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ESG – LEGAL RISK OR BUSINESS OPPORTUNITY?

– THOUGHT LEADERSHIP

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ESG – 'Environmental, Social and Governance' issues – sometimes referred to as sustainable or responsible business issues are of increasing importance to businesses for the opportunities they bring, but also the reputational and economic risks that come with making the wrong decisions.

ESG is embedded in business conversations across investor communities, in board rooms, compliance functions and amongst regulators and policy forming bodies. For some, the journey started a long time ago, but for others, the question remains "what should I worry about?" In this briefing we look at what lies ahead.

ESG and the EU

The first policy initiatives directly related to ESG date back to 2018. The European Commission moved away from voluntary, industry-led initiatives to a concrete proposal for legislation for asset managers, requiring them to integrate ESG factors into investment decisions. It also legally defined what is sustainable. Gail Orton, Clifford Chance's Head of EU Public Policy, says: "We can expect much more activity from policy-makers in this area, particularly in relation to the E part of ESG."

Late last year, the European Commission launched a new flagship policy – the European Green Deal –with the aim of the EU becoming "the first climate neutral continent in the world by 2050." The Green Deal includes: farming and food; energy; transport; industrial pollution and waste. "We should expect to see policies emerge in relation to those topics, including a carbon border tax for example," says Orton.

The Green Deal will require significant investment if it is to be successful. The EU is investing up to EUR 1 trillion and also has a sustainable finance agenda to encourage private sector investment for the transition to a climate-neutral economy.

However, the stakes are different for different Member States as some want more time to reach the target and others want to take action sooner. The goal is set at EU level rather than country by country. Poland, for example, is still heavily reliant on coal, so can take longer to reach the target, while countries such as Austria, Finland and Sweden have pledged to reach the benchmark before the 2050 date and can therefore become "carbon sinks."

But the differences are not only between Member States. The European Parliament also has a role in setting these policies. The 2019 elections to the European Parliament delivered a surprising result; for the first time in the Parliament's 40-year history, we saw the two biggest parties fail to win a combined majority and the big winners were the liberal group and the greens. "And that matters for the next few years because it means you cannot get anything through the Parliament without involving the liberals and the greens who will both push hard for ambitious climate policies," says Orton.

What impact will Coronavirus have on the EU's ESG priorities?

It has been very difficult, sometimes impossible, to go about business as usual in light of Coronavirus. Here are three examples:

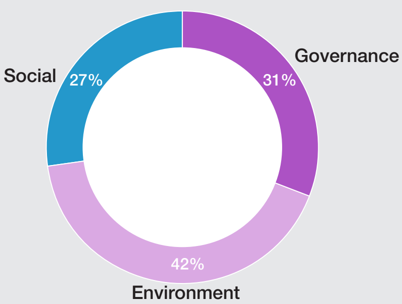
1. There is an obligation at EU level to use 10% of renewables, basically biofuels, in the transport sector. A direct result of the crisis saw moratoria introduced by certain member states, removing the 10% rule so as to provide more flexibility, and perhaps avoid agri-food price increases.
2. The aviation sector saw a 90% drop in flights. A decision was taken not to use 2020 as the benchmark year for their emissions targets.

3. The EU was at the forefront of the debate on single use plastic reduction and only a year ago adopted legislation to severely curb its use, for example, in food outlets. Now there are calls for delays to implementation because of the role that these plastics are playing in our lives.

However, elsewhere, we have seen a continued focus on green policies. The crisis saw unprecedented intervention in the private sector by EU governments in the form of State aid. The European Commission encouraged governments to impose green conditions on aid that was granted, with a varying degree of success. Orton says: "A good example is the decision by the French government requiring that Air France stop all domestic flights for which there was a train journey of less than two and a half hours and to make dramatic cuts to its carbon-dioxide emissions in exchange for aid to the tune of EUR 7 billion. So this debate between supporting business through the crisis and not losing sight of climate ambitions will not go away anytime soon."

During a recent webinar with clients we asked the following question:

What is highest on the agenda of your Board?



What impact will Brexit have on the EU's ESG ambitions?

The UK has always been an important advocate on climate change policies, and it will be interesting to see which countries step in to take its place. "However, the EU is concerned that rather than continue to be an advocate, the UK may seek to gain a competitive advantage by lowering its environmental standards or labour laws," says Orton. The EU is therefore insisting on what it calls level playing field provisions in the agreement; it wants a legal commitment from the UK that it will not undercut the EU across a range of issues. "The risk that arises here is that if the UK does diverge from EU rules, businesses will end up having to comply with two different systems," she says. And she adds: "The opportunity is that it may be possible to influence the direction of travel in the UK, for example if there are perceived improvements that could be made to how the EU has tackled some of these issues in the past."

