforcement actions (and shareholder claims) with respect to ESG disclosure matters, there is a clear risk that many companies may have overstated their ESG efforts. Companies that are highly rated by ESG rating agencies may have a fundamental business strategy that has a negative impact to society. Some view this as a form of greenwashing. Historically, media reports have largely focused on "greenwashed" products or lines rather than entire companies (as described at question 2.4 above in relation to ASA bans). This may change, however, as larger and less ESG-conscious companies are required to disclose how they take ESG factors into account. In addition, fund managers are using the UN's SDGs to describe some investments as "sustainable" or "ESG-conscious" without providing clear evidence of the positive impact they have generated. Certain funds are described as "ESG funds", yet they simply exclude certain types of investments, such as tobacco and arms (with very few excluding fossil fuel investments), rather than actually analysing investments' specific "E-S-and-G" credentials. The nuanced differences between "sustainable investing", "impact investing" and "ESG investing" can also lead to confusion for investors. For UK fund managers managing funds falling within scope of the EU's Sustainable Finance Disclosure Regulation ("**SFDR**") and their investors, this product classification has helped prevent this form of greenwashing to a certain extent.

The difficulties for investors in assessing an issuer's ESG credentials in detail can hinder effective ESG investment. Technological advances have begun to assist analysts in this area, for example, by including certain global ESG issues as requirements in investments (such as access to clean water, or alignment with the Paris Agreement on climate change). A significant amount of capital in UK so-called "sustainable investments" is in fact invested in passive tracker funds, which follow the movements of a particular index such as the FTSE 100, a significant proportion of which is made up of oil and gas companies. The result is that passive, sustainable investment funds are (at present) unlikely to make a significant impact on specific ESG goals for investors and can arguably be used by funds to overstate their ESG credentials. Some investors would argue that a fund that is invested in finite natural resources (such as oil and gas) could not be an ESG investment, whilst others might claim that, as many traditional fossil fuel companies look to diversify their offerings and become more sustainable, investing in these companies is actually helping this process of change and so is the very definition of an ESG-conscious investment (many disagree with this view). Again, the inconsistency is not helpful to those seeking to promote ESG issues. The FCA in July 2021 published analysis of what constitutes greenwashing and how to avoid it; however, it has not yet adopted the EU's SFDR or announced proposals for an equivalent UK regime.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The responsibility for ESG issues varies depending on the size and type of the organisation, but largely the responsibility will fall to the board of directors of a company, and to the managers within a fund. As explained in question 1.2 above, the Companies Act places requirements on the directors of a company to promote the success of the company for the benefit of its shareholders, including the requirement to have regard to various ESG-related factors, and larger companies are required to disclose how these factors were taken into account in the decision-making process.

The responsibility for addressing ESG issues is often delegated to specific individuals or committees with greater ESG expertise, key operations executives, and those within the organisation's legal, regulatory and compliance responsibilities (such as the general counsel or members of the in-house legal team). Organisations may also outsource the work to consultants to help develop the strategy and plan for implementation in the first instance. Where investment firms are signatories to the PRI, one of the mandatory disclosures, when reporting, is to indicate the internal and/or external roles used by the organisation, along with indicating for each whether they have oversight and/or implementation responsibilities for responsible investment.

ESG strategies were often previously called CR (corporate responsibility) or CSR (corporate social responsibility) strategies. Some organisations may still have a CSR committee, which is likely to be tasked with ensuring compliance with the business' ESG obligations and objectives.

The role of the management body in setting and changing the strategy of an entity in relation to ESG issues is key, in particular so that others involved in implementing the strategy appreciate its importance and understand the key drivers behind it. As noted in question 2.2 above, while ESG issues are often perceived as being driven by younger generations of stakeholders, typically those at the top of an organisation are (at present) not "millennials", so the buy-in of business leaders and managers is crucial for the success of ESG initiatives.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

As discussed in question 1.2 above, directors have an obligation under the Companies Act to "have regard" to various stakeholder constituencies (for example, employees), albeit in the context of discharging their primary duty to promote the success of the company for the benefit of its shareholders.

Investors are placing a growing importance on workforce engagement, often seen as the key component of the "S" in ESG, meaning that the interests and concerns of companies' employees are being considered more and more in boards' decision-making processes.

Recent amendments to the UKCGC require listed companies to adopt one of three workforce engagement methods (as explained in question 1.2 above). It is open to a board not to adopt any of these measures and instead to choose its own arrangements and explain why they are effective. The majority of FTSE 350 companies have opted to appoint a non-executive director. The reference to "workforce", rather than employees, in the UKCGC ensures that part-time and flexible employees and agency workers are included within this engagement framework.

Board committees are often used – particularly audit and risk committees – to consider specific ESG matters. In addition, some entities will establish a dedicated sustainability, ESG or health and safety committee to provide oversight of all ESG matters and report to the board on these issues. Such dedicated committees provide for the ability to have an allocated budget and, perhaps more helpfully, to set or alter the company's agenda to align with changing ESG trends or requirements and to recommend changes to the board. There is, however, currently no requirement in the UK to have an ESG committee. As described above, many companies will already have a CSR committee, which may well address some of the ESG aims of an organisation.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Under section 430 of the Companies Act, directors of certain listed companies must prepare a directors' remuneration report for each financial year of the company. This contains a retrospective overview of the director's remuneration for the previous financial year (the "**DRR**"), together with a forward-looking policy that sets out the framework and limitations for future remuneration for directors (the "**DRP**"). The DRR is subject to a non-binding shareholder vote each year, whilst the DRP must be put to a binding vote of the shareholders at least every three years.

