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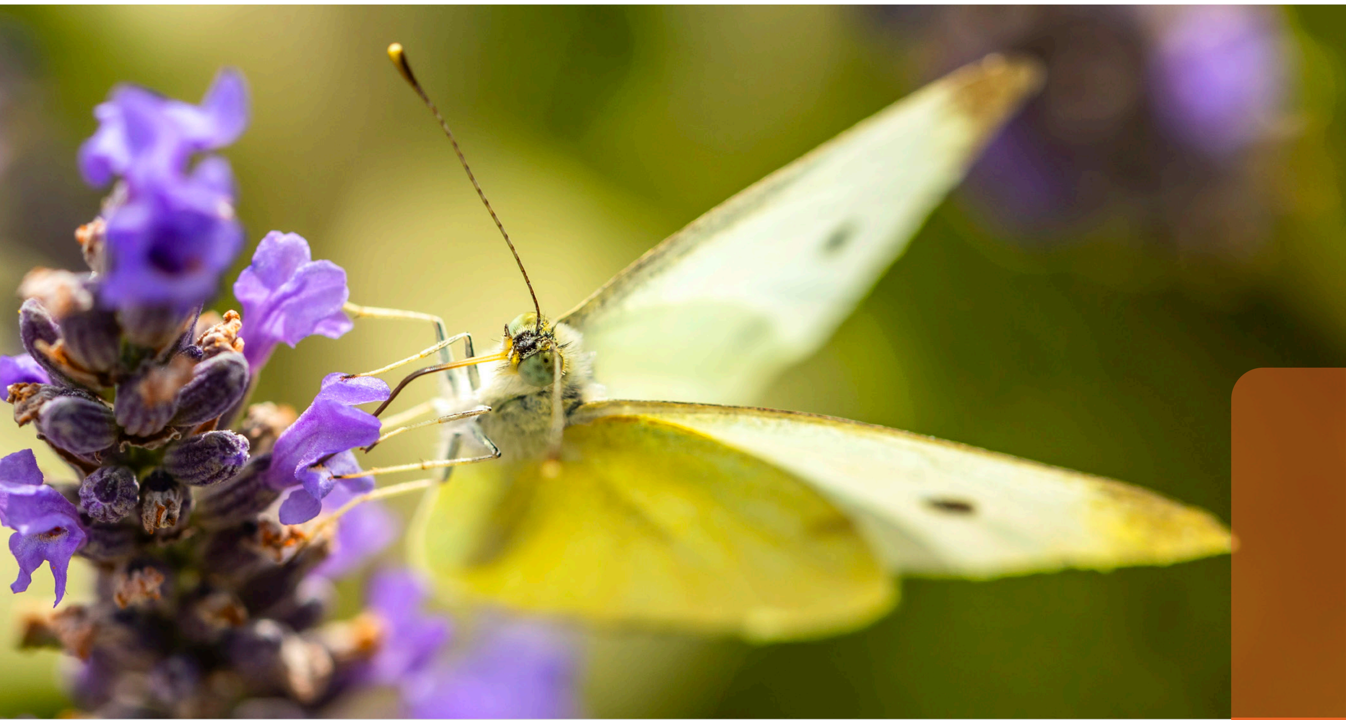

Environmental, Social & Governance Law

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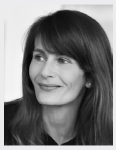
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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

As society (in the UK, EU and indeed globally) continues to drive environmental, social and governance ("ESG") and sustainability concerns higher up the agenda, the regulatory landscape has expanded accordingly. While previously a matter for social responsibility, reputation and risk management, corporates and investors must now consider a patchwork of legislative requirements when formulating an approach to ESG.

Although it is generally accepted that ESG can mean different things to different businesses, for the purposes of this chapter, we will take ESG to mean "*regulations relating to the overall sustainability of a company both as regards to the company's external impact, and the impact of changing society and environment on the company*". This will necessarily mean that operational aspects of ESG and environmental law in particular, such as waste or water quality, are not comprehensively covered.

It is worth noting that UK businesses are still impacted by some EU ESG regulations. This is naturally the case where they wish to access the EU market, but the EU has also adopted measures with extraterritorial impact, including, notably, the Corporate Sustainability Reporting Directive ("CSRD"). Further out, the linked proposal for a Directive on Corporate Sustainability Due Diligence is similarly expected to bite on UK businesses with significant EU turnover.

There are also several keystone pieces of UK ESG legislation.

The Climate Change Act 2008 set the world's first legally binding national emissions reduction target, which was converted to a Net Zero by 2050 target in 2019. That overarching target is tracked via the setting of "carbon budgets" on a five-year cycle, determining the total amount of carbon which may be emitted consistent with the Net Zero goal. More detailed policy measures are set out in the Government's Net-Zero Strategy, which has recently been subject to challenge. High-level policies in the Net-Zero Strategy are then translated into regulation by various Government departments, notably the Department for Energy Security & Net Zero (among others).

