CLIFFORD CHANCE

ESG ISSUES FOR CORPORATES
RISKS AND OPPORTUNITIES

GROWING THE GREEN ECONOMY

OCTOBER 2019

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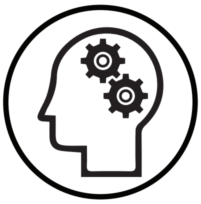


Sustainability and environmental, social, and governance (**ESG**) factors have fast risen towards the top of the board agenda — corporates are increasingly aware that a failure to address these matters can be detrimental to their businesses, both financially and reputationally. In the current business climate, a company's purpose, culture and values have never been so under the microscope. Investors and wider society are increasingly of the view that the generation of profits cannot of itself be the ultimate purpose of a company, but rather to run a successful business with a clearly defined purpose and set of values which guide decision-making and with a long-term strategy which recognises the role that the company plays in wider society.

Legal and best practice requirements on institutional investors and asset managers to take into account ESG factors when making investment decisions have a direct consequence for investment in corporates. Institutional investors and asset managers require clear disclosures by the companies in which they invest of their respective policies and actions on ESG issues in order to enable them to report back to their stakeholders that they are investing in line with their own stated policies on sustainability and ESG matters.

Failing to take sustainability issues into account when making key decisions and not having sustainability as a key driver of any long-term business strategy will adversely impact corporates. ESG preparation and planning must be a key focus of boards if corporates wish to remain attractive as investment opportunities.

Over the last decade, there has been increasing appetite amongst international and supranational organisations, governments, regulators, investors and consumers to transition to a more sustainable, ethical, resource-efficient, low carbon, "green" economy, with ESG factors at the heart of that economy. There have also been calls for greater social equity which, in the UK, has led to developments such as gender pay gap reporting amongst larger companies[1] and the requirement on corporates to prepare an annual statement illustrating the steps taken to ensure that modern slavery is not taking place in their businesses or supply chains[2]. From a governance perspective, amongst other initiatives, there has also been a push to encourage

1 The Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 require employers with 250 employees or more to publish annually information on their gender pay gaps. Note the Government also consulted on ethnicity pay reporting in 2018 (the consultation closed in January 2019), which means we may see further pay gap reporting requirements being introduced in the future.

2 This is required under the Modern Slavery Act 2015.

diversity (both in terms of gender and ethnicity) on the boards of FTSE 350 companies[3] and to give shareholders a greater say over executive remuneration. Further, recent amendments to company law have introduced a new requirement on large companies[4] (which applies to financial years beginning on or after 1 January 2019) to include, in their strategic reports, a statement describing how the directors have had regard to the matters set out in section 172(1)(a)-(f) of the Companies Act 2006 during the financial year under review (section 172 statement). The matters set out in section 172(1)(a)-(f) include the impact of the company's operations on the community and the environment. This publication focuses mainly on the 'E' in ESG.

3 Following, amongst other things, the 2016 Hampton-Alexander Review: FTSE women leaders – improving gender balance in FTSE leadership and the Parker Review on ethnic diversity of boards. The UK Corporate Governance Code 2018, which applies to premium listed companies for accounting periods beginning on or after 1 January 2019, amongst other things, provides that board appointments should promote "diversity of gender, social and ethnic backgrounds".

4 A large company is one which meets two out of three of the following : (i) turnover of more than £36m; (ii) balance sheet total of more than £18m; and (iii) more than 250 employees.

Background: why has ESG become such an important issue?

The Paris Climate Agreement[5] raised the profile of climate change at every level and has led to an increased discourse about sustainability and sustainability efforts globally. The EU and national governments have taken steps to help achieve the goals of the Paris Climate Agreement by introducing new legislation, regulations and guidelines on sustainability.

While many of these new laws and regulatory requirements apply, or will apply, to those operating in the finance industry or financial services sector[6], they will have a knock-on effect on corporates. See further "Overview of legal and regulatory developments" below.

Macro-economic pressures, including concerns about climate change, the emergence of the enlightened consumer (who wishes to consume only 'ethically produced[7]' goods and services) and a greater sense of responsibility amongst shareholders to invest in sustainable businesses are acting as a catalyst for change.

Governments, organisations and investors are willing to draw attention to perceived deficiencies in, or non-compliance with, environmental reporting requirements and call corporates to account: there has been an explosion[8] of climate change-related litigation brought by governments, organisations, shareholders and individuals against corporates and other businesses in recent years due to (in part) the increasing number of climate change-related laws and regulations.

Ethical and sustainable business practices are championed by consumers, investors and finance providers alike. ESG products and funds have, in recent years, become increasingly popular with investors, resulting in an increased demand for such products and funds – the trend is likely to continue its upwards trajectory, particularly from support by millennial investors who are more likely to favour sustainable investments.

Millennials, who are very much focused on ESG issues, are increasingly becoming an important consideration for institutional investors and asset managers. Automatic pension enrolment in the UK has brought millennials into the investment chain and, as a result, their influence has grown. A recent report[9] into the attitudes of millennials towards sustainable and responsible investments identifies a number of key trends,

5 The Paris Climate Agreement sets out a global action plan to put the world on track to avoid climate change by limiting global warming to well below 2°C above pre-industrial levels and pursuing efforts to limit it to 1.5°C (as this would significantly reduce the risks and impacts of climate change).

6 e.g from 1 October 2019, new requirements on trustees of defined benefit (**DB**) and defined contribution (**DC**) pension schemes with more than 100 members come into effect which require trustees to ensure that their statement of investment principles includes the trustees' policies on: (i) how financially material factors, including those arising from ESG considerations (including climate change) are taken into account over the time horizon of the scheme in the selection, retention and realisation of investments; (ii) the extent (if at all) that non-financial matters are taken into account; and (iii) engagement and voting activities regarding investments (i.e. stewardship).

7 i.e. which have a minimal negative impact on the environment (if any), do not have a negative impact on the local community and are not produced by child labourers or workers who are not treated with dignity or remunerated adequately.

8 The total number of actions commenced worldwide stands at around 1,500.

9 See further "Millennials and responsible investment", which represents the output of the joint research project conducted by First State Investments and KeplerCheuvreux.

including that an overwhelming majority of millennials are interested in responsible investment and that environmental concerns were considered by over a third of participants to be the area of most focus.