There is currently no legal requirement to link remuneration or incentives to ESG metrics, but it is likely that more ESG-conscious organisations may decide to go beyond their legal obligations in this regard, and we are beginning to see organisations creating links between achievement of certain ESG outcomes and remuneration.

The PRIs (see question 1.3 above) explain how to link ESG factors to remuneration to ensure that executive management can be held to account for the delivery of sustainable business goals. A recent survey by the London School of Business showed that 45% of the UK's FTSE 100 companies now have an ESG target linked to variable pay, with 37% including one in their bonus plans (with a typical weighting of 15%). It is more difficult in some sectors than others to recognise which ESG factors affect long-term financial performance. For example, in industries typified by high energy usage, it is easier to see that reducing greenhouse gas emissions leads to reduced energy usage and reduced costs; whereas measuring consumer satisfaction or workforce engagement is much more complicated, and companies will need to be clear on any metrics or methodologies used in such areas.

The UKSC obliges signatories to consider, among other things, "diversity, remuneration and workforce integration". Given the recent implementation of this code, it is likely that ESG-linked remuneration will become more prevalent in the future, especially as a result of the increasing public importance being placed on the "S" factors in ESG during the COVID-19 pandemic, as further described at question 6.1 below.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Various funds have publicly committed to integrating ESG into their daily operations and investment processes by becoming signatories to the PRIs and publishing statements setting out their approach; for example, by providing detail on the board oversight and committee structure (as described in question 3.2 above) and explaining how ESG is integrated into the investment process.

Investment managers who integrate ESG into their systems and processes tend to publicise this, but an internal cultural acceptance of ESG investing is harder to evidence or quantify.

ESG reporting has become more of the norm for fund managers, with the majority signed up to PRI reporting. It has been reported that it takes managers on average between two and four weeks to report in accordance with the PRIs.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

In the public markets in particular, providers of equity and debt finance are relying increasingly on both externally and internally developed ESG ratings. There has been accelerated growth in recent years of ESG rating agencies (such as FTSE ESG, Sustainalytics, Refinitiv and MSCI), which assess and rate global companies based on their ESG performance. This assessment can involve the review of issuer's annual accounts, reports for ESG-related topics and often their sustainability report (if applicable).

As described in question 2.6 above, the lack of consistency on reporting and levels of description in these disclosures can inadvertently hinder (or even bolster) a company's ESG rating. The lack of consistency in rating methodologies also leads to unreliability and a lack of comparability in the market (with the same company sometimes being seen as both ESG-friendly by some rating agencies and harmful to ESG by others), which impairs debt and equity finance providers' ability to make accurate comparisons. Given the difficulty in quantifying or giving a score to many ESG factors due to their intangible nature (in particular, in relation to social and, perhaps surprisingly, governance goals), the use of third-party agencies and automated programs has been criticised for not digging deeply enough into what companies are doing (as distinct from what they say they are doing) to improve their impact on ESG issues. In June 2021, HM Treasury announced the appointment of a new independent expert group established to advise on standards for green investment. The Green Technical Advisory Group ("**GTAG**") will oversee the UK government's delivery of a Green Taxonomy. To tackle this issue, larger investors are starting to develop their own review and research tools for better interrogation of ESG data.

In the private markets, in which investors typically invest in businesses that are not otherwise rated, market participants are mostly relying on internally developed policies and procedures that are largely informed by the codes, policies and reports mentioned above. Additionally, market participants are seeking support from external ESG consultants and advisors to inform investment decisions, rather than publicly available ratings along with ESG due diligence questionnaires.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds are "use of proceeds" bonds issued by companies or governments to fund green projects. The term "sustainable bond" has become the umbrella term for the suite of bonds issued for a variety of ESG purposes, including green, social, sustainability, transition and sustainability-linked. Green bonds are most commonly issued to finance low-carbon infrastructure, such as offshore wind turbines and grid connections. These bonds help access the large volumes of capital that are (and will be) required for the transition to a low(er)-carbon future.

There are different types of green bonds, including mainstream green bonds (issued to finance environmentally friendly business activities), social bonds (issued to finance activities designed to achieve social outcomes), sustainability bonds (combining environmental and social aims – not to be confused with sustainability-*linked* bonds, as explained in question 4.3 below), SDG bonds (for business activities that promote the SDGs), and the more niche blue bonds, forestry bonds and climate bonds.

These bonds can be issued by financial institutions, governments and, more commonly, companies to finance or refinance green projects. Green bonds tend to follow disclosure norms known as the "Green Bond Principles", which are published by an executive committee of investors, issuers and underwriters with the International Capital Market Association ("**ICMA**") as secretariat and are internationally accepted norms. These also form the basis of the Green Loan Principles first published by the UK Loan Market Association (the "**LMA**") in 2018 and updated in February 2021.

The LSE set up a dedicated "Green Bond Segment" in 2015 and it has a dedicated Sustainable Bond Market, which aims at championing "innovative issuers in sustainable finance and improves access, flexibility and transparency for investors".

Green bonds are playing an increasing role in the market and, although they and sustainability-linked bonds do not yet form a significant part of the market (as described in question 4.3 below), this seems likely to change in the coming years. Having previously been criticised for not issuing a sovereign green bond (unlike other European governments), the UK government is due to issue a sovereign green bond in 2021.

4.3 Do sustainability-linked bonds play a significant role in the market?

The use of sustainability-linked bonds has yet to become mainstream in the UK market (particularly when compared to other European countries that have historically been more proactive in addressing climate change in the debt markets in particular), but their use is gradually increasing. Moody's forecasts $125bn of global sustainability bond issuance in 2021. These bonds appear to be producing similar returns to more traditional bonds and are likely to continue to be used more widely (as further discussed at questions 5.1 and 6.1 below).