The Environment Act 2021 sets out a framework for the regulation of many different aspects of environmental performance, including producer responsibility, air quality, biodiversity (particularly in the context of planning applications) and prevention of illegal deforestation. The latter, once implemented, will require proactive due diligence to ensure that any forest risk commodities (likely to include palm oil, rubber and soya) used in UK commercial activities were not produced in violation of local anti-deforestation laws.

Sector-specific legislation (for example, in financial services) has introduced additional ESG-related requirements, particularly on disclosure and reporting (as detailed in question 1.2 below). The 2019 and subsequent 2023 UK Green Finance Strategy set out the Government's intentions for alignment of the private financial sector with its Net Zero commitment. Regulation in the sector is expected to increase in coming years, both in terms of disclosure requirements (e.g., reporting against international sustainability standards) and substantively (e.g., requirements to adopt a transition plan).

On the "S" or "social" side of ESG regulation, the key categories of regulation include supply chain regulations focused on human rights impacts, and workplace regulations addressing social aspects such as diversity and inclusion, equality, and anti-discrimination. Additional rules, particularly in the sphere of financial services, are expected to be developed in the coming years.

The Modern Slavery Act 2015 requires all entities with turnover above £36 million to publish a modern slavery and human trafficking statement detailing steps taken to ensure that these practices do not occur in the business' own operations or in its supply chain.

All businesses are subject to the Equality Act 2010, but those with more than 250 employees must report annually on their gender pay gap under the Equality Act 2010 (Gender Pay Gap Information) Regulations 2017. Listed entities must disclose additional diversity information under the Financial Conduct Authority ("FCA") Disclosure Guidance and Transparency Rules sourcebook ("DTR").

Governance regulation in the UK includes a comprehensive range of corporate governance requirements, primarily under the Companies Act 2006 and its implementing regulations. Governance requirements are particularly stringent for listed companies who must also adhere to the Corporate Governance Code ("the Code") which includes both substantive and disclosure requirements. The Code, however, is a "comply or explain" regime, meaning that companies are permitted to include an explanation for non-compliance in their annual report. In practice, however, most FTSE350 companies are likely to comply with the Code in full, and most companies listed on the Main Market of the London Stock Exchange would be expected to comply with the vast majority of its provisions.

Legislation targeting corporate crime is also well developed. The UK's 2010 Bribery Act was groundbreaking in prohibiting the offering, payment or receipt of bribes in general rather than only in connection with public officials, and also in its extensive territorial reach with the result that offences could be committed overseas by persons with a close connection to the UK, or by overseas persons in the UK. Businesses may also incur liability for failing to prevent bribery, unless they have "adequate procedures" in place to prevent this. Legislation on the anti-facilitation of tax evasion contains a similar "failure to prevent" corporate offence (under the Criminal Finances Act 2017). Finally, the Money Laundering Regulations 2017 place an explicit obligation on certain supervised entities including lawyers, estate agents, and accountants and financial services businesses to report any suspicious activity at the beginning of or throughout the relationship with their clients. However, any entity may commit the related offence of acquiring, using or possessing criminal property under the Proceeds of Crime Act 2002.

Finally, there are some notable "soft law" requirements in the ESG space, such as the Competition and Markets Authority ("CMA") "Green Claims Code", setting out guidance for companies making environmental claims in advertising. The Advertising Standards Authority has also used its CAP Code (the UK Code of Non-broadcast Advertising and Direct & Promotional Marketing) to take action against misleading environmental claims; it has sanctioned a leading bank for an advertising campaign which focused only on the climate-positive aspects of its lending business without reference to its financing of fossil fuels, and similarly an energy company which misrepresented (by omission) the proportion of its lower carbon versus carbon-intensive products and services.

1.2 What are the main ESG disclosure regulations?

Disclosure requirements relating to ESG matters are not new, but their volume has considerably increased in recent years.

Reporting of energy use and efficiency are long-standing requirements in UK law. The Energy Savings Opportunities Scheme ("ESOS") implemented the EU's requirement for large UK businesses to conduct energy audits, under Article 8 of the Energy Efficiency Directive 2012/27/EU. The scheme operates on a four-year cycle and aims to encourage voluntary improvements in energy efficiency in the intervening years. The Streamlined Energy and Carbon Reporting ("SECR") regime requires large companies and LLPs to report their energy usage and scope 1 and 2 carbon emissions within their annual report.

Non-financial reporting obligations were first introduced in 2017, to implement the EU's Non-financial Reporting Directive 2014/95/EU ("NFRD"). As part of the strategic report, the non-financial statement must include information on the impact of the business on environmental matters, employee relations, social matters, respect for human rights and anti-bribery and corruption. In the EU, these obligations have been subsumed into and expanded under CSRD, whereas UK companies must continue to comply with the NFRD requirements under UK law (as well as CSRD if they fall under its scope).

