Hot issues in ESG for financial services firms

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ESG issues are increasingly important for financial services firms, and touch on a number of key risks, ranging from climate change to diversity, treatment of employees, understanding supply chains and responding to financial crime. The pandemic has strengthened many firms' resolve to focus on sustainable growth as well as the resolve of the regulators to ensure that firms integrate sustainability into their business and risk decisions. A selection of key issues to keep in mind is set out below.

What do regulators expect on disclosing climate change risks?

If firms are not already making climate disclosures in line with the Taskforce on Climate-related Financial Disclosures (***TCFD***) guidelines, then they should certainly consider doing so. The UK's Financial Conduct Authority (***FCA***) has just finished consulting on a new listing rule which would require premium-listed issuers to disclose in line with the TCFD guidelines or explain why they cannot by 2021. The UK government has now announced this month that it intends to mandate climate disclosure in line with TCFD for all financial services firms (and issuers and other UK companies) by 2025. The indicative roadmap published by the UK's Taskforce on TCFD shows that there will be a staged approach with most action before 2023.

In April last year when the PRA set out its supervisory expectations in relation to firms' management of climate change risks, it noted that it expects financial services firms to develop and maintain an approach to disclosure over and above their existing obligations to disclose information on material risks. Climate change disclosures should be "*as insightful as possible*", and firms should be preparing for disclosure to be mandated in more jurisdictions, including by engaging with initiatives such as the TCFD framework.

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In July this year the PRA confirmed that some firms are publishing TCFD-format disclosures, and that a few firms are approaching fully comprehensive disclosures. However, some firms had not started to disclose. The PRA emphasised the value of high-quality disclosures and that developing such high-quality disclosures takes time — encouraging firms to start work on them now.

Regulators in Europe and Asia have broadly similar expectations (although have not yet indicated that disclosures will become mandatory).

The SFDR: shining a light on the sustainability of financial products and services

As sustainability rises up the agenda, directors of financial services firms and investment decision-makers face difficult questions on how they implement sustainable business practices. For example, should they integrate sustainable characteristics into their financial products and advice? If so, what are sustainable characteristics? Should firms consider the carbon emissions of assets, or the racial diversity of investee companies? Should they divest from companies that aren't providing employment opportunities in disadvantaged communities? Would offshoring production to less developed countries qualify as providing employment opportunities in disadvantaged communities? And should firms use their voting rights to encourage sustainable change?

Under its Sustainable Finance Disclosure Regulation (***SFDR***), the EU is seeking to bring these decisions into the spotlight. Financial market participants (portfolio managers, UCITS (undertakings for collective investment in transferable securities) and AIF (alternative investment fund) managers, and insurers providing insurance-based products) and financial advisers will be required to disclose whether, and to what extent, their products and services are sustainable. Periodic reports, websites and pre-contractual documentation, such as fund prospectuses, will need to describe the sustainability of the product or service being provided. Financial market participants will also need to monitor and disclose adverse sustainability impacts of their activities. The objective of the SFDR is to mitigate the risk of "greenwashing" (ie the provision of misleading information on how environmentally sound an activity, product or investment is) and to enable investors to purchase products and services that suit their sustainability preferences.

The SFDR's technical standards will clarify the content and presentation of the required disclosures. Along with the EU's Taxonomy Regulation (see separate article below), which supplements the SFDR requirements, the technical standards indicate what issues, metrics and thresholds firms should consider. The requirements and draft technical standards expressly cover the topics raised in the first paragraph above, as well as a substantial list of other sustainability issues.

With certain disclosure requirements set to apply from March 2021, firms should be preparing to gather and disclose the necessary information. The regulation will be onshored into UK law and, whilst the UK's approach to the technical standards remains unknown, it is expected to align with the EU's approach at least initially.

When can firms collaborate on ESG issues?

Firms seeking to collaborate on ESG issues should bear in mind that such collaboration, while well-intentioned, may fall foul of competition law in certain circumstances.
Competition law regimes around the globe typically prohibit agreements between competitors which have the aim or effect of reducing competition. There is generally provision for exclusion from the rules or exemption for collaboration that produces benefits for consumers, which outweigh any restriction of competition. However, ESG factors have traditionally struggled to be accepted as conferring sufficient benefits to outweigh a distortion of competition, and penalties for breaches of competition law can be significant (eg in the EU, companies can be fined up to 10% of their annual worldwide turnover).