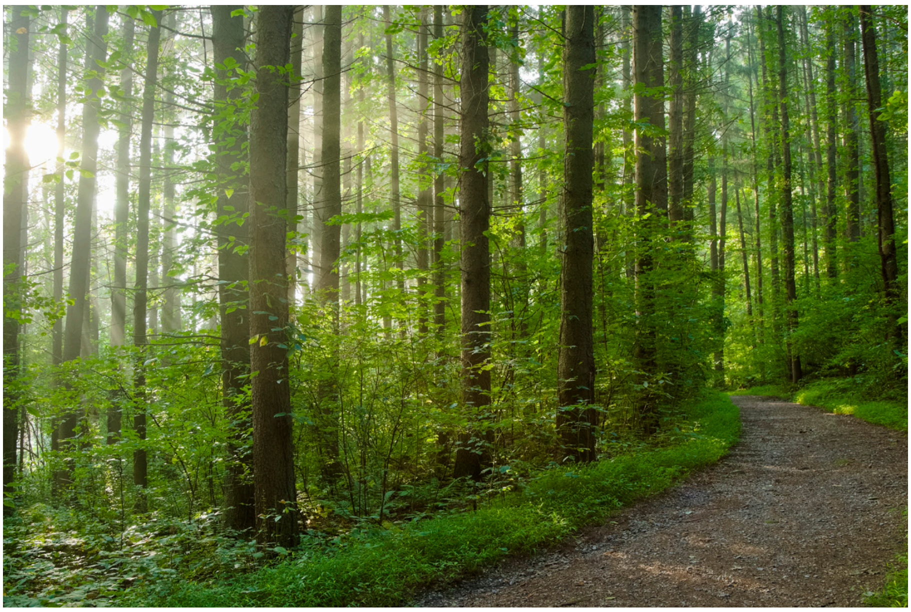
Demand for sustainable investments is being driven, in part, by millennials who prefer to invest in alignment with personal values.[10]

ESG investments may also avoid risk to portfolios – investors can use ESG screening criteria to avoid companies whose practices could present a risk factor (e.g. the widely-reported Volkswagen emissions scandal in 2015 had a negative impact on the car manufacturer, not only financially but also reputationally). High-risk, short-term gains by corporates at the expense of sustainability do not sit well in today's social and political climate.

Environmental activist shareholders of companies in the oil and gas sector have undoubtedly acted as a catalyst to their companies taking climate change seriously (including ensuring that their business strategies are consistent with the goals of international environmental agreements, such as the Paris Climate Agreement). They have demanded that resolutions be added to the agenda at annual general meetings and even managed to strong-arm corporates to link executive remuneration with greenhouse gas emissions[11].

Shareholders, particularly long-term (institutional) investors, are increasingly no longer 'passive investors': they are more willing to challenge decisions by boards and question the direction in which their companies are heading. They are willing to challenge directors on what they perceive to be excessive remuneration packages. See further "Shareholder activism" below.

Corporates must adapt and respond to this evolving ESG climate.



10 EY report: Sustainable investing: the millennial investor.

11 As agreed by the board of Royal Dutch Shell at its 2019 AGM.

Overview of legal and regulatory developments

We have seen a proliferation of political discourse, consultations, laws, regulations and guidelines (at both the international and domestic levels) in the ESG field, some of which are still being developed/are yet to be finalised.

International/EU developments that corporates should be aware of include:

- The UN Principles for Responsible Investment
- The UN Sustainable Development Goals
- The OECD Guidelines for Multinational Enterprises and Due Diligence Guidance for Responsible Business Conduct
- Recommendations of the Task Force on Climate-related Financial Disclosures
- The EU Sustainable Finance Action Plan
- The EU taxonomy of sustainable activities
- Legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations
- The Non-Financial Reporting Directive and Guidelines on Climate-related Information
- The EU Shareholder Rights Directive II

Corporates should also be aware of ongoing developments and guidance at the national level, including, in the UK:

- The Financial Conduct Authority's (FCA's) discussion paper on Climate Change and Green Finance
- The Government's Green Finance Strategy: Transforming Finance for a Greener Future and responses by certain UK regulators
- The Financial Reporting Council's (FRC's) Stewardship Code
- The London Stock Exchange's Guidance for issuers on the integration of ESG into investor reporting and communication

Note that there are other ESG developments that will be relevant to corporates, but we have highlighted those we consider most relevant in this publication.

International and EU developments

Some of the developments discussed in this section will affect corporates directly because they apply to, or impose requirements on, corporates themselves (such as requirements to make certain disclosures), while others will affect corporates indirectly via the investment chain — the developments may apply to/impose requirements on institutional investors and asset managers who may, in turn, request information, disclosure or certain action from corporates so that they may satisfy their own obligations. The investor community will be scrutinising corporates more rigorously to see which ESG disclosure/reporting frameworks or standards they are applying or have otherwise adopted. Some of these frameworks/standards are considered below.

The UN Principles for Responsible Investment (UN PRI)

The UN PRI apply to corporates indirectly.

The UN PRI are a voluntary set of investment principles that were developed by investors for investors. They offer a range of possible actions for incorporating ESG issues into investment practice. Institutional investors and asset managers that are signatories to the UN PRI commit to the six principles, including that they will seek appropriate disclosure on ESG issues by the entities in which they invest[12]. Possible actions for achieving this include that the signatories:

- request standardised reporting on ESG issues (using tools such as the Global Reporting Initiative);
- request that ESG issues be integrated within annual financial reports;
- request information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact); and
- support shareholder initiatives and resolutions promoting ESG disclosure.

Corporates should be prepared for such requests and actions from institutional investors and asset managers who are signatories and should note that the number of signatories is increasing rapidly – even if a corporate's investors are not currently signatories, they may become signatories. For further details on the UNPRI see text box below.

What are the UN Principles for Responsible Investment?

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.**
- Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- Principle 6: We will each report on our activities and progress towards implementing the Principles. The UN PRI set out lists of possible actions in relation to each of the six principles.

12 Asset owner and investment manager signatories must report annually on their responsible investment activities through the PRI Reporting Framework.

The UN PRI website has published some guidance/reports on its Listed equity tools page that may be relevant to listed issuers.

The UN Sustainable Development Goals

The UN Sustainable Development Goals apply to corporates directly.

In 2015, all UN Member States adopted the 2030 Agenda for Sustainable Developments which includes 17 Sustainable Development Goals (**SDGs**). These address global ESG challenges such as ending poverty and inequality, tackling climate change and environmental degradation, and encouraging prosperity and peace and justice. Each SDG has specific measurable targets to be achieved by 2030. For details on the SDGs see "What are the UN Sustainable Development Goals" below.

