Insights

ESG AND SUSTAINABLE GROWTH FIND REGULATORY CLARITY

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Last year saw a real focus on the importance of sustainability in business activities, highlighted by the dramatic and very direct Extinction Rebellion campaign, the UN's Climate Action Summit in September and the high profile actions of individuals such as Greta Thunberg. After a relatively slow start, the financial services industry is beginning to acknowledge the importance of sustainability in its dealings with clients and investors, and in the development of product ranges. 2020 is likely to see that pace increasing further with a number of measures being taken at the national and international level.

As policymakers have become more interested in how asset managers achieve their non-financial goals, we are seeing a long-term trend emerge of environmental, social and governance ("ESG")/sustainable, responsible and impact investment ("SRI") standards driving regulatory compliance. ESG and SRI are also beginning to influence standards of care, with investors and lenders increasingly using ESG/SRI measures to evaluate the performance of investments. Asset managers who implement their commitment to sustainability and who hold consultants, managers and advisors to account, are likely to create a competitive advantage for themselves – and a "sustainability multiplier effect" in the market.

Legal and regulatory environment

There is strong political drive for responsible and sustainable business conduct – in the UK, EU-wide and globally. The UK backdrop, alongside various industry-led initiatives, includes the FCA's support for introducing climate-related mandatory disclosure requirements for regulated firms (as set out in its October 2019 Feedback Statement on Climate Change and Green Finance), and the Department for Work and Pensions' recommendation that pension scheme trustees prepare an optional policy on how investment strategies consider non-financial factors, such as ethics, social and environmental impact, and quality of life.

In November 2019 the EU adopted a package of measures on sustainable finance, coming into force from 10 March 2021. The reform's key tenets are taxonomy, disclosure, investor duties, benchmarks and suitability. Asset managers will be required to integrate sustainability risks into

their operating models, provide more detailed disclosures on ESG policies and sustainability risks and increase due diligence on the ESG profile of funds.

This legislation has a much shorter implementation period than most other EU financial services legislation, with affected firms only having 15 months to become compliant (with a delay until January 2022 for the first annual reports containing ESG/sustainability information). Given this short window firms will need to begin their implementation planning early in 2020. Further, as EU delegated legislation is expected to impact MiFID II and IDD suitability testing, firms should also be prepared to take ESG considerations and preferences into account in the suitability assessments they undertake to see if proposed investments are appropriate for a client.

Investors and managers are already committing to aspirational and voluntary investment principles to mandate a more systematic approach to ESG integration into investment, risk and organisational processes. A growing number are signatories to the UN Principles for Responsible Investment. This involves a manager's commitment to six voluntary and aspirational investment principles, including: considering ESG issues when making investment decisions; seeking disclosures from ESG entities in which they invest; and reporting on ESG activities.

Side letter provisions are becoming more common, for instance that the manager maintains and/or introduces appropriate ESG strategies to the management of portfolio investments. Another framework recently consulted on, and which may become increasingly recognised by the funds industry, is the Sustainable Development Goals ("SDG") Impact Practice Standards for Private Equity Funds. This UN initiative provides a practical end-to-end checklist designed to integrate impact into fund design and execution.

Clarity and challenges

Policymakers are keen to provide clarity on what sustainable investments are by creating an EU-wide classification system to provide a common language to identify economic activities that can be considered environmentally sustainable. The new taxonomy should give greater transparency for end-investors, allow better comparison between products and reduce opportunities for "green-washing". Although this taxonomy is EU-centric and only likely to be mandatory for products that are marketed as a "sustainable investment", we expect it to become the global language of mainstream impact investment.

Regulatory consistency across the various standards, to avoid duplication or divergence, is key. Other challenges include specifying appropriate time horizons (particularly since many climate-related risks may crystallise beyond a firm's typical planning horizon) and modelling and methodological difficulties.

Conclusion

We are seeing sustainability becoming more central to managers' and investors' considerations. 2020 will be a crucial year for codifying and embedding the EU sustainable finance measures, along with similar initiatives emanating from the UK and other jurisdictions. The current investment landscape presents an opportunity to align operating, legal and governance approaches to ensure long-term value through sustainable business conduct. We expect in many cases this will involve re-examining portfolio company governance as voluntary frameworks develop into legal requirements.

MEET THE TEAM

Matthew Baker

London

matthew.baker@bclplaw.com
+44 (0) 20 3400 4902

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