The main differences between sustainability-linked bonds and traditional bonds are the disclosure and marketing requirements for the issuer, plus the economics of the bond being linked to a specific set of key performance indicators around which targets known as sustainability performance targets ("**SPTs**") are set.

In ICMA's Sustainability-Linked Bond Principles, sustainability-linked bonds are described as focusing on incentivising the issuer's efforts on improving its sustainability profile by aligning the bond terms to the issuer's performance against mutually agreed, material and ambitious, predetermined SPTs. The use of proceeds (i.e. purpose of the bond) is not a key determinant for these bonds in the same way as it is in green bonds.

Whilst sustainability-linked bonds have yet to emerge as a product of choice for issuers, we envisage their use may become more prevalent in the near future.

4.4 What are the major factors impacting the use of these types of financial instruments?

The lack of a centralised database and standardisation of ESG data in the EU and the UK creates the same problems for issuers of these bonds as for equity finance providers and other market participants.

The UK's Green Finance Strategy is aimed at addressing these problems by outlining some key actions, including working with the British Standards Institution to develop sustainable finance standards. It seems likely in the UK that investor pressure and regulation will increase, pushing market participants towards the use of ESG financial products. We therefore anticipate that the use of these financial instruments will continue to accelerate.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The Green Bond Principles (referred to in question 4.2) published by ICMA set out certain procedural standards. These voluntary standards are aimed at encouraging the issuer of the bond to:

- disclose the type of projects that the bond will be used for, which should be limited to a list of eligible green projects;
- describe the process of determining which projects will receive allocations;
- describe how proceeds from the financing will be managed (including any reinvestment); and
- report on how the proceeds were allocated and on key performance indicators of the issuer's selected investments.

It is recommended (but not compulsory) that an issuer obtains a third-party audit, opinion or certification, covering the (i) pre-issuance review of the alignment of their green bond to the principles (use of proceedings, project evaluation, management of proceeds and reporting), and (ii) post-issuance verification of the tracking of proceeds and allocation of funds.

As described above, these processes are not currently regulated in the UK by the government or any other regulator any more (or less) stringently than a traditional bond, and there are no specific laws or regulatory frameworks in the UK mandating the sustainability credentials of issuers. Most sustainability-linked bonds are issued largely for reputational reasons. However, ironically, the greatest risks associated with these bonds can be reputational. This is in part due to increased public and media interest in these bonds, and the scrutiny placed on them and the underlying projects, to ensure they are not being used by either the bond holder or the issuer to greenwash their ESG credentials (as discussed in questions 2.4 and 2.6 above).

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

Yes, COVID-19 has undoubtedly led to a significant increase in the importance investors and firms are now placing on ESG practices in the UK. While the pandemic changed the world in many ways, its impact on ESG may be one of the most important changes for those UK businesses.

In particular, as a result of the pandemic, the "S" in ESG was propelled forward (as discussed in question 6.1 below), partly due to the detailed level of press coverage of businesses' ESG practices during the pandemic and partly due to the need for a greater private sector response in assisting with these measures. According to Moody's, the pandemic resulted in a surge of social and sustainability bond issuance in 2020, reflecting a change in attitudes of investors and issuers.

The UK government has acknowledged that COVID-19 may present an "opportunity … to further green the economy to achieve net-zero by 2050".

Additionally, with COP26 to be hosted by the UK in Glasgow in November, and the sixth assessment report of the Intergovernmental Panel on Climate Change (the "**IPCC**") declaring unequivocally in August 2021 that human activity has warmed the atmosphere, already affecting every inhabited region across the globe, it is expected that there will be an increased rapid focus from both the UK government and UK businesses on the "E" of ESG.

6 Trends

6.1 What are the material trends related to ESG?

As described at question 2.2 above, there has been a significant surge in the UK in recent years in increasing ESG efforts, from the general public, investors and the UK government itself.

That said, Brexit has likely affected the UK's legal framework in relation to ESG. At the time of writing, the UK government is still to deliver a UK Green Taxonomy. Although this framework will likely be broadly aligned with the EU Taxonomy, it is expected to deviate in certain respects on some issues. It is unclear whether green taxonomies will be at their most effective if they are not truly consistent across national and regional boundaries.

In November 2020, the UK government set out a "ten-point plan" for a green industrial revolution, including a wish to create 2 million "green collar" jobs in the UK by 2030. This plan will mobilise £12bn of government investment, and potentially three times as much from the private sector, to create and support up to 250,000 green jobs. The Prime Minister intends to "turn the UK into the world's number one centre for green technology and finance, laying the foundations for decades of economic growth by delivering net zero emissions". The plan also includes the creation of a UK Infrastructure Bank to increase green infrastructure, deploying £12bn of equity, debt and guarantees. It is expected, however, that the bulk of investment in green initiatives will come from the private sector.

More organisations (including universities and business schools, as well as larger financial institutions) are increasing training modules on ESG. Furthermore, the increasing weight organisations are placing on ESG and the time needed to comply with regulations and principles has led to an increase in ESG-specific jobs, most of which tend to be taken by "millennials" who (as discussed at question 2.2 above) have tended to exhibit a greater interest in this area than the generations before them (although, as noted above, one's age is by no means a hard-and-fast determinant of commitment, or lack thereof, to ESG).

Both investors and media outlets are placing a greater emphasis on the social part of ESG, as "human capital" stories have increased throughout the COVID-19 pandemic, with significantly more media attention than before being placed on how companies are treating their staff and judging more generally how they perform throughout the crisis.

