CLEARY GOTTLIEB

ALERT MEMORANDUM

# Sustainable Finance: A Global Overview of ESG Regulatory Developments

*October 22, 2020*

The last few years have seen a marked worldwide expansion in "ESG"-labelled investment products, bringing sustainable finance into the spotlight as a clear financial industry megatrend. By 2018, investment in sustainable assets in five of the world's major markets (Europe, the United States, Japan, Canada and Australia-New Zealand) stood at $30.7 trillion, a 34% increase over the previous two years,[1] and it was estimated that over 80% of institutional investors had an ESG component as part of their investment strategies.[2]

And the trend is only accelerating: capital flows into funds incorporating sustainability and ESG-driven strategies hit an all-time high in 2019 and Q1 2020.

The 2020 'perfect storm' of global economic fallout caused by the **COVID-19 pandemic,** renewed global political focus on the **Black Lives Matter** movement and the **workers of the gig economy**, plus the pall of smoke from **unprecedented wildfires** on five continents, is reinvigorating scrutiny from consumers, regulators and employees on ecological and social sustainability considerations, providing fresh impetus to sustainable finance. Regulatory developments are moving in tandem, particularly with respect to ESG labelling and transparency obligations, which the ever-growing pool of sustainable investors rely on to determine the extent to which financial products and investee companies meet their predetermined ESG investment criteria.

Against this backdrop, Cleary is launching a series of thought leadership pieces that will focus on recent and ongoing developments in the regulations that govern sustainable finance and ESG reporting by financial firms, with a particular focus on European regulatory efforts.

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[1] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
[2] https://www.pwc.com/us/en/services/assets/pwc-esg-divide-investors-corporates.pdf

# I. Background

The expression "**sustainable finance**" refers to the process of incorporating sustainability factors into financial decision-making.

It stems from three realisations.

*The first* – "financing green" – is that the resources that are necessary to bring a shift towards sustainable development (pursuant to the targets set under the 2015 Paris Agreement, among others) far exceed the capacities of the public sector alone. According to current estimates, in order to achieve its 2030 environmental targets, Europe must close an investment gap of almost €180 billion per year.[3] This implies the need to raise, mobilize and reorient additional private capital in the same direction.

*The second* – "greening finance" – is that financial institutions at the core of our global economy are themselves profoundly exposed to sustainability risks. From an environmental sustainability perspective, it was estimated that close to 50% of the risk exposure of Eurozone banks is directly or indirectly linked to climate-related disasters and extreme weather events (which also result in higher costs for insurers and parties insured).[4] From a social sustainability perspective, it has become clear that working conditions and growing inequalities have concrete consequences for companies (including financial institutions and their counterparties), ranging from legal to reputational, and can hamper long-term, stable growth. In other words, de-risking, by focusing on sustainable options, is good for business.

*The third* is that the financial system (from securities and credit markets to investment funds and insurance firms) can play a pivotal role through the intermediation of risks and investments that take into account environmental, social and governance (ESG) factors. More specifically:

**E:** Environmental considerations refer to climate change mitigation / adaptation and the environment more broadly, and related risks (such as natural disasters).

**S:** Social considerations refer to issues of inequality, inclusiveness, diversity, labour relations and investment in human capital and communities

(environmental and social considerations are often intertwined, as in the case of a pandemic).

**G:** The governance of public and private institutions – including management structures, employee relations, beneficial ownership and executive compensation – plays a role in ensuring the inclusion of social and environmental considerations in the investment decision-making process.

# II. Global trends

Although the increased focus on sustainable finance has been global, it has differed significantly between jurisdictions – in particular:

**Europe:**

— Europe is the worldwide leader in sustainable investing, home to almost half of global sustainable investment assets at the end of 2018.[5] The broad, early acceptance of ESG-driven strategies in European finance partly explains why EU regulators are spearheading regulatory reforms in the field.

— In 2018, in response to the EU's commitments under the 2015 Paris Climate Agreement, the European Commission launched the "Sustainable Finance Action Plan", whose action drivers provide much of the conceptual framework for sustainable finance regulation. This regulatory reform trend was further strengthened in 2020, with the announcement of the EU's "Green Deal"

[3] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

[4] https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart201905_1~47cf778cc1.en.html#toc3

[5] https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GSL_082520_Final.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=24494

and various calls from investors and industry players to place sustainability considerations at the heart of the EU's post-pandemic recovery plan.[6]

**United Kingdom:**

— In 2019, pending Brexit, the UK government published its own "Green Finance Strategy" stating that the United Kingdom would "match the ambition" of the EU's Action Plan.