Large companies must include in their strategic report a "Section 172(1)" statement, which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) of the Companies Act 2006 when performing their duty under section 172 (i.e., the duty to promote the success of the company). These matters include the interests of the company's employees, business relations with suppliers, customers and others, the impact of the company's operations on communities and the environment, and desirability of the company maintaining a reputation for high standards of business conduct.

Reporting under the Taskforce for Climate-related Financial Disclosures ("TCFD") is required for listed companies and some FCA-regulated entities including asset managers, and reporting in alignment with the TCFD framework is also required under the Companies Act 2006 for companies with more than 500 employees, and either listed on AIM, or with a turnover of over £500 million. LLPs of the same size are also required to report. TCFD reporting obligations also apply under the FCA rules to certain asset owners, including some UK pension schemes.

In the financial sector, where firms offer in-scope financial products (i.e., "market") into the EU, the Sustainable Finance Disclosure Regulation ("SFDR") requires pre-contractual and periodic disclosure of matters around sustainability risk and objectives, on a sliding scale, according to the ESG ambition of the firm and its financial products. SFDR firms are also required to report the extent to which their investments which promote environmental characteristics are aligned with the definition of "sustainable investments" under the Taxonomy Regulation.

As noted above, CSRD will impact companies with significant EU business, requiring a detailed report on the material impacts of the business, as well as risks and opportunities to and for the business, across the spectrum of ESG topics. Any entity covered by CSRD additionally needs to prepare a report under the Taxonomy Regulation.

Social and business ethics disclosure requirements include, as detailed above, the Modern Slavery Act 2015, gender pay gap reporting regulations, and for listed companies, diversity information.

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

The UK Stewardship Code ("UKSC") offers a guide on good practice for institutional investors, and the most recent update of that Code includes reference to considering ESG matters in making investment decisions. Asset owners and asset managers are bound by the principles in the UKSC on an "apply or explain" basis.

Larger UK companies and financial entities commonly subscribe to international voluntary ESG initiatives and reporting frameworks, including the CDP (formerly the Carbon Disclosure Project) and the Global Reporting Initiative ("GRI"), and for financial entities, the UN Principles for Responsible Investment ("PRI"). Increasingly, businesses with higher climate ambition are setting science-based targets for emissions reduction and verifying it with the Science Based Targets Initiative ("SBTi"), which then requires disclosure of progress against the target on an annual basis.

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

The UK has enthusiastically supported the adoption by the International Sustainability Standards Board ("ISSB") of its first two sustainability standards, IFRS S1 on general sustainability disclosures and IFRS S2 on climate-related disclosures which were finalised in June 2023. The UK is already assessing them for integration into UK law, with any necessary national modifications. To be known as Sustainability Disclosure Standards, the standards would be mandatory for reporting by listed companies and certain FCA-regulated entities, potentially as soon as 2025. In relation to this, the Government is considering mandating that the largest companies adopt and disclose transition plans by large financial institutions, and its Transition Plan Taskforce published a framework for drafting effective transition plans in October 2023.

The FCA is also expected to publish Sustainability Disclosure Requirements ("SDR") for regulated financial entities before the end of 2023. Though not equivalent to the EU's SFDR, SDR would similarly target improved transparency leading to better informed decision-making by investors. Unlike SFDR, SDR would recognise itself as a labelling regime, creating three categories of sustainability labels for financial products. There is currently no proposal for disclosures in line with a

UK Taxonomy, work on which has proceeded more slowly than initially expected. The Prudential Regulation Authority ("PRA") and FCA are also consulting on new rules related to diversity and inclusion in financial services firms.

A legislative reform agenda published by the Government in May 2022 contained plans to update the Modern Slavery Act 2015, though as yet this has not progressed. The proposal would expand the aspects on which all in-scope companies must report in their Modern Slavery statements and increase civil penalties for non-compliance.

The Environment Agency has signalled that it may extend the scope of ESOS to medium-sized companies in the next reporting period (compliance deadline in 2027).

In the EU, the draft Directive on Corporate Sustainability Due Diligence ("CS3D") is expected to impact UK companies with significant business in the EU, though the exact scope is still to be decided. The Directive will introduce a requirement to identify, assess and act to mitigate or prevent human rights and environmental impacts via a robust due diligence programme extending throughout the value chain.

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

In addition to the transparency initiatives referenced above, there are some private sector-led initiatives, particularly in the financial sector, focusing largely on climate change. The Glasgow Financial Alliance for Net Zero ("GFANZ") is an international coalition of financial institutions aiming to accelerate the decarbonisation of the economy, though it has seen several high-profile members leave over the last year. Other private sector-led climate initiatives include the Net-Zero Asset Owner Alliance ("NZAOA") which, although convened by the United Nations, is a member-led alliance of institutional investors who have committed to net zero investment portfolios by 2050.