In the past, the SDGs have struggled to gain traction in the boardroom, and reporting in line with the SDGs was not seen as straight forward. However, a growing number of listed companies are stating in their Annual Reports that their sustainability commitments are aligned with the UN Sustainable Development Goals and some are disclosing how specific SDGs are being supported and are explaining what efforts they have made to advance specific SDGs. A 2018 report by KPMG revealed that 40% of the world's 250 largest companies were discussing the SDGs in their corporate reporting[13].

The SDGs are supplemented by a report published in August 2018 by the Global Reporting Initiative (GRI)[14] and the UN Global Compact[15] entitled "Integrating the SDGs in corporate reporting: a practical guide". The guide outlines a three-step process to assist companies in embedding the SDGs in existing business and reporting processes:

- Step 1: the process of prioritsation of impacts and identification of SDGs for a company to act and report on (define priority SDG targets)
- Step 2: how to set business objectives, select disclosures and analyse performance (measure and analyse)
- Step 3: guidance on reporting and improving SDG performance (report, integrate and implement change)

13 How to report on the SDGs: What good looks like and why it matters, KPMG, February 2018.

14 The GRI Sustainability Reporting Standard are widely adopted global standards for sustainability reporting.

15 The UN Global Compact encourages companies to conduct their business responsibly (by aligning strategies and operations with its Ten Principles on human rights, labour, environment and anti-corruption) and take strategic actions to advance broader societal goals, such as the UN SDGs. Companies can choose to become signatories (at the national or regional level) or participants (at the global level and at their national or regional level).

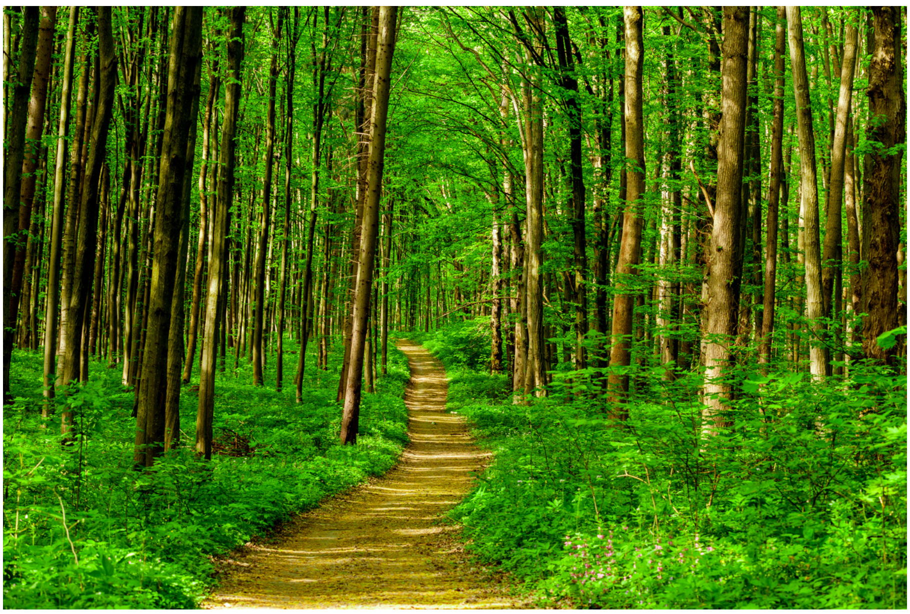
The SDGs are becoming increasingly important for the investor community. The SDG Investment Case, published by the UN PRI in 2017, highlight that the SDGs "are an articulation of the world's most pressing sustainability issues, and as such, act as the globally agreed sustainability framework". It further states that the SDGs can "support investors in understanding the sustainability trends relevant to investment activity and their fiduciary duties".

To the extent companies are reporting on actions they are taking to advance the SDGs Or specific SDGs, the guide may assist with taking stock of their current actions and identify additional priorities to contribute to achieving the SDGs.

What are the UN Sustainable Development Goals?

The OECD Guidelines for Multinational Enterprises and the Due Diligence Guidance for Responsible Business Conduct apply to corporates directly.

Some listed companies apply the Organisation for Economic Co-operation and Development (**OECD**) Guidelines for Multinational Enterprises (**OECD Guidelines**), published in 2011, to ensure a uniform approach to business standards across their worldwide operations. The OECD Guidelines are supplemented by the OECD Due Diligence Guidance for Responsible Business Conduct (**RBC**) which was published in 2018. The RBC provides practical support to entities in relation to the implementation of the OECD Guidelines and includes additional explanations and examples of due diligence. The RBC draws on sector specific due diligence guidance issued by the OECD, e.g. extractive industries, financial sector, agricultural supply chain.



Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)

The TCFD recommendations apply to corporates directly.

The TCFD was commissioned by the Financial Stability Board to develop voluntary, industry-led recommendations aimed at companies (both financial and non-financial) with public debt or equity to include forward-looking climate impacts in their financial filings.

The TCFD final report and recommendations on climate-related financial disclosures focus on four key areas representing core elements of how organisations operate: governance, strategy, risk management and metrics and targets. The four overarching recommendations are supported by 11 key climate-related financial disclosures (see text box at the end of this subsection for details on the four key areas and the 11 recommended disclosures).

The UK Government endorsed[16] the TCFD recommendations and has recently expressed an expectation (in its Green Finance Strategy paper[17]) that all listed companies and large asset owners should disclose in line with the TCFD recommendations by 2022.

The primary aim of the TCFD recommendations is to ensure that investors, lenders and insurance underwriters have sufficient information about how climate change could affect their actual and proposed investments.

How voluntary compliance by corporates has fared so far

A significant number of companies have committed to support the TCFD voluntarily; however, although climate-related disclosure has increased, it is still insufficient for investors and remains inconsistent because companies are failing to:

- provide clarity on the potential financial impact of climate-related issues on them;
- report consistently on the financial impact of climate-related issues; or
- demonstrate how these issues impact the resilience of their strategy using scenario analysis[18].

Corporates need to improve their climate change-related disclosures.

The TCFD recommendations are accompanied by guidance to organisations on implementing the TCFD recommendations. The guidance is divided into three parts:

- guidance for entities operating in all sectors;
- supplemental guidance for entities operating in the financial sector (aimed at banks, insurance companies, asset owners, and asset managers); and

16 The Government announced in September 2017 that it has officially endorsed the recommendations.

17 As announced by the Government in its paper: Green Finance Strategy: Transforming Finance for a Greener Future, published in July 2019. The Government also announced that it would (i) develop TCFD guidance for pension schemes; and (ii) set up a joint taskforce with UK regulators to examine the most effective method of approaching disclosure, including whether mandatory reporting might be a feasible option.