In terms of relations with third countries – which is what the UK will become at the end of the transition period – we will see an even greater desire by the EU to extend its climate ambitions to countries that have access to its market. The EU argues that there is little point in changing production methods to reduce our carbon footprint, if we then import these goods from third countries with no regard as to how they were produced or the emissions related to them. This is the rationale for the Carbon Border Adjustment Mechanism, a carbon border tax. A consultation has recently been launched by the European Commission and a proposal for legislation is due in the first half of next year.

What about regulatory activity?

EU regulatory activity is addressed at states, consumers and, most of all, business. There is a huge range of recent or upcoming legislation and standards.

"The financial sector is particularly targeted by new rules as it has a key role to play in the economy," says Thomas Voland, a partner from Germany who specialises in European and German public law. "For example, the disclosure regulation sets out how financial market participants and financial advisors must integrate ESG risks and opportunities in their processes, as part of their duty to act in the best interest of clients. It also sets uniform rules on how those financial market participants should inform investors about their compliance with the

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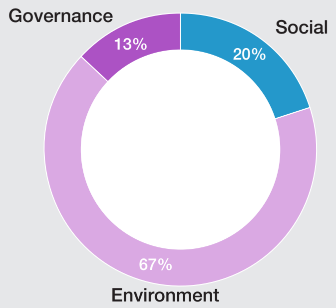
For the next two years, where do you see most opportunities for your company?



integration of ESG risks and opportunities. It requires all financial market participants to explain on their website, in pre-contractual disclosures or in their annual statements how they integrate sustainability risks in their investment decision-making process."

Another new law, which is closely linked to the disclosure regulation, is the taxonomy regulation. This helps specify the notion of "sustainable" and creates the world's first-ever "green list" – a classification system for sustainable economic activities. This will create a common language that investors can use everywhere when investing in projects and economic activities that have a substantial positive impact on the climate and the environment.

The energy sector is also heavily affected. In Germany, for example, the government has decided to phase out coal-fired power plants by 2038. This will result in tremendous change. Currently, coal and lignite still make up 35 percent of Germany's electricity generation.

Other examples of environmental regulation are the entry into force of tightened rules on emission trading from 2021, the prohibition of single use (one-way) plastics and the tightening of CO2-emissions thresholds for cars and trucks.

Recent regulation focuses on the environment – what about social and governance issues?

"The EU has signalled that it regards climate change and human rights as linked issues, so the social aspect of ESG is covered as an annex to environmental regulation," says Voland. For example, the Taxonomy Regulation requires that, in order to qualify as 'environmentally sustainable', businesses align *inter alia* with the UN Guiding Principles on Business and Human Rights.

The Conflict Minerals Regulation, which will come into force on January 1, 2021, establishes mandatory due diligence and disclosure regulations for companies importing gold, tin, tungsten and tantalum into the EU. This may affect companies from various sectors, including tech, automotive and chemistry. But the Commission intends to go further. It has announced that it wants to introduce a general, cross-sector mandatory human rights and environmental due diligence in 2021. Several European countries already have in place or intend to introduce similar requirements at national level.

The "G" for governance part of ESG is often affected as sustainability provisions require adaptations of the compliance management system, new boardroom responsibilities and new policies. Voland says: "We see specific G developments. For example, Germany is currently discussing a draft act on criminal sanctions against enterprises for a large variety of wrongdoings. The question as to whether a company has strong or poor governance will play a key role in this act."

Will new regulations make things difficult for businesses or are there also new opportunities?

"Business won't become easier, but the new rules can at least provide some certainty and contribute to a level-playing field," says Voland. "There are also many exciting opportunities. For example, the phase-out of coal in Germany will be accompanied by a large variety of structural measures and support. The government has announced a EUR 40 billion investment package for infrastructure and R&D."

The European Commission has also recently published a union-wide road map for hydrogen. In this area, the Commission estimates an investment need – and potential – of more than EUR 450 billion. In addition, seven EU Member States, including France, Germany, Italy and Poland have established a so-called Important Project of Common European Interest to fund research and innovation activities in the battery sector.

"We are advising our clients to monitor regulatory activities and ideally go beyond compliance. ESG is a boardroom topic and should be dealt with top down as non-compliance with ESG requirements can cause operational, financial and reputational risks. We see increasing shareholder activism and more and more litigation activity relating to ESG. And ESG requirements may trigger a fundamental change of business cases that needs to be managed properly," he says.