— Although the commitment was reiterated by government sources (including the UK Treasury) up to late 2020, detailed initiatives are still to be disclosed (including, in particular, as to the "on-shoring" of the EU's sustainable finance regulatory taxonomy framework already in force).

**United States:**

— ESG investing in the United States continues to expand at a rapid pace, making it the world's second major market for sustainable finance.[7]

— Unlike in the EU and despite increasing pressure from large institutional investors, the U.S. Securities and Exchange Commission (SEC) has so far been reluctant to adopt ESG-specific guidelines and instead only requires that disclosure of ESG risks be made if they are "material", formally declining to publish any rule-making in the area of ESG in 2020.[8]

— In September 2020, a subcommittee of the U.S. Commodity Futures Trading Commission published a report on managing climate risks, addressing a series of recommendations to national financial regulators and laying out measures that market participants may adopt in order to catalyse climate-related investments.[9]

— In June 2020, the U.S. Department of Labor issued a proposed rule that would clearly require pension plan investment fiduciaries to prioritise financial returns and not subordinate those to non-pecuniary benefits (which may include ESG factors).[10]

— Shareholder ESG proposals have not slowed during the Covid-19 pandemic, with a renewed focus on the social impact of the pandemic on companies' workforces. During the 2020 proxy season, social and environmental proposals (focusing in particular on climate change) continue to outnumber governance/compensation proposals. Among environmental proposals, the majority relate to climate change and an increasing number call for concrete action rather than just disclosure.

**Asia:**

— In Japan, sustainable assets under management quadrupled from 2016 to 2018, making it the third largest centre for sustainable investing after Europe and the United States. Although Japanese companies have been reporting environmental measures since the late 1990s and almost all companies in the Nikkei 225 index currently report sustainability initiatives, there are increasing demands from investors for enhanced transparency in ESG disclosures.

— In China, the Shenzhen and Shanghai stock exchanges are expected to follow Hong Kong with new requirements for listed companies to disclose more details on ESG practices, in a move that is in line with the Chinese government's stated "green finance" strategy.

[6] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en

[7] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf

[8] Specifically, the SEC chose not to include specific requirements on climate change or other ESG disclosures in the amendments it proposed in January 2020. This position was maintained in August 2020 over the objections of two dissenting commissioners delivered statements focusing on diversity and climate change. See https://www.clearygottlieb.com/news-and-insights/publication-listing/sec-maintains-the-status-quo-on-climate-change-disclosures and https://www.clearygottlieb.com/-/media/files/alert-memos-2020/secs-cautious-updates-to-corporate-disclosure-requirements.pdf

[9] https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf

[10] https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623

**Middle East:**

— There has been increased focus on ESG issues by family offices and SWF investors in the Middle East, particularly with respect to region-specific matters including food security, supply chains and logistics, combatting modern day slavery and renewable energy projects.

**Latin America:**

— In Brazil, the Inter-American Development Bank (IDB), the Brazilian Association for Development and the Brazilian Securities and Exchange Commission have launched the "Finance Innovation Lab", a national forum on sustainable finance that aims to develop financial instruments to foster sustainable investment and to propose regulatory changes to prepare the market for sustainable finance opportunities.

— In Mexico, the national stock exchange has created a green finance advisory council to support the development of green bonds and to prepare for more and better ESG financial sector disclosures practices.

— In Colombia, banks' "Green Protocol Initiative" (on sustainable lending practices) was expanded to include the promotion of responsible investment, and the Colombian financial regulator has started a project focused on climate change risk and green finance.

— Overall, indications that 2020 could see a significant increase in Amazon deforestation have resulted in increased ESG investor and activist focus on agribusiness.

**Australia and New Zealand**:

— Australia and New Zealand make up the region with the world's greatest proportion of responsible investment assets relative to total assets under management, with 63% of assets using a responsible investment approach.[11]

## III. Challenges

The rapid increase in the number of ESG investors and sustainability-focused financial products has been met with an equally substantial proliferation of ESG-related definitions and standards. It is estimated that globally there are more than 600 ESG industry-issued rankings and ratings and more than 4,500 ESG key performance indicators, in what has been almost ubiquitously labelled an "alphabet soup" of ESG metrics.[12]

***The biggest challenge faced by financial firms*** is to be able to accurately extract, measure and provide relevant ESG information on credit exposures and the investments that they provide, or advise on. The markets' need for greater ESG-related transparency and fairness has in fact clashed against an underlying lack of data, and practical limits on due diligence into investee companies (including as regards the resilience of investees' own supply chains).

