ESG INVESTOR

Act Naturally

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Environmental reforms will require asset managers to manage and report on a wider range of risks and opportunities, says Simon Witney, Senior Consultant, Travers Smith.

Last year, many alternative asset managers worked harder than ever to ensure that their investment approach was equipped to meet one of the defining challenges of our time: sustainability. Although not a new theme for most firms, it was close to the top of the agenda in 2021.

While legal and compliance teams struggled to keep up with new and emerging sustainability regulation, senior decision-makers re-focused on the opportunity. Increasing investor demand for investment funds that are part of the solution to societal problems – and a growing aversion to those that do not actively avoid harm – requires a strategic response. But the active ownership model that is an integral part of private capital's heritage means alternative asset managers are very well-placed to respond.

Climate first

ESG issues are many and varied, but the climate emergency overshadowed many others in 2021. That will not change any time soon: European regulators are prioritising climate-related issues in their regulatory responses. The EU's Taxonomy, now live, will only cover economic activities that address climate change until at least January 2023. The UK's taxonomy will similarly prioritise climate issues, and many UK-regulated alternative asset managers – along with most other economic actors – will soon have to issue reports on climate change related financial risks and opportunities using the internationally recognised **TCFD framework**.

The US has re-signed the Paris Agreement on Climate Change and will bring forward new mandatory disclosure rules for public companies in 2022. Last year's COP26 – with a full day dedicated to finance – raised awareness and added significant momentum. Many firms signed up to pledges to play their part in reducing greenhouse gas emissions and will be held to account for their performance in the decade to come.

But climate issues are clearly not the only ESG-related concern of policymakers and investors. Demonstrating respect for human rights and addressing other social concerns will continue to be vital, and new **EU laws** are likely to impose far-reaching requirements for private companies to report on their external impacts. Investment firms wanting to be leaders in sustainability are already getting ahead of these challenges, rather than waiting for policymakers to deliver.

"Ambitious environmental programme"

Meanwhile, the current UK government has identified nature as an important theme for 2022. Passed at the end of last year – although mostly not yet in effect – the government boldly claims that the **Environment Act** "will deliver the most ambitious environmental programme of any country on earth" and sets an example "for the rest of the world to follow". Many of the detailed rules are still in development, but a significant number of portfolio companies will be affected – with consequences for due diligence, governance and exit planning.

Among the specific areas tackled in the wide-ranging new law are air quality, biodiversity, water conservation and resource efficiency. The government has given itself broad powers to make regulations addressing producer responsibility, both along familiar lines such as product compliance schemes, and in new areas such as deposit return programmes. Rules will address resource efficiency, aiming to promote more durable and recyclable products with a lower environmental impact through their lifecycle. Many businesses will need to adapt to these new rules and, with sustainability already a significant driver of customer behaviour in some sectors, there may be advantages to being ahead of the curve. Investors who promote sustainability may want to factor these important policy goals into their ESG data collection and reporting.

Biodiversity and conservation are key themes of the UK Environment Act; the government has said that it will halt species decline by 2030. A new long-term biodiversity target will be supported by laws requiring that biodiversity gain is a condition of planning permission or development consent, require authorities to promote a 'general biodiversity objective' through their policies, and divide England into Local Nature Recovery areas. 'Conservation covenants' are another important tool – existing landowners and certain leaseholders can enter into agreements with authorities for the conservation of the natural environment or natural resources of their land, but critically these covenants attach to the land and bind future holders. As conservation covenants are rolled out, any future land acquisition by investee companies will need to take account of the additional cost of complying with nature protection or enhancement obligations.

Far-reaching and wide-ranging

New rules will also seek to protect the natural environment outside the UK. For instance, under **new legislation** introduced under the Environment Act, any large organisation sourcing certain overseas commodities – likely to be foodstuffs but also rubber – will need to conduct supply chain due diligence to ensure that any such products are not linked to illegal deforestation.

A new framework for firms to report on nature-related risks and opportunities – following the same approach as the TCFD's recommendations on climate change – is in development by the Taskforce on Nature-related Financial Disclosures (**TNFD**). Given the UK's enthusiasm for international standards and its commitment to tackle nature-related issues – which are, of course, also intrinsically linked with climate change – asset managers would do well to think about their approach to environmental issues more broadly this year. They might also want to take a look at the TNFD's preliminary reporting proposals, expected in the coming months, and consider whether they can evolve their own investor reporting to take account of them.

This article was co-authored by Sarah-Jane Denton, Consultant in the Risk & Operational Regulatory Group.