The "Walker Guidelines", an evolving set of guidelines relating to enhanced disclosure and transparency in the private equity sector, were initially released in 2007 after widespread criticism of the industry. The British Venture Capital Association ("BVCA"), in conjunction with the Private Equity Reporting Group, continue to update the Guidelines to capture current best practice. The focus of the Walker Guidelines is good governance, with the aim of improving public perception of the private equity industry.

The Taskforce on Nature-related Financial Disclosures ("TNFD") has published a framework for nature-related disclosures based closely on TCFD. Though not mandatory for now, there is expected to be widespread voluntary adoption of it.

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 (or in opposition) of those views?

For most investors and asset managers, consideration of ESG factors at all stages of the investment process has become a business imperative. There is widespread recognition of the importance of sustainable investing and the impact ESG factors can have on the financial performance of their investments and as such, ESG integration is being used to enhance the traditional financial analysis by identifying potential risks and opportunities that are not captured by other methods. Often, institutional investors are also subject to financial sustainability rules and associated disclosure to their relevant stakeholders themselves, which drives additional pressure.

Investors and asset managers alike are becoming increasingly aware of the impact poor ESG performance can have on their investments, from direct impacts (such as climate-related flooding impacts on property investments and tightening regulations) to indirect impacts (such as changing consumer preferences associated with ESG issues) – all of which ultimately go to longer term financial performance and risk. At the same time, government-led initiatives to shift the UK and the EU to low-carbon economies create significant investment opportunities in sectors such as electric vehicles, clean tech and renewable energy infrastructure. Whilst ESG risk mitigation has been a feature of investment decision-making and portfolio management for some time, this link between ESG performance and positive investment outcomes is a relatively recent development.

In the last few years, we have seen investors and asset managers in the UK (as in other jurisdictions) building their in-house ESG capabilities and expertise in response to the demands of a fast-evolving regulatory framework and the heightened stakeholder pressure to perform well on ESG. Regulatory developments, to a large extent, have focused on the investor level, which in turn increases the demand on asset managers to promote ESG integration across their portfolios. Alignment of interest and values in relation to performance on ESG issues is certainly growing in importance. Asset managers subject to the FCA's Shareholder Rights Directive requirements may also monitor their investee companies on social and environmental impact and corporate governance as part of their shareholder engagement with those companies.

On the other hand, some investors and asset managers remain somewhat sceptical about ESG integration – they question the clarity and consistency of ESG data, the lack of standardisation in ESG ratings and the actual impact of ESG factors on financial performance. Alongside the growing enthusiasm for ESG we mention above, there are calls for better standardisation and clarity in ESG reporting to support its more widespread adoption.

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

Employees (of all ages, but perhaps most notably the younger ESG-conscious millennial workforce) increasingly exert pressure on their employers to improve internal ESG policies and measures or deliberately choose employers with an environmental and social conscience. To attract and retain the best talent, businesses are having to adapt and embrace ESG-related initiatives extending well beyond the normal diversity and inclusion considerations.

Similar pressures come from customers and consumers who increasingly apply an ESG-conscious lens to their investing or spending preferences, often favouring products and investment opportunities that they believe to be most responsible, transparent and committed to making a positive social and environmental impact. That said, the current cost of living crisis in the UK has inevitably curbed the growth in this trend, with many customers and consumers forced to prioritise cost over a brand's ESG practices.

Further influence comes from non-profit organisations and members of the civil society who often push for stronger ESG practices and are increasingly trying to hold corporations accountable for their social and environmental impact (as further explained in question 2.5 below).

While for some businesses in the UK, ESG compliance may still be seen largely as a regulatory burden, increasingly we are seeing businesses of all sizes responding to the attitudes and influences on ESG referred to above, taking steps to improve ESG performance in order to meet stakeholder performances and demands. Adopting better ESG practices can help to drive operational efficiencies, improve reputation, foster innovation, attract top talent and generate customer loyalty.

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

The FCA regulates conduct matters in the financial services industry in the UK and in recent years has had a sharp focus on issues relating to ESG within the financial sector, including new rules to improve transparency around the consideration of ESG risks. Tackling greenwashing is also a core regulatory priority for the FCA, as evidenced in its SDR proposals outlined above (see question 1.4). The PRA also regulates ESG matters to the extent they have a bearing on "prudential" matters for UK banks, insurance and the largest investment firms.

The Pensions Regulator ("TPR") which oversees workplace pension schemes, has increased its focus on ensuring that trustees comply with their ESG and climate change reporting duties (see question 2.4 below), and the Financial Reporting Council ("FRC"), also considered a key regulator in the ESG space, plays a role in determining ESG compliance for publicly traded companies. Compliance with SECR and other requirements to include non-financial information in annual filings is the responsibility of the FRC. Though the FRC's enforcement activities are generally light touch, it has recently focused on climate risk and is closely monitoring compliance with TCFD reporting requirements.