Certain competition law regulators in Europe (eg in the Netherlands and Greece) are taking steps to seek to ensure that competition law does not stand in the way of justifiable collaboration between competitors on ESG issues, and more regulators will likely follow suit. The European Commission recently launched a public consultation on the issue. The UK's Competition and Markets Authority (***CMA***) is alive to the issue (eg its 2020/2021 Annual Report referred to the need for the CMA to "*act in a way which supports the transition to a low carbon economy*") but it is yet to set out any concrete steps or issue any practical guidance on the matter. Competition law regulators in Asia are similarly yet to take any significant steps but are known to be considering the issue carefully.

Firms are, understandably, keen to collaborate on ESG initiatives, particularly given their often investment-heavy nature … However, such collaboration may be prohibited under applicable competition law rules

It remains challenging to identify the fine line between legitimate collaboration and anticompetitive collusion. Accordingly, companies that are considering collaborating with competitors should seek specialist competition law advice, even if that collaboration is intended to further ESG goals.

The EU's celebrated Taxonomy Regulation – what does it address?

The EU's Taxonomy Regulation establishes an EU-wide classification system intended to provide businesses and investors with a common language to identify to what degree economic activities can be considered "environmentally sustainable" or "green". It aims to encourage consistency and efficiency via the use of a single standard across the EU and to reduce "greenwashing".

The Taxonomy Regulation also imposes disclosure requirements, including requirements for certain firms offering financial products to disclose how and to what extent the criteria in the Taxonomy Regulation are used to determine the environmental sustainability of their products. Large listed companies, banks and insurers will also be required to make statements about how their activities align with the taxonomy as part of their non-financial reporting requirements.

While the framework legislation for the Taxonomy Regulation has applied in the UK since July 2020, the disclosure requirements will only begin to apply from 1 January 2022, i.e. after the end of the Brexit transition period. However, some of the disclosure requirements will apply to certain firms offering financial products in the EU, regardless of where they are based. The UK government has also recently announced that it will implement a green taxonomy post-Brexit. The UK taxonomy will take the scientific metrics in the Taxonomy Regulation as its basis, subject to review by a newly-formed UK Green Technical Advisory Group to ensure they are right for the UK market. The details of the UK's approach are yet to be announced, but this raises the question of whether some level of divergence between UK and EU approach may result. For firms required to make disclosures in accordance with the taxonomy requirements, substantial work may be necessary to put in place processes to gather the required information and make the necessary assessments. If firms have not already done so, it may be prudent to start considering how the taxonomy requirements may apply to their activities.

Climate change litigation: latest cases against financial institutions

Until recently, global climate change litigation focussed on tort claims against energy companies and others whose activities are

perceived to impact directly on the environment, but the focus is now broadening to claims against other corporates, including financial institutions. In fact, in the last year we have seen the highest number of climate-related cases ever filed against financial institutions, mainly in Australia and the Netherlands. The ongoing focus is still non-disclosure of climate risk.

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Some of the most interesting recent cases include:

- A complaint against a bank in the Netherlands, alleging that the bank had breached the OECD Guidelines as although it reported about its own emissions, it did not report publicly about its indirect emissions through companies and projects that it financed and, contrary to the Paris Agreement, had not set its own public targets to reduce emissions resulting from its financial products. The parties ultimately agreed on the various steps the bank would take to set concrete climate goals in line with the Paris Agreement;
- A case brought against an Australian superannuation fund by a member of the fund, who alleged that the trustees of the fund had breached a statutory informational duty to him by failing to disclose information about climate change risk, and a fiduciary investment duty by failing to take account of climate change risks. This case has settled this month, and as part of the settlement the superannuation fund has acknowledged that climate change is a material, direct and current financial risk to it, and agreed to (among other things) achieve a net zero carbon footprint by 2050, disclose in line with TCFD and take various other steps to promote the goals of the Paris Agreement; and
- In July this year, a case brought against the Australian government and two of its officers for failing to disclose climate risk in documents promoting sovereign bonds. The bondholder alleges that the non-disclosure constitutes misleading and deceptive conduct. While this case was not brought against a financial institution, there are obvious parallels.

There has not yet been any climate-related litigation against a financial institution in the UK, but where arguments are run successfully in this area they are usually quickly replicated around the globe.