***The biggest challenge faced by investors*** is that disparate ESG standards hinder comparability – it is extremely difficult (if not impossible) to effectively compare the ESG credentials of companies that report under competing ESG standards. Investors (and indeed environmental activists) are further concerned that the difference in reporting standards, coupled with the fact that they are voluntary, allows companies to "cherry-pick" data that paints them in a good light and has led to concerns about so-called "greenwashing". Similarly, while data-intensive risk-assessment technological solutions exist, current regulations do not ensure the consistent, objective, quantified and reliable disclosure of climate-related risk factors that would allow investors to comfortably identify targets that both increase economic reward and reduce their portfolio's climate risk.

***One of the biggest challenges faced by issuers*** is knowing how to navigate the plethora of ESG reporting standards, with managers often being unsure of exactly what to disclose in light of the array of

[11] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf

[12] https://www.wbcsd.org/Overview/News-Insights/General/News/ESG-ratings-it-s-a-bit-of-a-zoo

(sometimes conflicting) frameworks. Some have tried to follow multiple standards simultaneously, increasing cost and complexity.

It is not only the absence of coherent regulation that is hindering sustainable finance efforts; existing laws sometimes act as an impediment. For example, competition/antitrust law applies to agreements between companies on labels and verification mechanisms and certain requirements must be satisfied for such agreements to be permissible (such as objective and verifiable criteria, absence of obligation, prohibition or boycott and avoidance of competitive information exchange).[13]

Overall, it is clear that demands from investors that companies use multiple frameworks to report ESG factors have increased the compliance burden and led to concerns about sustainability reporting fatigue.[14]

Over the years, there have been various attempts to introduce global standards aimed at harmonizing ESG reporting, but (ironically) such efforts have become part of the problem as they have resulted in a number of frameworks that may be viewed as in competition with one another:

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| **1997** | **Global Reporting Initiative ("GRI"):** the oldest and most popular framework for ESG reporting, which is used by around 40% of U.S. companies and 60% of European companies in their sustainability reporting. |
| **2006** | **UN-backed Principles for Responsible Investment:** 2,059 signatories representing $80 trillion in assets have signed up to six principles for sustainable investing. |
| **2007** | **Carbon Disclosure Standards Board ("CDSB"):** established in connection with the Carbon Disclosure Project ("CDP"), the CDSB framework is a tool for companies to disclose climate change-related information in financial reports. |
| **2008** | **Workforce Disclosure Initiative:** aimed at providing greater disclosure on workplace practices, it has been backed by more than 100 investors representing $12 trillion in assets. |
| **2010** | **30% Club:** campaign led by chief executive officers taking action to increase gender diversity at board and senior management levels. |
| **2011** | **Sustainability Accounting Standards Board ("SASB"):** provide industry metrics that track the impact of environmental issues on company accounts and have become increasingly popular in recent years (with one in four members of the S&P 500 now making reference to them). |
| **2013** | **Corporate Human Rights Benchmark:** ranking that examines the human rights performance of 98 global companies based on publicly available data. |
| **2015** | **UN Sustainable Development Goals:** 17 Sustainable Development Goals, and 169 associated targets, were adopted by the General Assembly of the United Nations in September 2015 to inform a global action plan on "people, planet and prosperity" through to 2030. |
| **2017** | **Task Force on Climate-related Financial Disclosures ("TCFD"):** backed by the G20's Financial Stability Board, the TCFD are a voluntary set of guidelines aimed at |

[13] For more on the subject of competition law and sustainability agreements, refer to our alert memorandum published on our website at: https://www.clearygottlieb.com/news-and-insights/publication-listing/eu-commission-call-for-contributions-on-competition-policy-supporting-the-green-deal

[14] *E.g.*, in January 2020, Larry Fink (chief executive of Blackrock) stated that the companies BlackRock has invested in should use the ESG standards established by both the Task Force on Climate-related Financial Disclosures and the Sustainability Accounting Standards Board.

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| | assessing a company's exposure to climate change risk. |
| **2017** | **Climate Action 100+:** initiative of more than 500 investors with more than $47 trillion in AUM to engage with and assess the performance of the world's largest greenhouse gas emitters in tackling climate change |
| **2018** | **One Planet SWF Framework:** framework backed by leading SWF investors to promote the integration of climate change analysis in the management of large, long-term and diversified asset pools. |
| **2019** | **NFRD Guidelines Supplement**: EU updated guidelines on non-financial reporting in the annual reports of over 6,000 European companies, which integrated the recommendations of the TCFD. |
| **2020** | **IOSCO Report on Sustainable Finance and the Role of Securities Regulators**: report discusses the challenges created by sustainability and climate-related issues for securities regulators in meeting their core regulatory objectives of protecting investors, reducing systemic risk, and maintaining fair, efficient and transparent markets. |

## IV. Solutions on the horizon?

Efforts to harmonise the various taxonomies and frameworks in the field of sustainable finance have gathered pace during 2020 – and are being pushed forward by EU regulators. Developments in the EU are significant not only for their breadth and depth but because the EU rules are binding, whereas the existing global standards remain voluntary.