The Environment Agency ("EA") is a key actor in the enforcement of environmental regulations, but its focus is largely on practical environmental protection measures, including environmental permitting and producer responsibility. It is, however, the regulator in respect of ESOS, and regularly takes action (of varying severity) to enforce that regime.

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

To date, enforcement action for ESG issues has been fairly limited to particularly active regulators like the Competition and Markets Authority ("CMA") and the Advertising Standards Authority ("ASA"). In particular, ASOS, Boohoo and Asda are currently under CMA investigation for alleged greenwashing (although this investigation, at time of writing, has not yet reached a conclusion), and as noted above, the ASA is active in pursuing greenwashing.

In September 2023, the Pensions Regulator ("TPR") issued its first fine against a pension scheme for failing to publish a report on trustees' management and governance of climate-related risks and opportunities. ExxonMobil Pension Plan was fined £5,000 for failing to publish its TCFD report by a set deadline. Schemes, like Exxon, which receive a penalty for failing to publish their climate change report will now be named and shamed in the TPR's compliance and enforcement bulletin.

We are not aware of any notable enforcement actions taken by the FCA to date specifically relating to ESG failures. This is perhaps unsurprising given that ESG is a relatively new area of focus in financial regulations and many of the current standards are still voluntary in nature. That said, the FCA has been clear in its policies and in public communications that it will take necessary enforcement action where it deems appropriate to do so. In particular, the FCA has announced that it will be focused on greenwashing, and the expected "anti-greenwashing" rule in the proposed SDR regime seems to underline that intention.

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 ESG litigation landscape (and with that, the potential reputational risks associated with ESG) is rapidly evolving. The law is fast-moving in this regard, and claimants and activists are really driving the agenda and pushing for novel ways to hold organisations to account. From a litigation perspective, the appetite to bring highly novel claims remains unabated. Principles of tortious liability continue to be tested, not only through novel "parent company liability" claims but also "value chain claims" which seek to impose liability on UK-domiciled companies for alleged wrongdoing by third parties in their supply chains and usually overseas. Most recently, such claims have been seen against retailers and social auditors, illustrating that litigation risk is crystallising for clients in sectors far removed from those traditionally associated with ESG claims.

Often, ESG-related claims can survive early attempts to strike them out because of the very novelty of the allegations. Claimants are also seeking to bring types of claims which were not, historically, typical in the ESG space: for example, ClientEarth's recent (albeit unsuccessful) derivative claim against the directors of Shell plc alleging a failure to protect the company against climate change-related risk. Procedural innovation is also evident: funding has now been secured on behalf of a class of UK bill-paying households against water and sewerage companies in England in relation to allegedly unlawful discharge of untreated waste water and sewage. Innovatively, this claim is being brought under the "opt out" class action procedure available in the Competition Appeals Tribunal. This is the first such competition class action claim which alleges environmental harm, providing yet another example of claimants seeking to use innovate litigation tools to pursue their claims for ESG-related harm. As ever, reputational risk is a key consideration in dealing with ESG litigation, given that these claims are often brought with the objective of furthering ESG-related agendas including through publicity, and where reputational risk can be a powerful form of leverage in the dispute, including to achieve settlement despite the novel and untested nature of the allegations advanced.

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

As with any new fast-moving regulatory space, increasing ESG regulation has not been without significant push-back from certain stakeholder groups across certain key areas.

Firstly, and perhaps most obviously, ESG and sustainability in general are highly politically charged issues on which people hold strong and divergent opinions. To that end, measures such as mandatory ESG reporting do not currently have unanimous support on a first-principles level within the public at large or across geographies. Businesses potentially facing significant backlash from their customer base or political causes for compliance with mandatory ESG reporting will be concerned about the bottom-line financial impact of any such efforts. Differing approaches internationally can present challenges for a business operating a global ESG programme.

Further, with the lion's share of new reporting regulations coming in Directive form from the EU, it will be up to individual Member States to implement these into their respective domestic law frameworks. Given the tight deadlines for compliance already faced by in-scope entities, if Member States diverge from Directives during implementation, this would place exceptional strain on entities who would need to grapple with these differences.

Finally, it is no secret that the swathes of four-letter-acronym ESG regulations have already been the source of significant time and resources for corporates and investors as they scramble to understand the impact of each. There are, also, only a finite number of service providers with the capacity and expertise required to advise on these highly complex regulations. Combining these two factors appears to create the perfect storm of regulatory overload, where businesses and their service providers struggle to ensure complete compliance with all relevant regulations by the time compliance deadlines arrive. For many in-scope entities of these regulations, this will feel as though they are being set up to fail.