Private equity, alternative assets and ESG

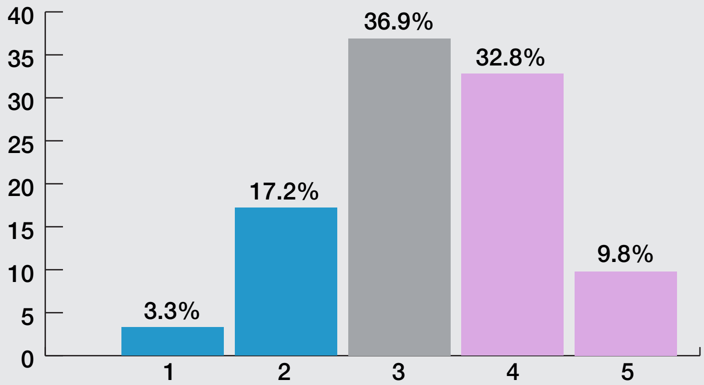
ESG has been a critical element of the compliance framework in the PE and alternative asset industry for almost two decades. "ESG is also, as a rule, a key factor in all fundraising related processes, in particular since the introduction of the United Nations Principles for Responsible Investment (UNPRI) in 2006. It is important to understand that the industry has adopted the principles for fiduciary and performance enhancing reasons and to meet investor or stakeholder expectations, not because of any regulatory or statutory pressure," says Munich-based Partner, Sonya Pauls.

For many leading institutional investors, in Europe, ESG compliance and a strong ESG track record is a strict due diligence criterion and a dealbreaker, not a 'tick-the-box' issue. The investors' analyses not only focus on the framework that is in place for the relevant product placed but also the historical track-record data and the manager's performance to date.

"It is important to note that ethical considerations aside, managers that apply ESG criteria help to create better and better run businesses. Risk impacts returns – there are quite a number of studies that clearly demonstrate this," says Pauls. Examples include KKR's de-risking of businesses in the palm oil industry, Doughty Hanson addressing child labour in the Tumi business and many others. "In this context it is critical to note that for many investors, the concern about reputational damage is greater than investment performance as such. However, ESG is about safeguarding both," she adds.

During a recent webinar with clients we asked the following question:

To what extent do you feel your company has embraced ESG and has the necessary governance in place to do so? (5 high / 1 low)



What are the future challenges?

The Private Equity, VC and other alternative asset industry has to a large extent, in Europe, fully embraced ESG as a risk management tool at all levels – the manager, the fund and critically, at the portfolio company level, extending to global supply chains. The industry started with SRI – socially responsible investments guidelines – more than three decades ago and has built a solid track record in ESG over the past decade or so, explains Pauls.

The industry is now evolving further, to embrace more positive, impact-focused criteria, measured against the 17 UN Sustainable Development Goals (SDGs). "As regards future developments, I do believe that impact driven strategies will be a new focus and a new, even more positive feature of the alternative asset industry in addition to the now quite established ESG criteria," she says.

Challenges will continue to evolve around measuring compliance and impact. However, the industry is quite used to analysing not only quantitative but also qualitative criteria and there are many tools available, such as the Global Reporting Initiative – GRIs 2000. Future challenges will centre around sanctions in Limited Partner/General Partner relations as ESG compliance moves to a quasi-vicarious liability standard. "We are seeing some investors starting to request termination scenarios in the event of ESG breaches or even broader reputational impact, so I do think that managers will be confronted with a new concept of responsibility, regardless of fault in a strict legal sense," says Paul. And she adds: "Whilst there is always much to improve, I would say that the European PE and alternative asset industry is ready and well prepared to embrace any regulatory developments."

What other ESG challenges lie ahead?

"During the Coronavirus crisis and lockdown, a number of macro issues have risen up the agenda," says Gail Orton. "At an international level, George Floyd's death in the US and the Black Lives Matter movement could have a lasting impact on the policy agenda, perhaps that will be in relation to rules on diversity and inclusion."

She adds that on a smaller, more local scale, in the agri-food sector, we have seen an incredible resilience in our supply chains. Apart from initial panic buying there were no food shortages during European lockdowns. EU countries did not stop flows of goods within the internal market.

"But there are pockets of activity where questions will be asked about supply chains and the working conditions of those employed in them. For example we learned that meat processing plants seem to be vulnerable (following outbreaks in the US, there were major outbreaks in Germany, the Netherlands and Wales). And in the UK there has been a local lockdown maintained in the city of Leicester following a spike in COVID-19 apparently due to working conditions at clothing factories. Will these things lead to more of a political focus on S and G? Maybe"

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