People perspective: diversity in the spotlight

Diversity is a topic that has generated attention in its own right for many years, but it is also a prominent feature of the ESG agenda and is now receiving attention in that capacity. Increasing levels of disclosure and explanation are expected and that, in turn, gives more ammunition to stakeholders if they consider that companies' efforts are falling short. Requirements in some jurisdictions extend to setting legally enforceable targets — California, for example, has had in place mandatory gender diversity requirements for the boards of Californian headquartered companies for the last two years, and legislation requiring board members from "under-represented communities" (broadly covering racial or LGBT+ characteristics) is imminent.

In the UK, public gender pay gap reporting reveals areas of gender imbalance (typically amongst the senior ranks) and requires an explanation of the steps being taken to address it. The debate continues as to whether ethnicity pay gap reporting should become mandatory, but in the meantime some organisations have voluntarily started disclosing this data. In 2020, the pandemic has led to a suspension of the UK's gender pay gap reporting requirement — a welcome relief from an administratively onerous requirement for some, but a possibly worrying sign for others of the risk of diversity slipping down the priority list as COVID-19 consumes people's time and attention.

In its letter to remuneration committee chairs in July 2020, the UK FCA made clear its expectation that culture should not be deprioritised, notwithstanding the redirection of resources to deal with the impact of COVID-19. The FCA noted the role of remuneration and recognition practices in driving culture, and drew specific attention to diversity and inclusion as part of a healthy culture, telling chairs "*you should both assess the extent to which your firm's remuneration policies positively promote diversity and inclusion across all protected characteristics and also take appropriate steps to address areas of weakness or concern*". The FCA also referred to gender and ethnicity pay gap reporting, stating that it provides "*a quantitative window into inequalities and we expect firms to consider the analysis from those reports and use them to address any inequalities*".

The role of remuneration (and thus remuneration committees) in driving forward the sustainability agenda has featured in a recent European Commission study, and diversity is an increasing area of focus for the European Commission. In its September 2020 action plan on racism, the Commission announced that it would start collecting diversity data in respect of its own 30,000-strong workforce, paving the way for the development of evidence-based policies and measures to tackle racism. Data privacy and cultural factors are often cited as barriers to diversity data collection in Europe, and the Commission's move is seen by some as a demonstration of the importance it places on finding a way to overcome these barriers.

ESG and data ethics: doing the right thing

Data ethics is a hot topic right now because authorities are focused on businesses doing the right thing in an environment where consumer trust has broken down. The UK Information Commissioner, for example, has defined "*increasing public trust*" as one of its strategic goals. Data ethics moves the dial from "what can we do?" to "what should we do?", and in doing so provides a useful way for companies to maintain goodwill. Legislation is by its nature reactive, so as technology offers more powerful ways to manipulate data, it is up to businesses, regulators and society to work out where the limits should be. This is particularly so in the financial sector where consumers, new technology and regulation meet and we know data ethics has caught the interest of the FCA and the Bank of England.

The European Commission has also shown interest and, as part of its recent Digital Finance Strategy, it has tasked the European Supervisory Authorities with providing clarity on how AI-based solutions can be applied in the financial sector in a "*safe, sound and ethical manner*".

Although data ethics is being discussed in a number of contexts there are recurring themes of transparency, governance and explainability that while debated as part of ethical principles can also assist with other areas such as GDPR compliance.

Organisations in the financial sector should monitor developments closely in particular any more concrete changes that embed data ethics into regulatory frameworks (eg whether the FCA will update its Treating Customers Fairly principles in light of data ethics, the outputs of the Monetary Authority of Singapore's (***MAS***) Veritas initiative (a partnership with the financial and technology industry partners to develop a framework for evaluation of MAS's FEAT principles for the responsible adoption of AI and data analytics), and whether the Hong Kong Monetary Authority will follow up on its efforts to encourage authorised institutions to adopt the Ethical Accountability Framework developed by the Hong Kong Privacy Commissioner). Organisations should consider whether there are benefits in setting up data ethics review boards to stay ahead of regulatory change.

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How reliable are sustainability ratings?

Financial services firms increasingly rely on ratings generated by sustainability agencies to make a wide range of investment decisions. However, studies have shown that sustainability ratings differ dramatically between agencies, making it difficult for firms to evaluate a company's ESG performance — and sometimes the ratings produce unexpected results. As widely reported, fast fashion retailer Boohoo was given a high rating by MSCI for its ESG metrics, placing it in the top 15% of its peers — and many ESG funds had invested in it on that basis, only for serious problems in its supply chain in the UK to be revealed during the pandemic.