2.7 Have ESG issues attracted shareholder activism, and from whom?

For listed companies in the UK, shareholder activism (including through, for example hedge fund managers) on ESG issues is on the rise, forcing directors to think about the way in which they are making decisions and the extent to which they are engaging with stakeholders. Whilst there have been no major legislative changes that have influenced the activism landscape, there is a consensus that the UK will continue to be an attractive market for activists, fuelled by a number of factors, such as a weak pound and a regulatory regime which affords shareholders with significant rights. An increasing number of companies have been receiving proposals to table climate change resolutions (called "say on climate" resolutions) at their AGMs, in particular within energy/natural resources companies and the financial services industry.

With the increasing amount of disclosure on ESG-related matters globally, there has been a marked increase in "trojan horse" activism, with some activists pulling levers likely to garner support from non-financial investors who may have, for example, ESG concerns, alongside financial underperformance issues. A recent example of this is Third Point's engagement with Shell, lobbying for a restructuring of the group based on climate-related concerns.

3 Integration of ESG into Strategy, 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 as a topic has moved rapidly up the agenda for many UK boards who increasingly recognise the business imperative of performing well on ESG, both to mitigate risk and seize opportunity, but there is no uniform approach to allocation of ESG responsibilities and market practice is yet to be established. In the context of UK corporates, however, responsibility will often start with the directors (individually and collectively as a board).

Under the Companies Act 2006 ("CA 06") directors of UK companies are legally required "to promote the success of the company for the benefit of its members as a whole", and in doing so, are required to "have regard" to the interests of other stakeholders and take a longer-term view on success when making decisions. Section 172 of the CA 06 requires directors to have regard to a non-exhaustive list of matters, including, for example: (i) interests of the company's employees; (ii) the need to foster business relationships with suppliers, customers and others; and (iii) the impact of the company's operations on the community and environment. These additional considerations are instrumental only, meaning that they are to be taken into account if, and to the extent that, they affect shareholder value. However, as boards become more focused on the financial and strategic relevance of ESG performance, we are seeing greater emphasis on the integration of ESG considerations in board-level decision-making.

Directors, as officers of the company, are also principally responsible for the company's compliance with relevant laws and regulations on the full spectrum of ESG issues. Many companies now have a dedicated ESG or sustainability officer, to ensure an appropriate level of expertise to keep pace with the fast-evolving legal and regulatory landscape, collate the relevant data for reporting and disclosure purposes and to implement and maintain appropriate ESG policies. Companies may also partner with external sustainability consultancies or similar firms to oversee their ESG commitments and ensure they are meeting them.

Management teams who are principally responsible for the day-to-day operations inevitably have a role to play in implementing ESG policies and meeting ESG commitments. Often management will work closely with the board or the ESG/sustainability officer to identify and respond to ESG risks and opportunities – baking ESG targets and commitments into the business plan can be an effective way of encouraging collaboration and alignment between management and the board on overall approach to 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 *vis-à-vis* management?

There is no one-size-fits-all approach. As noted in question 3.1 above, the board of directors and/or an ESG or sustainability officer will typically be responsible for addressing ESG issues and integrating ESG considerations into their decision-making processes. We're also starting to see delegation of ESG supervision and management to dedicated ESG committees or ESG responsibilities featuring in the terms of reference of other duly appointed committees of the board, such as the audit and remuneration committee.

In the private equity and alternative asset management sector, there is increased focus on the management of ESG issues across the portfolio of investee companies, particularly where a fund is classified as an "Article 8" fund under the EU's SFDR (i.e., the fund's strategy is to promote, among other characteristics, environmental and/or social characteristics, and the companies in which it invests follow good governance practices). Certain bespoke positive covenants and monitoring rights will likely be requested by the investor to drive the right behaviour by management at the portfolio company level and to ensure that the investor is able to meet the disclosure obligations of an Article 8 fund. Increasingly, voluntary market-pressured ESG reporting is also driving investors (regardless of SFDR classification) to closely monitor the ESG performance of their portfolio, often through increased information-gathering rights.

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

As already noted, investors and corporates increasingly recognise not just the legal liability and reputational damage that may result from poor ESG performance, but also the opportunities that strong ESG performance may provide for their business or investment to flourish. Unsurprisingly therefore, we are seeing novel ways of trying to push the ESG agenda forward and achieve behavioural change through ESG-linked incentives.

Linking executive pay to ESG targets (as well as financial targets and other relevant measures) is an increasingly common method of embedding a focus on ESG performance in the FTSE 100. According to research published by PwC (in respect of disclosures made in 2020, relating to the 2019 performance year), almost half of FTSE 100 companies at that time had an ESG target in the annual bonus and the Long-term Incentive Plan ("LTIP") or both, and this trend is on the rise, reflecting a growing expectation, particularly amongst institutional shareholders and their representative bodies, that listed companies will include some ESG-based performance measures as a condition to bonus entitlement or the vesting of share-based incentive awards (particularly for senior employees and executives).