More globally, the UN's Global Investors for Sustainable Development Group has recently called on the G20 to push for the establishment of global ESG disclosure standards and, in September of this year, adding its efforts to those of the International Accounting Standards Board and the Financial Accounting Standards Board, the International Organization of Securities Commission (IOSCO, a global umbrella body for securities regulators) launched a task force to harmonise standards.

Perhaps most significantly, on 22 September, the International Business Council ("**IBC**") of the World Economic Forum ("**WEF**") (in collaboration with the Big 4 accountancy firms) released a set of universal ESG metrics and disclosures to measure stakeholder capitalism, which delivered on a commitment from the WEF Annual Meeting at Davos in January 2020 that was supported by 120 members of the IBC.[15] Rather than an attempt to reinvent the wheel, the metrics are drawn from the existing leading frameworks and, in particular, GRI, SASB, TCFD and CDSB. In parallel, the IBC has facilitated five leading ESG framework providers (including CDP, GRI and SASB) in their release of a statement of intent detailing how their work and the IBC's project are fundamentally complementary and could form the natural building blocks of a single, coherent, global reporting system.[16]

## V. Future insights

Against this complex backdrop, and following on from a number of ESG-related publications recently produced by the firm, Cleary is launching a series of publications that will focus on recent and ongoing developments in the regulations that govern sustainable finance and ESG reporting by financial firms.

Among other things, we will highlight the significant progress made by the EU by setting out an overview of the EU regulatory framework for sustainable finance and ESG reporting, before

[15] http://www3.weforum.org/docs/WEF_IBC_Measuring_Stakeholder_Capitalism_Report_2020.pdf

[16] https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

focusing on certain important elements of the EU regime – namely:

1. Taxonomy Regulation: EU Regulation no. 2020/852 on the Establishment of a Framework to Facilitate Sustainable Investments;
2. Sustainable Finance Disclosures Regulation (SFDR): EU Regulation no. 2019/2088 on Sustainability-related Disclosures for the Financial Services Sector; and
3. Non-Financial Reporting Directive (NFRD): Directive 2014/95/EU on disclosure of non-financial and diversity information by certain large undertakings and groups.

These developments are likely to be of interest to a broad variety of companies and investors. The upcoming EU changes will have direct relevance for (i) companies based in Europe (in the financial sector and other industries) and current / prospective investors in those companies; (ii) active and passive investment funds with a European connection and investors in those funds; and (iii) financial advisers operating in the EU. They should also, however, interest investors and companies with no European connection, as regulators in other jurisdictions will no doubt be closely observing the successes (and failures) of the EU's top-down approach to ESG reporting and sustainable finance, with a view to adopting their own measures in the not-too-distant future.

In each upcoming alert, our analysis will include:

(i) scope,

(ii) key provisions,

(iii) timeline for entry into force,

(iv) an explanation of the practical changes that the regulation will bring about for financial industry players and

(v) strategic takeaways.

## Related Publications by Cleary

For more on this topic, subscribe to our alerts to receive future publications, and view our previous alerts below:

— "EU Commission Call for Contributions on 'Competition Policy Supporting the Green Deal'" (October 19. 2020)
https://www.clearygottlieb.com/news-and-insights/publication-listing/eu-commission-call-for-contributions-on-competition-policy-supporting-the-green-deal

— "Incorporating ESG Considerations Into Private Equity" (October 7, 2020)
https://www.clearygottlieb.com/news-and-insights/publication-listing/incorporating-esg-considerations-into-private-equity

— "Navigating COVID-19" Supply Chain Considerations: (July 15, 2020)
https://www.clearygottlieb.com/news-and-insights/publication-listing/navigating-covid19-supply-chain-considerations

— "A Sustainable Recovery for Europe: The EU's Green Deal" (July 9, 2020)
https://www.clearygottlieb.com/news-and-insights/publication-listing/a-sustainable-recovery-for-europe-the-eus-green-deal

— "Social Bonds In Response To The Covid-19 Crisis: A Guide For Issuers" (April 14, 2020)
https://www.clearygottlieb.com/news-and-insights/publication-listing/social-bonds-in-response-to-the-covid19-crisis

— "Navigating The ESG Landscape" (January 10, 2020)
https://www.clearygottlieb.com/news-and-insights/publication-listing/navigating-the-esg-landscape

— "Environmental, Social And Governance Focus" (January 9, 2018)
https://www.clearygottlieb.com/news-and-insights/publication-listing/environmental-social-and-governance-focus-2018

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