Despite the global protests connected to the Black Lives Matter Movement and associated engagement from communities and businesses, it was reported in 2020 that around 27% of organisations had put all or most of their diversity initiatives on hold as a result of the COVID-19 pandemic, including sponsorship of external events and programmes. This behaviour appears at odds with the increased focus on ESG initiatives, and it is to be hoped that businesses will continue to prioritise diversity initiatives at least as much after the pandemic (if not more) than was the case before.

6.2 What will be the longer-term impact of COVID-19 on ESG?

At the time of writing, the UK government has mostly removed restrictions; however, it is unclear whether restrictions will be re-introduced as a result of potential future COVID-19 variants and surges. The inevitable economic downturn is likely to have both negative and positive effects on ESG. The greater public and media interest may prompt organisations to ensure they do not fall short in ESG areas, given the possibility of adverse publicity (and the concomitant adverse financial effects, such as investors pulling investments if ESG measures are not met). COVID-19 is generally viewed in the UK as a long-term catalyst for ESG, as it has increased awareness, both within the UK and globally, of worker health and safety, income inequality and wider social and environmental issues.

On the whole, we believe it is likely that there will continue to be a greater emphasis in the UK on ESG in the longer term – in particular, an acceleration of the emphasis on "social" issues as a result of COVID-19 and "environmental" impact as a result of the recent IPCC findings and shifting government policy. How businesses treat their employees and all other stakeholders (for example, their supply chain and business partners) seems likely to become more important, and public disclosures and metrics (which will be more closely analysed) are likely to become the norm.

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In the United States, the growing focus on ESG has thus far led to voluntary, market-led responses rather than new regulations. This stands in contrast to the European Union, where the European Commission has adopted specific prudential and conduct-based directives on ESG. However, the regulatory landscape in the United States will likely change in the coming months. This year saw a flurry of new ESG initiatives and proposals driven by the Biden Administration. In February 2021, the President issued an executive order requiring the federal government to "drive assessment, disclosure, and mitigation of climate pollution and climate-related risks in every sector of our economy". The following month, the U.S. Securities and Exchange Commission (SEC) announced an all-agency approach to tackling climate change and other ESG risks and opportunities, which included, among other things, the creation of a Climate and ESG Task Force in the Division of Enforcement and the ramping up of enforcement on climate-related risks. The SEC is also undertaking a review of mandated climate-related and other ESG disclosure in public company filings, with recommendations expected before the end of this year. The Financial Stability Oversight Council (FSOC), which is made up of the heads of several federal agencies including the Treasury, the SEC, the Federal Reserve Board and the Office of the Comptroller of the Currency (OCC), recently issued a report on climate-related financial risk that, among other things, calls for new disclosures, endorses building on the core concepts of the Task Force on Climate-Related Financial Disclosures (TCFD) and recommends a variety of actions regarding climate risk across the federal financial regulatory agencies.

In addition, the Department of Labor (DOL), which regulates private-sector employee benefit plans, recently proposed new rules expressly enabling Employee Retirement Income Security Act (ERISA) fiduciaries to consider ESG factors in investment decisions and to engage in proxy voting without the perception that fiduciaries need a special justification for the ordinary exercise of shareholder rights on ESG matters. At the state level, a dozen states have enacted or are poised to enact requirements to enhance diversity on boards, and a small handful of states, including California, Connecticut, Illinois, New Jersey, New York, Oregon and Washington, have leveraged regulation of their pension systems to advance sustainable investment. In addition, federal and state agencies have also long overseen disclosure relating to the environment, workplace safety and discrimination and harassment, minimum wages, environmental pollution and labour protections.

1.2 What are the main ESG disclosure regulations?

In the United States, there are currently no mandatory ESG disclosures at the federal level, although the SEC requires all public companies to disclose information that may be material to investors, including information on ESG-related risks, and requires disclosure of whether and how diversity is considered a factor in the process for considering director candidates. The SEC announced earlier this year that it intends to provide updated guidance on ESG disclosures. The updates are expected to be released later this year. In addition, the SEC has approved a change to the Nasdaq rules that will require most Nasdaq-listed companies to have, or explain why they do not have, at least two diverse directors on their boards. The new Nasdaq rules will also require disclosure of voluntary self-identified gender, racial characteristics, and LGBTQ+ status of a company's board.

In January 2020, the SEC stated that companies should identify and address "those key variables and other qualitative and quantitative factors that are peculiar to and necessary for an understanding and evaluation" of the business and, accordingly, material to investors in their Management's Discussion and Analysis (MD&A) disclosures. While not aimed specifically at ESG measures, nor mandating any new disclosures, the guidance references several ESG metrics (such as energy consumption and employee turnover) as examples of Key Performance Indicators that may be included in MD&A disclosures. The guidance included direction as to the type of textual disclosure that should accompany such metrics, including a clear definition of the metric and how it is calculated, a statement explaining its inclusion, and explanation on how management uses the metric in managing or monitoring business performance.

In August 2020, the SEC revised Regulation S-K to require new descriptions, where material to an understanding of the business, of (1) a company's "human capital resources", and (2) "any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel)".

Shareholders have also used Exchange Act Rule 14a-8 to submit shareholder proposals requesting broader ESG disclosures. The 2021 proxy season continued to see an uptick in ESG-related proposals, particularly those relating to climate risks and diversity, equity and inclusion.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

There are a number of voluntary ESG disclosure frameworks that provide guidance on disclosing ESG performance. Such frameworks include the Global Reporting Initiative (GRI), the Value Reporting Foundation (formerly the Sustainability Accounting Standards Board (SASB)), TCFD, and the Stakeholder Capital Metrics framework created by the International Business Council of the World Economic Forum (WEF) and the four major accounting firms. Overall, the current voluntary disclosure regime remains fragmented with disclosure frameworks varying in scope, depth and approaches to materiality. Nonetheless, investor and stakeholder interest in ESG has prompted increasing numbers of companies to disclose ESG performance, which disclosures are typically aligned with one or more voluntary ESG disclosure frameworks. BlackRock and State Street have encouraged companies to disclose against SASB and TCFD. Many companies have also reported against the GRI framework, either separately or together with SASB and/or TCFD. As investors continue to demand decision-useful and comparable data, a number of disclosure frameworks have also announced plans to collaborate on standardising disclosure standards.