18 As reported by the TCFD in its Status Report, published in June 2019.

- supplemental guidance for non-financial groups (aimed at groups operating in the following sectors: energy, transportation, materials and buildings and agriculture, food and forest products).

On 23 September 2019, the Sustainability Accounting Standards Board (**SASB**) and Climate Disclosure Standards Board (**CDSB**) published the TCFD Good Practice Handbook which identifies good practices in implementing the TCFD recommendations and has been produced in response to the often-asked question, "What does good practice on TCFD disclosure look like, and which company reports can we look at?". The handbook provides examples of good practice from across G20 countries. Key takeaways highlighted in the handbook include:

- ensuring connectivity of information in the disclosures being made — the 11 TCFD recommendations should be viewed holistically and connected with other information in the mainstream report;
- adopting the correct lens for viewing climate-related risks and opportunities — this involves considering the risks and opportunities likely to arise from climate change impacting the business (rather than the converse);
- adequately differentiating between the role of the board and management in respect of climate-related risks and opportunities — companies should provide clarity on how the board exercises its oversight function and how this differs from management roles and responsibilities;
- clarifying the interrelationship between the strategy and risk management core elements — the SASB and CDSB note that there appears to be confusion between these two separate core elements and suggest that consideration of specific climate-related risks and opportunities should be disclosed in line with the TCFD's strategy recommended disclosures, whereas the process for identifying and managing these risks, including integrating them within existing risk management processes, should be disclosed under the risk management core element;
- ensuring that TCFD disclosures adequately link financial and non-financial information in the mainstream report – SASB and CDSB highlight the importance of tailoring the TCFD disclosures to the business and sector and making vital connections between financial planning, performance and strategy to climate-related risks and opportunities; and
- addressing the materiality of climate-related risks clearly – disclosures should explain the process by which companies assessed and determined the materiality of climate-related risks to their business and metrics and targets should relate directly to the risks or opportunities identified by the company in its strategy and risk management disclosures so that it is clear which risks the company viewed as material.

The TCFD has also developed a set of principles for effective disclosure (see text box at the end of this subsection for a list of the principles). The principles are designed to assist organisations in making clear the linkages and connections between climate-related issues and their governance, strategy, risk management, and metrics and targets. The principles also assist with determining the parameters and expected content or nature of disclosures (see Appendix 3 to the TCFD Recommendations or Part F of the guidance for further details).

The TCFD recommendations now form part of the European Commission's Guidelines on reporting on Climate-related Information (which are discussed in The Non-Financial Reporting Directive (**NFRD**) and Guidelines on Climate-related Information (Action point 9 under the Action Plan below).

Listed companies should familiarise themselves with the TCFD recommendations, principles of effective disclosure and guidance to assess whether adequate thought has been given to the impact of climate change on the business and be prepared to make TCFD-compliant disclosures. In particular, companies should ask themselves key questions, such as:

- has the board been sufficiently involved in overseeing climate-related risks and opportunities?
- has the company scoped out the actual and potential impacts of climate-related risks on the business, strategy and financial planning based on appropriate forward-looking climate scenarios?
- are there adequate processes in place to identify, assess and manage climate-related risks and are these integrated into the company's overall risk management?
- where the company has been making climate change-related disclosures, have they provided clarity on, and reported consistently on, the potential financial impact of climate-related issues on them?

If the answer to any of these questions is 'no', companies should start to think about these issues and consider what steps they can take to ensure they are prepared if and when compliance with the TCFD recommendation becomes mandatory.

Where listed companies are already making disclosures in accordance with the TCFD recommendations, they should assess whether these have met investor expectations or whether there is room for improvement (see "How voluntary compliance by corporates has fared so far" above for a high-level overview of failings identified by the TCFD in its most recent status report on the adoption of its recommendations).

What are the four key areas of the TCFD recommendations and accompanying recommended disclosures?

1. **Governance**: disclose the organisation's governance around climate-related risks and opportunities:
   - describe the board's oversight of climate-related risks and opportunities; and
   - describe management's role in assessing and managing climate-related risks and opportunities.
2. **Strategy**: disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material:
   - describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term;
   - describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning; and
   - describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.
3. **Risk Management**: disclose how the organisation identifies, assesses and manages climate-related risks:
   - describe the organisation's processes for identifying and assessing climate-related risks;
   - describe the organisation's processes for managing climate-related risks; and
   - describe how processes for identifying, assessing and managing climate-related risks are integrated into the organisation's overall risk management.
4. **Metrics and Targets**: disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material:
   - disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process;
   - disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks; and
   - describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

What are the TCFD's principles for effective disclosure?

- Principle 1: Disclosures should present relevant information
- Principle 2: Disclosures should be specific and complete
- Principle 3: Disclosures should be clear, balanced and understandable
- Principle 4: Disclosures should be consistent over time
- Principle 5: Disclosures should be comparable amongst organisations within a sector, industry or portfolio
- Principle 6: Disclosures should be reliable, verifiable and objective
- Principle 7: Disclosures should be provided on a timely basis

The EU Sustainable Finance Action Plan (Action Plan)

The Action Plan aims to reorient capital flows towards a more sustainable economy[19], mainstream sustainability in risk management, and foster transparency and long-termism. To achieve these aims, the European Commission has adopted 10 separate action points and has tasked the Technical Expert Group on sustainable finance (**TEG**) to assist in developing legislative proposals in relation to some of the workstreams coming out of the action points. Note that there may be multiple workstreams arising under an action point.

Several action points are of relevance to corporates (either directly or indirectly), and some of the ensuing proposals, regulations and guidance arising under those action points are discussed below.

See the text box below for the list of action points.

What are the 10 Action Points under The EU Sustainable Finance Action Plan?

Some of the ensuing proposals, regulations and guidance referred to under the Action Points listed below in bold are considered in this article.

- **Action 1: Establishing an EU classification system for sustainable activities**
- Action 2: Creating standards and labels for green financial products
- Action 3: Fostering investment in sustainable projects
- Action 4: Incorporating sustainability when providing financial advice
- Action 5: Developing sustainability benchmarks
- Action 6: Better integrating sustainability in ratings and market research
- **Action 7: Clarifying institutional investors' and asset managers' duties**
- Action 8: Incorporating sustainability in prudential requirements
- **Action 9: Strengthening sustainability disclosure and accounting rule-making**
- **Action 10: Fostering sustainable corporate governance and attenuating short-termism in capital markets**

19 Mirroring the aim of the Paris Climate Agreement to align financial flows with a pathway towards low-carbon and climate-resilient development.