Sustainability ratings are often criticised for their lack of transparency, particularly around the assumptions that agencies make when there is no publicly available data, or where data is incomplete or insufficiently detailed, and also for focussing on business models of companies rather than the nature of products and services offered. This last factor means that companies in controversial sectors can receive very high ratings.

Given these dynamics, there is debate as to whether sustainability ratings agencies should be regulated. European regulators are actively considering the question; the European Securities and Markets Authority has been vocal about the need for a regulatory framework, and the European Commission is considering how the industry's transparency and cohesion can be improved, with results due this autumn.

UK regulators have not yet announced any formal consultation — although the FCA did indicate in October last year that it planned to consider the role played by specialist providers of ESG data services and investors' use of them. Given the impetus in the new Stewardship Code for firms to take ESG issues into account when investing for others, the current discrepancies in ratings seem unworkable — and therefore future regulation is both likely and desirable. A space to watch.

The rise of ESG-related disputes

The risk of ESG-related claims against corporates is increasing — from claims arising out of data breaches, anti-money laundering and supply chain failures to non-disclosure of climate change risk and human rights issues. All of these claims are capable of being brought against financial institutions, and many lend themselves to group actions. Some of these claims would have been brought in any social and economic climate — such as claims arising out of high-profile events which have resulted in a drop in the corporate's value or other tangible impact. But others are closely connected to our newly increased focus on responsible business, which is particularly acute during the pandemic, and on the increased disclosures and statements that corporates make publicly about their goals and strategies in this area.

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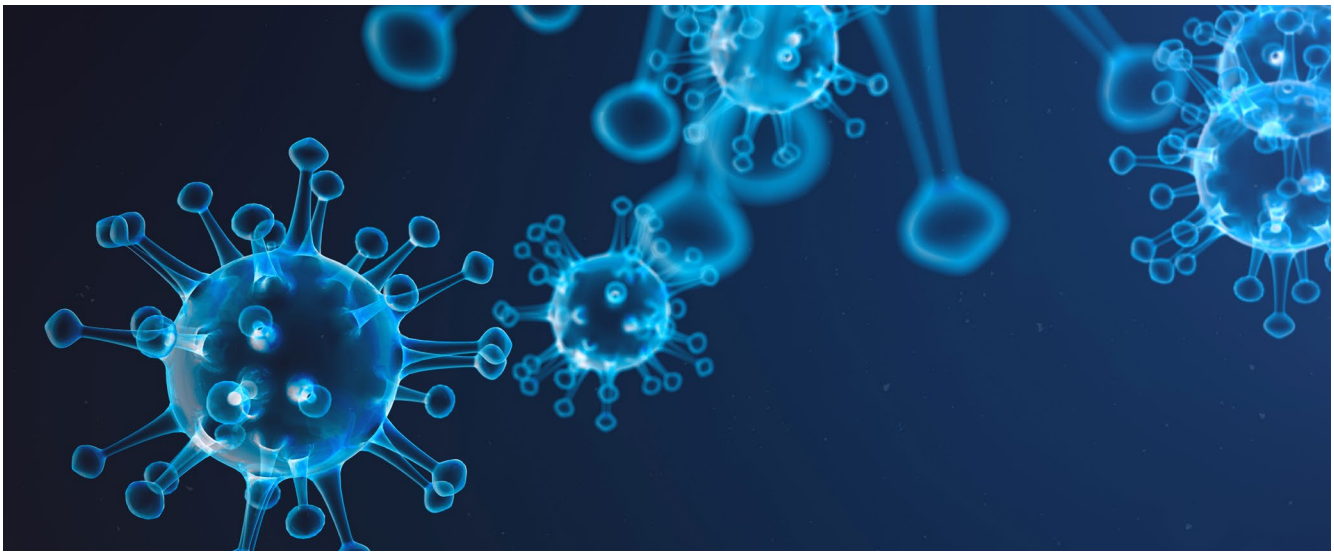
What are the hallmarks of an ESG-related claim?

Many ESG-related claims are traditional, in the sense that they will be brought by shareholders or other stakeholders seeking compensation for loss caused by a firm's failure to regulate its business or a misleading statement which has been relied on to make an investment decision. However, others are increasingly being brought by strategic claimants, including individuals, NGOs and other groups focussed on environmental and human rights issues who are more interested in achieving a change in a corporate's practices than damages. These types of claimants look to use other dispute-resolution mechanisms to bring their cases too, such as complaints for breaches of the OECD Guidelines, which are then resolved by National Contact Points in each OECD country. And the one thing that all ESG-related claims have in common is the potential for high reputational impact.