1.4 Are there significant laws or regulations currently in the proposal process?

Growing policy momentum has created a greater focus on ESG outcomes and metrics. In the past two years, five bills have been brought before Congress covering ESG disclosures, climate risk disclosures, tax payment disclosures, human rights and shareholder protections. While none of these bills were passed, they signal growing regulatory interest in ESG.

Earlier this year, the SEC announced an all-agency approach to tackling climate change and other ESG risks and opportunities, which included, among other things, the creation of a Climate and ESG Task Force in the Division of Enforcement and the ramping up of enforcement on climate-related risks. The SEC is also undertaking a review of mandated climate-related and other ESG disclosure in public company filings, with recommendations expected before the end of this year.

The DOL has also proposed new rules expressly enabling ERISA fiduciaries to consider ESG factors in investment decisions and to engage in proxy voting without the perception that fiduciaries need a special justification for the ordinary exercise of shareholder rights on ESG matters. The proposed rules declare that a fiduciary's duties of prudence and loyalty may require consideration of the economic effect of climate change and other ESG factors, noting that "a prudent fiduciary may consider any factor … material to the risk-return analysis". In particular, investment consideration may include: (i) climate change-related factors, including the exposure to "physical and transitional risks" and the impact of government regulations; (ii) governance factors, including board and executive compensation, corporate avoidance of criminal liability and compliance with applicable laws and regulations; and (iii) workforce practices, including diversity and equal employment opportunity, worker training and labour relations. The DOL also proposes to change the existing "tie-breaker" test. The current rules require documentation that competing investments be economically indistinguishable before the fiduciary may consider collateral factors other than investment returns. The proposed rules would replace such requirements with a new standard enabling fiduciaries to consider collateral factors after prudently concluding that competing investment choices "equally serve the financial interest of the plan". Fiduciaries would still need to meet other requirements – such as ensuring that collateral benefits do not come at the cost of reduced returns or greater risk, and making appropriate disclosures to plan participants.

1.5 What significant private sector initiatives relating to ESG are there?

The most significant private sector initiatives on ESG to date have focused on ESG disclosures, with significant input from corporates and investors. SASB, TCFD and the WEF's disclosure frameworks are all privately led initiatives. GRI is a joint partnership between the United Nations and two non-profits, Ceres and the Tellus Institute. The private sector, notably institutional investors, have spearheaded thought leadership and defined best practices on ESG by setting engagement priorities centred on ESG issues and adopting proxy voting policies that seek to promote the integration of ESG into the operations and strategy of their portfolio companies. Corporate leaders have also helped reshape consensus on the purpose of corporations: in 2019, the Business Roundtable issued a statement redefining the purpose of the corporation to include a commitment to all stakeholders, *in lieu* of its previous position that the primary purpose of the corporation is to serve its shareholders.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

A growing number of investors and asset managers believe that ESG can have a material impact on the long-term performance of their investment portfolios and have integrated ESG considerations into their investment decision-making. Such investors also believe that companies that integrate ESG risks and opportunities into their operations and business strategy are more likely to deliver sustainable, long-term value to their shareholders and other stakeholders. To this end, investors and asset managers have pushed for standardised, comparable and decision-useful ESG disclosures to assist with their investment stewardship and to hold companies accountable for ESG performance. Many institutional investors also use private and public engagement and leverage their proxy vote decisions to advance their views. The most prominent institutional investors have also leveraged their thought leadership and public platforms to support the adoption of ESG disclosure frameworks, to support regulations that support ESG investing and to increase public awareness of ESG issues.

For example, BlackRock's Chairman and Chief Executive Officer, Larry Fink, has requested that its investee companies disclose in accordance with SASB (or similar) and TCFD's guidelines. BlackRock warned that it would "be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and … plans underlying them". Similarly, State Street Global Advisors announced that it had endorsed SASB standards, will use its proprietary "R-Factor" ESG scoring methodology to benchmark companies, and will begin to take voting action against companies that are ESG laggards. Public sector investors, such as CalPERS and the New York State Common Retirement Fund, have similarly integrated ESG into their investment decisions and engaged with companies to improve sustainability, assessments of climate risks and workforce diversity, among other topics. In the 2021 proxy season, institutional investors lent their support to several ESG shareholder proposals and are increasingly exerting their proxy vote power to pursue their ESG priorities.

Activist investors have also increasingly leveraged ESG issues as part of their campaigns. In the 2021 proxy season, Engine No. 1 successfully unseated three ExxonMobil board members in a highly contested proxy fight centred on Exxon's carbon transition strategy. The Children's Investment Fund Management also launched several "Say on Climate" campaigns, which called on shareholders to ratify the company's climate transition action plans.