The EU taxonomy of sustainable activities (Action point 1 under the Action Plan)

The EU taxonomy is an example of an EU development that (once adopted) will be relevant to corporates indirectly, as it will help investors identify investments that will contribute towards the low-carbon transition.

In May 2018, the European Commission published a proposal for a regulation on the establishment for a framework to facilitate sustainable investment. The European Parliament published its proposal in March 2019. According to the European Council position (published in September 2019), the taxonomy should be established by the end of 2021 in order to ensure its full application by the end of 2022.

The basic premise of the taxonomy is to describe when an activity can be classified as environmentally sustainable – which may be relevant when investors are deciding whether to invest in a corporate or to invest elsewhere. See text box entitled "EU taxonomy: what are the requirements for classifying an activity as sustainable?" for details on determining whether an activity is sustainable and impact on corporates.

The TEG has clarified that the taxonomy is a comparative tool and the intention is not that investors should invest in taxonomy-compliant/sustainable activities only, but it will assist investors in identifying investments that will contribute to the low-carbon transition and therefore work towards satisfying the Paris Agreement objectives.

Corporates may like to review the proposed taxonomy regulation and technical report by the TEG setting out proposed detailed technical screening criteria now (even though they are still a work in progress and have not been adopted) for an idea of how their activities are likely to be classified under the system and accordingly, how their operations may be viewed by asset managers and institutional investors in the future.

EU taxonomy: what are the requirements for classifying an activity as sustainable?

To be environmentally sustainable, an activity must:

- make a 'substantial contribution' to one or more of the environmental objectives;
- not significantly harm any of the environmental objectives (**DNSH**);
- be carried out in compliance with minimum social safeguards; and
- comply with any specified Technical Screening Criteria (**TSC**) – the TSC will detail what a 'substantial contribution' and DNSH is for each activity in certain sectors

Legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations (the Disclosure Regulation) (Action point 7 under the Action Plan)

The Disclosure Regulation is an example of an EU development that will affect corporates indirectly. Although it will apply to the investor community directly (once adopted), it will have a knock-on effect for corporates.

The Disclosure Regulation is expected to be adopted in Q4 2019. As drafted, it requires institutional investors and asset managers to integrate sustainability considerations into their investment decision-making process. It also aims to increase transparency to end-investors on how they integrate sustainability factors in their investment decisions, in particular, their exposure to sustainability risks (being environmental, social or governance events or conditions that, if they occur; could cause an actual or potential material negative impact on the value of the investment arising from an adverse sustainability impact).

Asset managers will be required to make certain website and pre-contractual disclosures, including disclosure on the manner in which sustainability risks are integrated into their investment decisions.

Corporates should familiarise themselves with:

- the requirements of the Disclosure Regulation – even though the requirements apply to 'financial market participants' and 'financial advisers' (asset managers); and
- the specific ESG policies and requirements of any asset managers who invest in them – doing so will give corporates the opportunity to align their policies and requirements (to the extent possible), and enable them to anticipate information requests that will be made and provide the asset managers with the information requested/necessary disclosures in the format that they require.

Consistency and transparency will be key factors. To the extent that any best practice guidelines develop, corporates should take the time to consider these.

The Non-Financial Reporting Directive (NFRD) and Guidelines on Climate-related Information (Action point 9 under the Action Plan)

The NFRD and new Guidelines on Climate-related Information are examples of EU developments that apply to corporates directly.

Directive 2014/95/EU requires large undertakings that are public interest entities (**PIEs**) with over 500 employees to report on **environment** matters, social and employee affairs, human rights and anti-corruption and bribery issues. In addition, the Commission adopted in 2017 Guidelines on Non-Financial Reporting (**2017 Guidelines**) regarding methodology for reporting non-financial information, including non-financial KPIs, general and sectoral, aimed at helping companies disclose non-financial information in a relevant, useful, consistent and more comparable manner.

Integration of climate-related disclosures in other non-financial disclosures will be key

The NFRD was implemented[20] in the UK in December 2016 by amendments to the Companies Act 2006 provisions regarding the content requirements for strategic reports of PIEs. In addition, amendments were made to the then Disclosure and Transparency Rules of the FCA, requiring disclosure by listed companies of diversity information in their corporate governance statements.

The NFRD was reviewed[21] by the European Commission in 2018 as part of its review of corporate reporting legislation and whether it was still "fit for purpose", including in relation to sustainability reporting requirements.

Following its review, the European Commission published its non-binding Guidelines on Climate-related Information in June 2019 (**2019 Guidelines**), which supplement its 2017 Guidelines.

The disclosures proposed in the 2019 Guidelines correspond to the requirements of the NFRD and integrate the recommended disclosures of the TCFD. They recognise that climate-related disclosures will vary from company to company according to factors such as the geographical location and sector in which the company operates and encourage integrating climate-related information with other financial and non-financial information as appropriate.

The 2019 Guidelines highlight that better disclosure of climate-related information can be beneficial for the reporting entity as (amongst other things) it may increase awareness and understanding of climate-related risks and opportunities which may result in:

- better risk management;
- more informed decision-making;
- improved strategic planning;
- a better corporate reputation;

20 By The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016.

21 The European Commission sought views in its consultation paper, Fitness check on the EU framework for public reporting by companies, published in March 2018.

- a diverse investor base; and
- a potentially lower cost of capital (e.g. resulting from improved credit ratings for bond issuance and better creditworthiness assessments by banks for loans).

Further, corporates that improve their disclosures may benefit from inclusion in actively managed portfolios and in sustainability-focused indices.

> A "one size fits all" approach does not work for climate-related disclosures. To the extent that companies are not already making climate-related disclosures, they should review the 2019 Guidelines and start thinking about how they can integrate climate-related information as part of their non-financial disclosures in annual reports.

The EU Shareholder Rights Directive II (SRD II) (Action point 10 under the Action Plan)

The amendments made by SRD II to the SRD discussed below affect corporates indirectly.

> Corporates should be aware of the new requirements that apply to their shareholders in the investor community (including obligations to justify investment decisions).

SRD II aims to enhance long-term shareholder engagement, issuer-investor dialogue and transparency in the voting process for listed companies. SRD II amends the Shareholder Rights Directive (the **SRD**) and aims to address certain failings of the SRD. SRD II came into force on 9 June 2017 with an implementation deadline in member states of 10 June 2019.