It remains to be seen whether this will emerge as a trend in remuneration packages in the private equity space – it might seem unlikely given the short-term focus of PE-backed company bonus schemes, which rarely include rigid KPIs and are instead operated on a discretionary basis and usually linked to exit. However, in the private equity industry, managers, particularly impact investing specialists but also some mainstream players, are starting to explore linking carried interest structures to ESG or impact performance – it will be interesting to see if a further development of this might see GPs introducing bonus schemes or equity ratchet mechanisms for management running off metrics which include ESG criteria.

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

Beyond putting in place and implementing effective (and ever more sophisticated) ESG policies and building on internal ESG expertise, many companies are taking a step further, integrating ESG consideration into their constitution. B Corporations (or "B Corps" as they are often referred to) are a good example of this, and have gained popularity in the UK in recent years. There are now over 1,500 certified B Corps in the UK, across 58 different industries, indicating a real momentum in this movement. These are companies that have voluntarily committed to meeting "*the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose*". The criteria that a business must satisfy in order to be certified as a B Corp are set by B Lab, and there is an ongoing vetting process once a company has obtained certification. Crucially, the company must change its constitution to confirm its commitment to (i) stakeholder interests, and (ii) having a material positive impact on society and the environment. Household names such as World of Books, Gousto, Innocent Drinks, The Body Shop and FatFace, to name but a few, have committed to giving stakeholders equal billing with shareholders in their company's corporate purpose, while also getting a certification from B Lab to confirm that they deliver on that promise.

3.5 How have boards and management adapted to address the need to oversee and manage ESG issues?

The approach varies widely, depending on the size and nature of a business and general attitudes towards ESG, but for those companies and asset managers who recognise the significance of doing well on ESG, there does appear to be a shift towards embedding ESG awareness and expertise across a business. While historically, ESG issues (and mainly downside risk and compliance issues) were managed by a small specialist team, often in a silo, there appears now to be a growing trend towards expanding the expertise and the focus (including on upside opportunities) across the business and to each stage of investment decision-making, which demands a greater understanding across the workforce.

Alignment of interest and goals between investors and their management teams on the ground is important, and the use of ESG-related metrics (carefully tailored to reflect the key ESG priorities of the business) to drive behavioural change is growing in prevalence.

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 are becoming increasingly reliant on internally and externally developed ESG ratings. As sustainable finance (whether in the form of green or social lending or sustainability-linked lending) has become a more widely available and recognisable product – and as demand for those products has grown – the importance of transparent and reliable data, allowing for objective assessment and industry benchmarking, has also grown. As a result, financial institutions have developed their own in-house, proprietary ESG criteria and ratings for their customers and lending products. There has also been significant growth in third-party ESG rating agencies in recent years, who asses and rate both global companies and sustainable lending products based on their ESG performance.

Companies are increasingly seeking external ESG ratings. However, the use of external ESG ratings has been hindered by a lack of consistency in the rating methodologies employed by the different rating agencies, which stems in part from the difficulty in quantifying ESG data, a lot of which (particularly when looking at social and governance) is intangible, or very industry- or company-specific. That lack of consistency results in a wide variation in the ratings ascribed to companies by different rating agencies, which undermines the reliability, comparability and therefore the usefulness of ESG ratings to investors.

As rating methodologies evolve and become more standardised, and as the quality and consistency of the underlying data improves, it is likely that external ESG ratings for both corporates, and for sustainable finance products (whether loans or bonds), are likely to become increasingly important and an increasingly useful tool for investors.

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

Green bonds are bonds whose use of proceeds must be exclusively used to finance or re-finance "green" projects, assets or business activities, while social bonds are bonds used to finance or refinance social projects. Both green bonds and social bonds come within the umbrella term "sustainable bonds" which encompasses the variety of bonds issued with an ESG element including green, social, sustainability, transition and sustainability-linked bonds.

The LSE has a dedicated "Green Bond Segment" (established in 2015) as well as a dedicated Sustainable Bond Market, which was developed in response to the demand from investors and companies to manage climate risk and create positive impact.

The sustainable bond market is growing rapidly, reaching US$4 trillion globally in June 2023, and accounts for an increasing portion of the fixed income market. There appears to be strong and persistent demand from investors for sustainable bonds, which has several benefits for issuers (including tighter yields) – both of these factors (investor interest and issuer benefit) have contributed to the growth of this market.

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

Sustainability-linked bonds are bonds whose interest rate is linked to a specific set of KPIs with "sustainability performance targets" or "SPTs" attached to them – failure to hit an SPT will result in a step-up in the interest rate. Sustainability-linked bonds account for a very small share of the global sustainable bond market currently (representing just 4% of the US$6.4 trillion of global issuance to date), although there was a significant increase in issuances of sustainability-linked bonds between 2020 and 2022 that has plateaued in the last year as scrutiny of the product has increased. There remains some scepticism around sustainability-linked bonds among investors – in particular, there have been concerns around the robustness of the sustainability goals that underpin them. Some environmentally focused investors might also be unwilling to hold debt issued by companies that could renege on their sustainable promises, particularly when the penalty to the company for failing to meet its sustainable goals is modest (see below).