Support for ESG, however, is not universal. Some investors and academics have expressed concern that integration of ESG into investment decision-making and business practices may help hide poor management performance and reduce accountability.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Non-profit organisations, particularly those focused on sustainability, as well as intergovernmental organisations, notably the United Nations, as well as certain academics and think tanks, have lent their support and served as public platforms for promoting ESG. For example, GRI, one of the most prominent ESG disclosure frameworks, was conceived as a partnership between the United Nations Environment Programme, Ceres and the Tellus Institute. In addition, the United Nation's Sustainable Development Goals, together with the UN Global Compact and UN Principles for Responsible Investment, have provided frameworks and thought leadership on how companies and investors should approach and advance ESG goals. Over the past few years, the public has also become more vocal on climate change issues: thousands across the globe have taken to the streets to demand regulatory action on climate change, and employees from several large tech companies have banded together to demand that their employers take action to address climate change.

As noted above, the Biden Administration has become an important driver of ESG-related activity in the United States.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

The SEC is the principal regulator of the public markets in the United States. The DOL, as the federal regulator of private-sector employee benefit plans, has also sought to regulate ESG. FSOC has proposed that other federal regulators and agencies, including the Federal Reserve Board, the OCC, the Federal Deposit Insurance Corporation, the SEC, the Commodity Futures Trading Commission and the Federal Housing Finance Agency, take new action on climate change data, disclosure and scenario analysis, including: (1) filing climate-related data and methodological gaps; (2) enhancing public climate-related disclosures; and (3) assessing and mitigating climate-related risks that could threaten the stability of the financial system.

In addition, state attorneys general have also been active in enforcing ESG-related matters, including disclosures of ESG risks and violations of state and federal environmental and employee health and safety regulations.

2.4 Have there been material enforcement actions with respect to ESG issues?

Material federal enforcement action on ESG issues has centred on fraud in connection with environmental and health and safety laws. In January 2016, the U.S. Department of Justice (DOJ) filed a complaint against Volkswagen, alleging that the company and six of its executives and employees had violated the Clean Air Act by falsifying emissions data and destroying evidence. Volkswagen pleaded guilty and paid US$2.8 billion in criminal penalties and US$1.5 billion in a separate civil settlement. Volkswagen executives were also indicted for participating in the fraud. In the fall of 2020, the DOJ settled criminal and civil investigations into Purdue Pharma that centred on violations of the Federal Food, Drug, and Cosmetic Act, the Federal Anti-Kickback Statute and the False Claims Act.

State attorneys general have led investigations into climate-related activities and disclosures of energy companies. In two of these cases, the New York Attorney General led investigations into whether the companies misled shareholders and the public regarding the links between their business activities and climate change. Peabody Energy settled investigations into its activities in 2015 by revising disclosures, but did not face any monetary penalties. In December 2019, a New York state court ruled that the New York Attorney General had "failed to establish by a preponderance of the evidence" that Exxon had violated the Martin Act, which enables litigation alleging shareholder fraud. State attorneys general, including in Connecticut, Hawaii and Vermont, have filed similar suits against energy companies, alleging that the companies violated the state's unfair trade practices law and deceived consumers about what the company knew about the impact of fossil fuels on climate change. Other states, and cities, have brought claims against fossil fuel companies on negligence, trespass and nuisance theories. Outside of climate change, multiple state attorneys general, as well as local governmental entities, settled suits brought against Purdue Pharma and the family that founded it, in connection with opioid abuse.

Earlier this year, the SEC announced an all-agency approach to tackling climate change and other ESG risks and opportunities, which included, among other things, the creation of a Climate and ESG Task Force in the Division of Enforcement and the ramping up of enforcement on climate-related risks.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

State consumer protection and unfair business practice laws have been used to challenge environmental or sustainability performance, with many suits being filed during the past few years. Where these claims are based on misrepresentations in product labels or even in other company statements such as marketing materials, they have had some success, with several lawsuits surviving motions to dismiss and a few having settled. Claims based on omissions have not had apparent success to date, but this could change as ESG disclosures become mandatory and the pace of litigation quickens. These claims are usually brought as class actions, and California has been a popular venue to file such claims, under one or more of the following state statutes: the Consumer Legal Remedies Act; the False Advertising Law; and the Unfair Competition Law. To prevail, a plaintiff must show that the challenged statement is false or misleading and likely to deceive members of the public.

Securities litigation arising from claims of incomplete or misleading disclosures has emerged as a concern for companies looking to make ESG disclosures. While strike suits from shareholders seeking to profit from forward-looking ESG disclosures may be inevitable, companies are generally able to shield themselves from civil liability under existing legal safe harbours. The Private Securities Litigation Reform Act of 1995 (PSLRA) established statutory safe harbours that protect forward-looking statements from private action under the Securities Act of 1933 and the Securities Exchange Act of 1934. The statutory definition of forward-looking statements covered under the PSLRA has generally been broadly interpreted and includes projections on future revenues and earnings, future plans and objectives of management, and discussions of future economic performance and financial conditions, as well as assumptions underlying future projections. In addition, the bespeaks caution doctrine provides common law protection for forward-looking statements that are accompanied by adequate risk disclosure to caution readers about specific risks that may materially impact the forecasts.

In addition to securities laws cases, a series of shareholder lawsuits litigated in the Delaware Court of Chancery have focused on allegations that boards have not properly overseen ESG-related risks. These cases have underscored the need for boards to monitor key risks and to document their monitoring efforts through minutes and other corporate records. A number of major technology companies have also been subject to recent lawsuits filed by employees alleging gender and race discrimination.

2.6 What are current key issues of concern for the proponents of ESG?

Among the chief concerns of proponents of ESG are (1) management of climate change risks, including adaptation to a low-carbon economy, (2) human capital management, particularly racial and gender diversity and inclusion in the workplace, and (3) questions around corporate purpose and how companies are serving the interests of all of their stakeholders. In light of the pandemic and other current events, concerns regarding employee welfare, supply chain resilience and regulatory compliance have also come to the fore, and privacy and cybersecurity issues remain top of mind.