Key changes (from an ESG perspective) made to the SRD by SRD II[22] include new requirements on *institutional investors and asset managers* (in view of the important role they play in the corporate governance and stewardship of listed companies) to:

- develop and publicly disclose a policy on shareholder engagement;
- disclose annually how they have implemented the policy;
- disclose how they have voted in general meetings of companies in which they hold shares; or
- explain why they have not complied with any of the above requirements.

The shareholder engagement policy must include detail of how institutional investors and asset managers:

- integrate shareholder engagement in their investment strategy;
- **monitor companies in which they have invested;**
- **conduct dialogues with companies in which they have invested;**

22 SRD II has also introduced additional requirements, e.g. in relation to shareholder rights to vote on directors' remuneration policies and reports, provisions to assist companies identifying their shareholders and related party transactions, but broadly, these rights already exist in the UK (albeit SRD II may slightly amend the existing UK provisions or broaden the scope of application to a broader range of companies). These and other requirements under SRD II are not discussed in this article.

- exercise voting (and other) rights;
- cooperate with shareholders;
- **communicate with stakeholders of companies in which they have invested; and**
- manage conflicts of interest (actual and potential)

A description of voting behaviour, an explanation of the most significant votes and the use of proxy adviser services must be included in the annual disclosure of the policy's implementation.

The shareholder policy and annual disclosure on information must be freely available on the websites of the institutional investors and asset managers.

Companies will already know how institutional investors vote, but they should be prepared for greater scrutiny by, and dialogue with, institutional investors and asset managers. They should also be prepared for greater engagement by institutional investors and asset managers with companies' key stakeholders.

SRD II has also introduced new requirements in relation to institutional investors' investment strategy and arrangements with asset managers:

- institutional investors must publicly disclose how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities, in particular 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 the institutional investor must publicly disclose certain prescribed information regarding its arrangement with the asset manager (information includes how the arrangement incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institutional investor, particularly in relation to long-term liabilities) – if the arrangement with the asset manager does not include any of the arrangements reflected by the prescribed information, it must clearly explain why that is the case; and
- all such information is to be made freely available on the institutional investor's website and updated annually (unless there is no material change).

SRD II has also introduced new requirements aimed at aiding transparency of asset managers: asset managers must disclose annually to the institutional investors for whom they invest how their investment strategy and its implementation: (i) complies with the arrangement with the institutional investor; and (ii) contributes to the medium to long-term performance of assets of the institutional investor or fund. Such disclosure must include certain prescribed information, including:

- on key material medium to long-term risks associated with the investments; and
- on whether and, if so, how, the asset managers make investment decisions based on evaluation of the medium to long-term performance of the company in which they have invested, including non-financial performance.

In the UK, these new requirements on institutional investors and asset managers have been incorporated into the FCA Handbook and the FRC is revising its UK Stewardship Code to incorporate the relevant requirements of SRD II (see "The FRC's Stewardship Code (the Code)" for further details).

Although of direct relevance to institutional investors and asset managers, companies should be aware of the new disclosure requirements on institutional investors and asset managers as they are likely to be shareholders. Asset managers who invest on behalf of institutional investors will have to be able to justify their investment decisions and show that they have assessed a company's long-term performance both financially and non-financially (i.e. taking into account ESG factors).

National developments

Some of the ongoing national developments discussed below will apply to corporates directly, whereas others will apply indirectly (as they will apply primarily to the investor community but will have an impact on corporates).

Corporates with cross-border operations should note that different developments or requirements may apply or be relevant in each of the countries in which they operate. Accordingly, there may be divergence in reporting requirements and practices which may pose practical challenges. This article reviews key national ESG developments in the UK only.

The FCA's Discussion Paper on Climate Change and Green Finance (DP18/8)

The outcomes of DP18/8 will impact corporates directly in terms of reporting requirements, in particular, in relation to climate-related disclosures (the aim being to improve reporting by listed issuers).

The FCA consulted (in the form of DP18/8 published in October 2018) on changes to the way in which the disclosure of climate change risk by listed issuers is regulated. The consultation closed on 31 January 2019. In relation to climate-related disclosures by listed issuers, the FCA:

- noted that there has not been a consistent approach to climate-related disclosures by issuers and it was not clear whether climate-related disclosures were actually helping investors to make informed decisions, or if they were instead causing confusion or even distorting markets;
- sought views on whether greater regulatory encouragement was needed to ensure greater consistency of disclosures to enable investors to compare the standards of climate change-related disclosures across different issuers more effectively and have greater confidence that they are meeting the requirements of any specific mandates or duties; and
- highlighted that inconsistent approaches by listed issuers to climate-related disclosures raised the question of whether the existing regime was adequate in prescribing disclosures, and that one method of encouraging greater consistency would be to require listed issuers to provide a statement explaining whether or not they have followed the TCFD recommendations in preparing their disclosures and, if not, an explanation as to why not (note that since publication of DP18/8, the Government has announced that it will expect listed issuers to disclose in line with the TCFD recommendations by 2022, as referred to in "Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)" above).

In its Feedback Statement on DP18/8 (FS19/6), the FCA states that in relation to climate change disclosures by issuers, it will publish a consultation paper in early 2020 in which it would:

- propose new rules for certain issuers aligned with the TCFD's recommendations on (at least initially) a 'comply or explain' basis, and
- clarify existing disclosure obligations relating to climate change risks

The majority of respondents to DP18/8 supported a 'comply' or 'explain' approach to regulation in this area and UK issuers will be familiar with this type of approach (e.g., the UK Corporate Governance Code). The FCA states that it will adopt a proportionate approach to any extension of requirements relating to issuers' disclosures and acknowledges that the impact of climate-related matters will differ across businesses.

Green Finance Strategy: Transforming Finance for a Greener Future, July 2019

While the Green Finance Strategy is primarily of direct relevance to the investor community, some of the requirements coming out of it will be of interest and relevance to corporates, as will the response to the paper by the FRC.

The Green Finance Strategy's two objectives are to: (i) align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by government action; and (ii) strengthen the competitiveness of the UK financial services sector.

The Government intends to meet these objectives by:

- ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision-making, and that markets for green financial products are robust in nature ("greening of finance");
- accelerating finance to support the delivery of the UK's carbon targets and clean growth, resilience and environmental ambitions, as well as international objectives ("financing green"); and
- ensuring UK financial services capture the domestic and international commercial opportunities arising from the "greening of finance", such as climate-related data and analytics, and from "financing green", such as new green financial products and services.