The impact of these bonds in promoting and achieving sustainability goals is unlikely to be significant at present, given that the interest rate step-up if an issuer fails to achieve its sustainability objectives is negligible (25 bps on average with only a few bonds in the market having a step-up of 40 bps or more). With such modest penalties, sustainability-linked bonds are not currently a key driver of sustainable objectives.

Interest in sustainability-linked bonds among issuers and investors is, however, expected to increase as the quality of the data underpinning the KPIs and the SPTs improves and becomes more readily verifiable. It will be important going forwards that these products are structured carefully, and that they are subject to robust external verification, to improve their perception in the market.

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

The key issue impacting the use of these financial instruments is the lack of standardisation in the ESG data that underpins them. That is expected to improve with (among other initiatives) the introduction of the UK's Green Finance Strategy.

The benefits (for issuers or investors) in opting for sustainable bonds over traditional fixed income bonds might in some cases be relatively modest – we see that in particular with sustainability-linked bonds. This hampers the growth in these products.

This is still a relatively nascent market which inevitably comes with its own challenges. Both issuers and investors are more cautious about newer products, with limited proven track record. That will improve as the market becomes more established.

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

The Green Bond Principles ("GBP") developed by the International Capital Markets Association ("ICMA") set out certain voluntary standards for green bonds. The GBP outline a number of ways in which issuers can obtain assurance and verification for their green bonds, predominantly through: (i) the development of a Green Bond Framework; and (ii) external reviews.

The GBP require issuers to explain the alignment of their green bond with the four core components of the GBP (being Use of Proceeds, Process for Project Evaluation and Selection, Management of Proceeds and Reporting), in a "Green Bond Framework" or in their legal documentation. The Green Bond Framework should also be made available to investors.

Issuers of green bonds can (and are encouraged) to seek external reviews and verification of their green bond processes and the green bonds themselves, which can be achieved in several ways, as follows:

(i) Third-party involvement – an issuer could involve a consultant or other institution with recognised expertise in sustainability to review and/or assist in the issuer's evaluation and selection of projects suitable for green bond financing.
(ii) Audits – issuers are encouraged to audit and independently verify key aspects of their green bond issuance, including the internal tracking method and the allocation of funds from the green bond proceeds to eligible green projects.
(iii) Third-party certifications/verifications – certain qualified third parties can certify and verify green bonds.

As outlined above, the GBP are a voluntary rather than mandatory framework. Green bonds are not currently regulated in the UK any more (or any less) rigorously than traditional bonds. However, the majority of issuers of green bonds issued in the UK do currently apply the GBP, and the FCA has made statements encouraging issuers to do so as well. The FCA has also indicated that it might consider a regulatory regime for green bonds in the future, should that come within the ambit of its powers.

5 Trends

5.1 What are the material trends related to ESG?

The rise of the so-called "anti-ESG" or "ESG backlash" movement in the US will, for the foreseeable future, present a difficult challenge for global corporates and investors, who are having to balance conflicting stakeholder concerns and inconsistent regulatory regimes.

For ESG sceptics as well as proponents of ESG, there is growing concern about the reliability of ESG data and "greenwashing", and the FCA (as noted above) has made clear in its proposals for the SDR that tackling greenwashing is a regulatory priority. It will be interesting to see in due course how regulatory tools to tackle greenwashing will be put to use – clearly a well-intended development to curb misleading statements on ESG, but there is also concern that "greenhushing" (where organisations deliberately choose to under-report or hide their green ESG credentials from public view to evade scrutiny) is on the rise.

One other emerging area of focus is the relationship between ESG and AI (Artificial Intelligence). AI can, of course, provide useful tools to progress various ESG initiatives and measure and monitor ESG-related risks, but we are only starting to grapple with the ESG risks in AI. On the social side in particular, AI may pose several risks, from job loss to data privacy, and the draft EU AI Act seeks to embed these concerns, together with measures for managing ESG risks in AI systems. The UK, on the other hand, appears to be heading towards a pro-innovation approach to AI regulation, which may see human rights and environmental concerns falling outside the scope of regulation.

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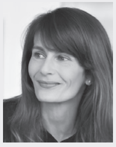

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Travers Smith's cross-disciplinary team of market-leading experts provides holistic advice to clients across every industry on the full spectrum of ESG and sustainable finance issues, from operational and compliance risks to high-profile cross-border litigation and reputation management. Our clients include notable financial institutions, asset managers, funds, pension scheme trustees, lenders, fintechs and corporates.

Having established our ESG practice over 10 years ago – one of the first law firms to provide a dedicated ESG legal offering – Travers Smith remains at the forefront of this legal sector and is top-ranked by *The Legal 500* in the environment and corporate governance space. We work with our clients to provide solutions-focused and tailored advice that balances the opportunities and risks that ESG initiatives in their businesses bring, including reputational considerations involved.

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