Proponents of ESG also continue to view the currently fragmented ESG disclosure regime as an impediment to implementing transparency and accountability on ESG, and there remain significant efforts, most recently from the WEF, to rally issuers and investors around a single standardised, comparable and decision-useful ESG disclosure framework. While still somewhat on the horizon, proponents of ESG increasingly raise concerns with greenwashing in general and in particular with the efficacy of carbon offsets as a meaningful method of satisfying carbon-neutrality pledges, and on the impact of business activity on clean water and other natural resources.

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

Well-advised boards and management collaborate closely to identify and oversee ESG risks and opportunities and to integrate ESG considerations into a company's business operations and strategy. While the legal duties of the board have not changed, investors and other stakeholders increasingly expect directors to assume responsibility for overseeing the management of ESG, including defining corporate purpose, ensuring that adequate processes are in place for monitoring, reporting and addressing ESG risks and opportunities, shaping long-term business strategy that takes into account ESG considerations, and aligning management incentives to foster the integration of ESG throughout the company's operations.

Management at all levels has an important role to play in the reporting of ESG risks and opportunities to the board, as well as integrating ESG into the company's day-to-day operations. The information and risk assessments generated by management can play an important role in shaping the board's perspective on long-term strategy and risk management. While some companies continue to address ESG within existing functions, such as legal and human resources, others have created dedicated roles to address ESG concerns within the company. For example, Chief Diversity Officers are increasingly common among organisations seeking to improve workforce diversity and inclusion. Other companies have created specialist internal taskforces on ESG.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

While the board is tasked with overseeing the management of ESG issues, it retains discretion on how to allocate this responsibility. In some cases, depending on the needs and circumstances of the company, the board has delegated oversight responsibilities with respect to certain ESG issues to specific board committees, such as the audit or the nominating and governance committee. Other companies may find certain ESG risks and opportunities to be particularly salient as to deserve a dedicated committee (e.g., environmental health and safety or privacy committee). These board committees typically would be responsible for liaising with management and outside advisors on the applicable matters and reporting on the company's performance and progress to the full board.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

There is growing interest in aligning compensation incentive structures with ESG goals and outcomes, particularly in the wake of the coronavirus pandemic. Currently, just over half of S&P 500 companies use ESG metrics in their executive compensation plans, most commonly in annual incentive plans, although the use of ESG metrics continues to grow. While the use of ESG metrics in incentive plans continues to evolve, the current most common approach is to use ESG metrics as part of a scorecard of non-financial or strategic objectives or as part of an individual performance assessment that is used to adjust incentive plan performance. Use of weighted metrics, as typically done for financial measures, is less common with ESG inputs, particularly when measuring performance on "E" and "S" issues. However, as the use and measurement of ESG metrics becomes mainstream and as companies commit to longer-term ESG goals, we would expect that ESG performance will likely play a growing role in incentive plans, including long-term incentive plans, and that the board will take a lead role in helping to establish the appropriate metrics and targets.

A 2020 study by Semler Brossy found that 62% of Fortune 200 companies included measures of ESG in their incentive plans. The most prevalent ESG metrics involved customer satisfaction (48%), talent development (41%), and diversity and inclusion (38%). By contrast, climate-related metrics such as emissions and renewable energy were used by only 17% of companies. It is worth noting that while ESG metrics are frequently included in compensation discussions, these metrics are not often major factors in determining actual compensation. A 2020 Glass Lewis report noted that ESG metrics often have modest weighting, and in many cases are subsumed within qualitative or individual performance components of compensation plans. Across companies, the principal challenge in implementing ESG incentive goals is devising objective criteria for measuring performance that will be well received by shareholders and can stand the test of time.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Companies are increasingly setting and publicising ambitious goals on ESG. A number of recent initiatives have focused on sustainability and diversity. Several major technology companies, in particular, have embraced zero-carbon pledges: Amazon has committed to net zero carbon emissions by 2040; and Microsoft plans to be carbon negative by 2030 and, by 2050, to remove all carbon it has emitted since its founding in 1975. Apple has committed to have carbon-neutral supply chains by 2030. Increasing numbers of companies have also set targets on improving racial and gender diversity in their workforce, particularly on boards and among senior management. The focus on diversity and inclusion has intensified in response to the multiple cases of highly publicised, racially tinged police brutality that have occurred in recent months. Other efforts at ESG integration have included increased engagement with shareholders and other stakeholders to identify ESG concerns and priorities, and expansion of internal and external ESG reporting processes aimed to monitor progress and compliance with ESG goals. Companies are also re-examining how their executive compensation policies can be structured to align management incentives with ESG performance.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

ESG ratings, whether internally or externally developed, are used by providers of debt and equity financing to measure the ESG performance of borrowers. These ratings can play a role in sustainability-linked financing, where the loan terms are tied to the borrower's ESG performance. While sustainability-linked loans currently remain a small sector of the debt market, the volume of sustainability-linked loans has grown rapidly and will likely continue to grow in the coming years. As reliance on ESG ratings increases, links are already being drawn between ESG ratings and credit ratings. Several of the major credit ratings agencies have recently entered the ESG ratings space: in 2019, Moody's acquired a majority stake in Vigeo Eiris, a major ratings provider, while S&P acquired Trucost in 2016 and created the S&P Dow Jones ESG index earlier this year, which gives companies ESG scores. Morningstar took a 40% stake in Sustainalytics, another major ratings provider, in 2017.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds and social bonds play a small but growing role in the U.S. markets, with Climate Bonds recording a doubling in the volume of green bond issuances year-over-year with US$227.8 billion issued in the first half of 2021. The United States does not have a regulatory system similar to the EU Taxonomy on Sustainable Finance or the EU Green Bond Standard, which sets performance thresholds for identifying environmentally sustainable economic activities and provides tools for verifying and reporting on green investment. While U.S. regulators have yet to follow their EU counterparts, private sector efforts are in place to promote standardisation and transparency on green bond issuances including a consultation draft released by the CFA Institute on ESG disclosure standards for investment products, including green bonds.