The paper highlights:

- an expectation that all listed companies and large asset owners will disclose in line with TCFD recommendations by 2022;
- the establishment of a joint taskforce with UK regulators to examine the most effective way to approach disclosure, including whether it would be appropriate to introduce mandatory reporting; and
- that the Government will publish an interim report examining progress on the implementation of the TCFD recommendations by the end of 2020.

FRC press release

The FRC published a press release in response to the paper. Of relevance to corporates, the press release states that the boards of UK companies have a responsibility to consider their impact on the environment and the likely consequences of any business decisions in the long-term and that they should address, and report on, the effects of climate change. Reporting should set out how the company has taken into account the resilience of the company's business model and its risks, uncertainties and viability in both the intermediate and long-term in light of climate change. Companies should also reflect the current or future impacts of climate change on their financial position.

The FRC highlights (amongst other things) that:

- the updated UK Corporate Governance Code requires boards to discuss how the matters (including environmental matters) set out in section 172 of the Companies Act 2006 have been considered by the company and report on how opportunities and risk to the future success of the business have been considered and addressed;
- the strategic report requires companies to report on their principal risks and environmental matters when material and that the FRC's Guidance on the Strategic Report has been updated to encourage (amongst other things) better non-financial reporting;
- it will monitor how companies and their advisers are fulfilling their responsibilities by (i) reviewing whether companies are complying with the statutory disclosure requirements of the strategic report (which includes reporting on principal risks and uncertainties) as well as any financial statement implications of climate change; and (ii) in relation to audit monitoring, considering the adequacy of the auditors' work on principal risk disclosures, including climate risk and the financial statement implications of climate change;
- its Financial Reporting Lab (**Lab**) will provide practical guidance later in 2019 on how companies can best consider and report on climate-related risk and opportunities – on 22 October 2019, the Lab published its report, Climate-related corporate reporting: Where to next?, which, among other things, sets out investor and company views on the four TCFD core elements (governance, business models and strategy, risk management and metrics and targets) and includes examples of developing reporting practices; and
- its project on the Future of Corporate Reporting will also consider the need for improved non-financial/sustainability information from companies.

Corporates should take note of the ongoing developments highlighted in the FRC press release.

The FRC's Stewardship Code (the Code)

Although the amendments to the Code will apply principally to institutional investors, they will have a secondary impact on corporates as, amongst other things, investor signatories will be required to take into account ESG factors when fulfilling their stewardship responsibilities, including making investment decisions.

The Code sets out good practice for institutional investors when engaging with UK listed companies and it applies on a comply or explain basis.

In January 2019, the FRC published a consultation on proposed amendments to the Code, including a draft revised Code. On 24 October 2019, the FRC published the 2020 version of the Code which is effective on 1 January 2020. The new Code is comprised of a set of 'apply and explain' Principles for asset managers and asset owners and a separate set of Principles for service providers. This article discusses some of the key Principles that apply to asset managers and asset owners only.

The Introduction to the new Code highlights that ESG issues have become material issues for investors to consider when making investment decisions and undertaking stewardship.

Under the new Code, signatories' purpose, investment beliefs, strategy, and culture should enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society, and their governance, resources and incentives should support stewardship.

The new Code also expressly provides that signatories should be systematically integrating stewardship and investment, including material ESG issues (and climate change), to fulfil their responsibilities.

Signatories will be required to disclose the issues (including ESG issues) they have prioritised for assessing investments prior to holding, monitoring through holding and exiting. Among other things, signatories may wish to explain:

- the processes they have used to integrate stewardship and investment (including material ESG issues) to align with the investment time horizons of clients and/or beneficiaries, or
- how they have ensured tenders have included a requirement to integrate stewardship and investment (including material ESG issues) and how the design and award of mandates include requirements to integrate stewardship and investment to align with the investment time horizons of clients and beneficiaries.

Signatories should be in a position to explain how information gathered through their stewardship activities has informed acquisition, monitoring and exit decision and how this has best served clients and/or beneficiaries.

Corporates should take note of the likely investment criteria and disclosure requirements on any of their investors who are signatories to the Code.

The London Stock Exchange's guidance for issuers on the integration of ESG into investor reporting and communication (LSE Guidance)

Listed companies should also be aware of the LSE Guidance, which aims to help issuers and investors "navigate the complex landscape of ESG reporting" and enable "richer data flows and dialogue on ESG" between them.

It highlights that issuers need to have a joined-up approach with investors when it comes to ESG issues. Investors feel that CEOs are not adequately communicating on the business value of sustainability issues. Issuers are failing to understand what information investors need.

The LSE Guidance identifies eight priorities for ESG reporting. See text box below for these priorities.

The LSE Guidance priorities for ESG reporting

- Strategic relevance – What is the relevance of ESG issues to business strategy and business models?
- Investor materiality – What do investors mean by materiality?
- Investment grade data – What are the essential characteristics of ESG data?
- Global frameworks – What are the most important ESG reporting standards?
- Reporting formats – How should ESG data be reported?
- Regulation and investor communications – How can companies navigate regulations and communicate effectively?
- Green revenue reporting – How can issuers get recognition for green products and services?
- Debt finance – What should debt issuers report and what are the emerging standards here?

Shareholder activism

Shareholder activism in the UK (and across the rest of the world) has been on the rise. Traditionally, shareholder activism was largely an issue for US corporates only, or UK corporates with private equity investors looking to extract as much value as possible before exiting and proceeding to the next "venture". In the aftermath of the global financial crisis, a new type of activist emerged: the long-term investor, such as institutional investors who were historically seen as passive. In more recent years, we have seen the emergence of yet another breed of activist: environmental activists (such as Climate Action 100+ and Follow This), spurred on by concerns about sustainability.

Just as the aims of activism are diverse - ranging from governance changes (including demanding changes to the existing board, board representation, changes to directors' remuneration packages, greater board diversity) to increasing the share price of a company so that an activist may sell their interests at a profit (which has been the strategy adopted by many hedge funds and PE houses, particularly where a company is the subject of a takeover) — so are the tools used by activists to raise awareness about a concern, or bring about a desired outcome.

Certain sectors are more prone to activism, including oil and gas (companies such as BP and Royal Dutch Shell who operate in this sector have been the target of environmental activism).

From an ESG perspective, we have seen environmental activist shareholders in the oil and gas sector apply pressure to compel or encourage companies to take on board the magnitude of climate change and to consider adopting different, more sustainable, practices, or to make climate change-related disclosures.