What should firms do to minimise their risk of ESG-related disputes? Have strong governance and risk management processes so that ESG-related issues are understood at all levels of the firm — which, for financial services firms reflects their regulatory obligations anyway — and make sure that any public statements or disclosures on ESG-related matters are accurate, thoughtful, and reflect the firm's true view of its risks.



Financial stability: testing resilience to climate change

Protecting the stability of the financial system from climate change is an area of increasing focus for the Bank of England. Among a number of measures, the Bank intends to conduct pioneering stress tests to assess the resilience of the UK's largest banks and insurers, and the UK financial system more broadly, to the risks of climate change. The tests will form the Bank's 2021 "Biennial Exploratory Scenario", the part of the Bank's stress testing framework used to explore less well-understood risks. The tests were expected to be run in late 2020, but due to the pressures of COVID-19, the launch has been postponed until June 2021.

The details of the scenarios will be specified by the Bank and will address both the physical risks of climate change, such as more frequent extreme weather events, and the transition risks of moving towards a carbon-neutral economy. Participants will need to assess the resilience of their balance sheets to three potential climate change scenarios: an orderly transition as a result of early action, a disorderly transition as a result of late action (ie where further action is delayed by ten years) and the "catastrophic business-as-usual" scenario in which no further policy action being taken results in the Paris Agreement 2°C limit being exceeded. The participants will also be asked how they would change their business models in response to the risks in each scenario. The Bank has proposed requesting a follow-up round of submissions to explore system-wide impacts where participants would respond to the aggregated results of the first round, and potentially revise parts of their submissions in response to Bank feedback.

It is hoped that the exercise will help provide firms with a coherent framework to assess their exposure to climate risk and encourage the development of new modelling approaches and better risk management techniques, as well as identifying gaps in existing data.

While certain jurisdictions (including the UK, France and the Netherlands) are leading the charge on stress testing for climate change, a trend is developing worldwide. For example, adding climate factors to existing stress tests was discussed in an IMF Staff Paper in February this year, the European Banking Authority has confirmed that it hopes to develop a climate stress test for banks in the EU in the long-term and work on climate-related stress tests has also either been announced or is expected in Canada, Japan, Australia, China and Singapore.

ESG investing: legal considerations for asset managers

"ESG investing" can take many forms (and names), but a fundamental feature is that investment decisions consider ESG issues. The consideration of ESG issues in investment decisions, and the marketing of "ESG" products present important legal considerations.

Communication of ESG investment characteristics will need to be clear and not misleading. Whilst considering the financial effects of sustainability issues is increasingly common practice, firms must ensure their approach to intergrating ESG into decision-making is appropriately marketed to avoid misleading investors. To give an extreme example, claims to maximise financial returns may not be compatible with strategies that prioritise reducing carbon emissions over financial return. Managers will also need to avoid "greenwashing" their products, ie overstating their sustainable characteristics, to attract ESG-conscious investors (see above article on the SFDR). Clear communication is particularly important for products aimed at inexperienced retail investors, such as UCITS funds, which under EU and UK law must provide detailed disclosures on investment objectives and policies.

ESG products will be subject to a variety of other regulatory requirements, applicable in both the UK and the EU. Firms offering ESG products will need to disclose the extent to which their investments align with the EU's taxonomy of sustainable economic activity (see article above). For environmental products, the specification of benchmarks for assessing performance will need to comply with EU environmental benchmark requirements as far as possible. Investor protection rules will require that the ESG characteristics of products are aligned with investors' sustainability preferences when advisers and managers conduct client suitability assessments and when product manufacturers conduct target market specifications. Managers caught by the SFDR may also wish to align remuneration policies with their consideration of financial ESG risks, as this alignment will need to be disclosed on their websites.

Finally, firms offering ESG products will need to ensure that agreements with delegated investment managers accurately provide for the desired ESG investment approach. ESG issues and outcomes can be difficult to measure, potentially making it difficult to assess manager performance. Careful drafting of investment management agreements can reduce uncertainty and minimise the risk of disputes.

Contributors

Please click on the names of any of the contributors below to see their contact details. For a full list of key ESG contacts worldwide, please visit our Sustainable Finance page where you will find contact details of our team of specialist lawyers across the globe as well as latest news, publications and details of upcoming events.

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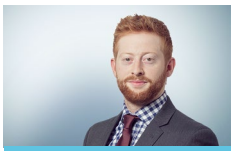

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