4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bond issuances have outpaced green bond issuances in the U.S. market in recent years, although such bonds remain a relatively small sector of the overall lending market. According to Climate Bonds, the first half of 2021 saw the sustainability-linked bond market segment growing to US$32.9 billion, representing 6% of total labelled debt issuance of US$496.1 billion for the period.

4.4 What are the major factors impacting the use of these types of financial instruments?

While still in its nascent stages in the United States, the growth of green and sustainability-linked bonds in recent years has been fuelled by growing interest among investors and companies looking to embrace ESG goals and to efficiently fund a transition to a green economy. Sustainability-linked bonds, in particular, provide investors and companies with the flexibility to invest in a wide range of projects while still capitalising on improvements in ESG performance. Increased transparency and standardisation in green and sustainability-linked bond issuances have also helped to fuel growth: the voluntary Green Bond Principles and Sustainability-Linked Bond Principles released by the International Capital Market Association have helped provide market participants with guidance on structuring, disclosing and reporting on green and sustainability-linked bond issuances. Newly adopted EU regulation on sustainable bond issuances will likely help to provide further increased transparency and standardisation on future issuances and draw even greater corporate and investor interest in these types of financings.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

Currently, in the United States, the assurance and verification processes for green and sustainability-linked bonds is largely guided by voluntary frameworks, such as the Green Bond Principles and Sustainability-Linked Bond Principles issued by the International Capital Market Association.

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

The COVID-19 pandemic has drawn significant attention to a number of "S" issues, notably issues relating to human capital management and diversity and inclusion, worker safety and well-being, and supply chain resilience. Employee health and safety, particularly among workers in essential industries, emerged as an immediate area of concern as the pandemic rapidly took hold of major U.S. cities. Growing awareness and concern over systemic racism has led to an increased focus on diversity and inclusion in who businesses hire, how they promote, where they invest, the suppliers they use, and the products and services they offer, as well as some high-profile corporate financial commitments to organisations focused on racial justice and community development. The disruptions and shortages that arose in the early days of the pandemic prompted companies to re-evaluate how to balance supply chain efficiency with supply chain resilience. Attention has also turned to executive compensation, with investors increasingly interested in how incentives can be aligned to ESG outcomes.

6 Trends

6.1 What are the material trends related to ESG?

Race to Carbon Net Zero: The continued push to "green" economies will present new opportunities and risks for companies and investors as they look to adapt to a low-carbon economy. Companies that are slow to adapt may face severe financial ramifications in the form of stranded assets and bear reputational costs as consumers continue to pivot to sustainability.

Disclosure to Integration: It is likely that ESG disclosure standards will continue to converge over time, providing investors with the standardised decision-useful data necessary to pinpoint ESG leaders and laggards. As part of that disclosure, companies, investors and other stakeholders are considering which metrics should require third-party verification or attestation. Attention is also being given to ESG integration, a trend that is likely to accelerate on the back of improved ESG disclosures providing both companies and investors greater clarity on ESG performance.

Growing Focus on Human Capital: Human capital issues will continue to attract investor and stakeholder attention as digitisation, automation and the growing globalised knowledge economy demand companies to be more agile and forward-leaning in shaping their future workforce. At the same time, companies will continue to juggle heightened expectations on diversity and inclusion in their workforce, particularly in senior-level management and on boards.

Vigilant Protection of Data: Data and cybersecurity have remained as top-of-mind ESG issues. Investors, companies and other stakeholders continue to focus on the critical risks posed in this area.

Updating Corporate Purpose: The ongoing shift toward stakeholder capitalism has prompted companies to re-examine their purpose and how they can achieve value for all their stakeholders. Looking ahead, stakeholders and investors will be looking to identify companies that have not advanced past the rhetoric.

Supply Chain Resilience: The COVID-19 pandemic has illustrated the fragility of many supply chains, and companies may need to re-evaluate how they balance supply chain efficiency with resilience. The shift toward a green economy, the impact of climate change, ongoing global trade tensions and pressure for reshoring have introduced new risks and uncertainties to be considered as companies rebuild their supply chains in the aftermath of the pandemic.

Compensation Tied to ESG Outcomes: As investor- and stakeholder-focus on ESG performance continues to grow, companies may face increased pressure to select and incorporate relevant metrics into compensation incentive structures. Improved ESG disclosures and standardisation of ESG metrics will likely create further impetus to tie compensation to ESG performance.

6.2 What will be the longer-term impact of COVID-19 on ESG?

The COVID-19 pandemic has accelerated many of the ongoing ESG trends while also reinforcing the importance of ESG. In the aftermath of the pandemic, investors and other stakeholders will want to know how companies approach systemic and critical incident risk management, and in particular, how they rebuild their internal policies and procedures and supply chains to anticipate future black swan events. Conversations around sustainability and adaptation to a low-carbon economy are also likely to gather pace as investors and the broader public link the pandemic with environmental degradation and draw parallels between the pandemic and climate change and the latter's potential to wreak an even more serious global calamity.

The pandemic has also accelerated the shift toward stakeholder capitalism by bringing into focus issues such as workplace safety and diversity and inclusion. The stark social and racial disparities that have been exposed amid the pandemic will likely increase demand for companies to adopt a corporate purpose that serves the interests of all its stakeholders and not just shareholders.

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