By way of example, at BP's 2019 AGM two special resolutions (resolutions 22 and 23) were requisitioned by shareholder groups coordinated by Climate Action 100+ and Follow This respectively, both in relation to climate change issues. Resolution 22 sought that BP include in its strategic report and/or other corporate reports, as appropriate, for the years ending 2019 onwards, a description of its strategy which the board considers to be consistent with certain goals of the Paris Agreement as well as certain information relating to capital expenditure, metrics and targets and provide annual progress reports on each of these.

Resolution 23 sought that BP set and publish targets that are aligned with the goal of the Paris Agreement to limit global warming to below 2°C, and that these targets be intermediate to long-term and cover the greenhouse gas emissions of the company's operations and the use of its energy products (including by the end-user).

While BP's board supported the climate change disclosures resolution (resolution 22) proposed by Climate Action 100+ and recommended that shareholders vote in favour of it, the board did not support the resolution on climate change targets (resolution 23) proposed by Follow This, and recommended that the shareholders vote against it.

At the AGM, resolution 22 was passed with the support of over 99% of shareholders. As a result of the passing of the resolution, BP will need to set out a business strategy consistent with the goals of the Paris Agreement on climate change. Resolution 23, on the other hand, was overwhelmingly rejected by BP's shareholders: over 91% of shareholders voted against it.

BP did not support resolution 23 because:

- setting specific long-term reduction targets is inconsistent with the flexibility that is central to BP's strategy;
- it calls for targets regarding end-user emissions that BP does not control; and
- it would risk significant erosion of long-term shareholder value.

It is interesting to note that in the same press release in which it stated it had received a requisition in relation to the Climate Action 100+ resolution which it supported, BP also announced that greenhouse gas emissions reductions had been included as a factor in the reward of 36,000 employees across the BP group globally, including executive directors.

Sometimes, activist shareholders have withdrawn resolutions they requisitioned that were meant to be voted at an AGM, e.g., recently Follow This withdrew a resolution it had requisitioned at the 2019 AGM of Royal Dutch Shell. The resolution called on Shell to change its climate policy. The resolution did not have the support of Shell's board (see 2019 Notice of AGM for the text of the withdrawn resolution and the reasons why the board did not support it). The resolution was withdrawn following the announcement by Follow This on 7 April 2019 that they had received requests for withdrawing the resolution from the shareholders who originally requisitioned the resolution. Shell managed to turn things around by agreeing with shareholders that it would set out plans to introduce industry-leading targets to reduce greenhouse gas emissions and link them to executive pay.

These actions highlight that companies must understand the concerns of their investors, and, where necessary, engage in discussions with activist investors, assessing carefully the merits of any suggestions put forward or concerns raised and consider whether they should be doing more in relation to ESG issues.

Action points for corporates

Boards should examine their company's purpose, culture and values and assess whether they sit well in the current ESG-focused climate, and consider whether it is appropriate to delegate the consideration and oversight of ESG issues to a separate ESG or risk committee which can dedicate sufficient time and resource to focus on the issues in greater detail, build expertise in the area and report back to the full board regularly. Likewise, boards may wish to seek expert guidance on sustainability issues from specialist ESG consultants if boards believe that the circumstances of their company render this desirable (e.g. because of the nature of business operations, there is a real possibility of negative environmental impact).

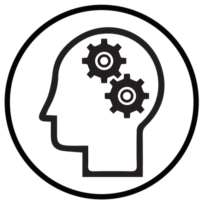
Boards should ensure that they have a well-considered long-term ESG strategy in place. They should also ensure that ESG issues are given greater prominence in day-to-day management.

Based on a robust ESG strategy, ESG risks should be identified, and systems and processes should be put in place to ensure greater corporate resilience. Adequate testing of any risk-management systems and processes should be undertaken regularly.

At the other end of the spectrum, ESG opportunities should not be overlooked: is there a way to make the business more robust and attractive to investors from an ESG perspective, by incorporating sustainability factors into its business model, or ensuring that its social and governance practices are exemplary? In addition to attracting and retaining investors, corporates should be showcasing positive ESG issues to attract and retain talented employees and management and build a solid ESG reputation.

In short, ESG should be high on the board agenda. Boards should be considering, on an ongoing basis, a number of questions, such as:

- is enough thought being given to how their businesses are operating from an ESG perspective, and is the current business model sustainable for the long term?
- has the concept of sustainability been mainstreamed into their risk management strategies and processes?
- have they done all they can to engage with, and align themselves with any reporting requirements of, their institutional investor base?
- are sustainability disclosures that are currently being made in annual reports "fit for purpose" in light of the escalating importance of ESG issues to their investors (including institutional investors) and the gradual evolution of reporting frameworks and expectations, and has their approach to reporting been consistent across the business?
- if they are concerned by the prospect of shareholder activism on ESG issues, have they taken adequate measures to anticipate and address shareholders' concerns?
- have they been identifying and seizing any ESG opportunities?



"Globally, 47.6% of issuers and 61.4% of investors have an ESG strategy. Amongst issuers, this indifferent view is led by Asia, the Gulf States and the US, with Asia again proving most agnostic amongst investors.

The highest levels of ESG strategy being incorporated into overall company strategy is claimed by Europe, particularly in the UK, which also reports both the highest level of issuers and investors actually disclosing their ESG strategy to the market".[23]

23 East & Partners: Sustainable Financing and ESG Investing report, September 2018, page 11. The report also notes that globally, around 52% of issuers and 39% of investors do not have an ESG strategy, but Europe, the UK and Canada buck the trend: the report found that just over 86% of issuers and almost 85% of investors in the UK had an ESG strategy (see page 8 of the report).

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GROWING THE GREEN ECONOMY

This article was originally published in **GROWING THE GREEN ECONOMY:** ADDRESSING THE SUSTAINABILITY CHALLENGES AND OPPORTUNITIES. This article has been updated following its original publication.

The severe warnings on climate change starkly documented by the IPCC report and others demonstrate why urgent action to meet the goals of the Paris Agreement is needed. The public, governments and legislators are taking notice and taking action. Much of the legislative effort to date has been focused on the financial system but there is an increasing emphasis on non-financial entities and the requirements that are beginning to be expected of them. These requirements stem from legislation, public pressure and possible litigation.

GROWING THE GREEN ECONOMY reflects the breadth and depth of the impact of these environmental and sustainable factors. **Visit www.cliffordchance.com/greeneconomy** to read and download the publication in full.

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