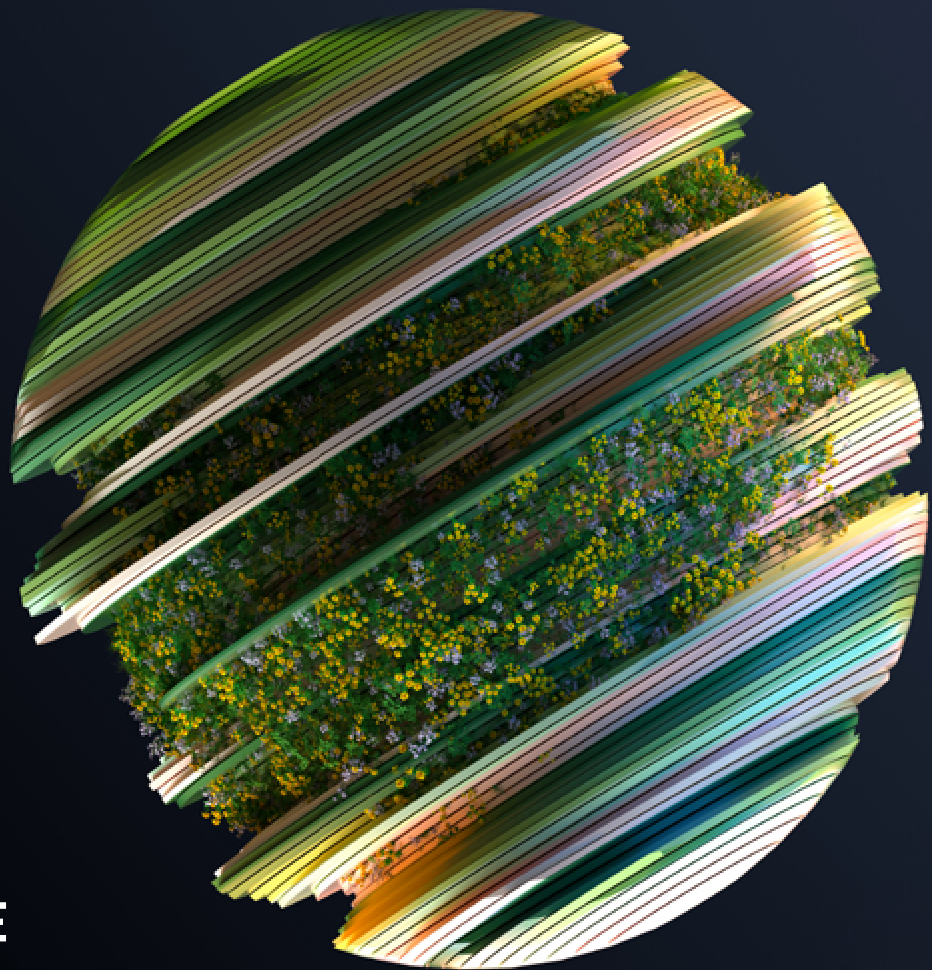
ISSUE 58

SPOTLIGHT ON

ESG, IMPACT & SUSTAINABILITY



A LOOK INSIDE

THE RISE OF INTERNATIONAL ESG DISCLOSURE STANDARDS

FINANCING THE UNSDGS: THE ROLE OF IMPACT FUNDS

THE EU GREEN DEAL AND VALUE CHAINS

McDermott Will & Emery

IN THIS ISSUE

ESG is understood to be an acronym for "environmental, social and governance," but the term can be challenging because it's used to describe similar but distinct communities of practice, including corporate social responsibility, socially responsible investing, corporate sustainability and impact finance.

In the 1980s, pension investor concerns for social and environmental issues evolved into what became known as socially responsible investing, which screened out investments that raised concerns over various human rights and environmental issues. This eventually spurred a corporate social responsibility (CSR) movement, pressuring corporations to take responsibility for the negative external impacts of their operations.

A global sustainability movement also began in the 1980s seeking to reconcile economic development with the protection of social and environmental balance. This was adapted in the private sector into corporate sustainability, an intentional strategy to create long-term value through improved social and environmental impact. Corporate sustainability differs from CSR in that the latter is often not driven by strategic business imperatives.

The investor perspective on financially material aspects of corporate sustainability coalesced under the term ESG, as famously used in a 2004 United Nations report issued by a coalition of 20 major financial institutions. The report included recommendations on integrating ESG value drivers into financial market research, analysis and investment. This was the birth of ESG, which has blossomed into an important asset class in worldwide financial markets.

Although ESG has become politically fraught in the United States, internationally ESG regulation is becoming pervasive. This issue details these global developments, which, with the potential to more closely align business imperatives with social good, are fundamentally altering standards of corporate responsibility and investment decisions and analysis.

Please contact the authors directly if you have any comments on our articles, or would like to discuss any of the issues raised.

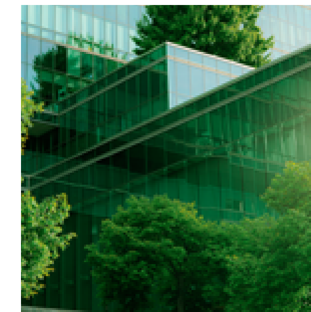
DAVID CIFRINO
Counsel, ESG, Impact and Sustainability

PUBLICATION EDITORS
Aileen Devlin
Kate Hinze

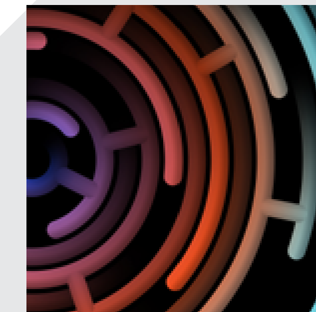
CREATIVE SERVICES
Kristen Wexler
Sarah Reuter

TABLE OF CONTENTS

02
The Rise of International ESG Disclosure Standards
David A. Cifrino



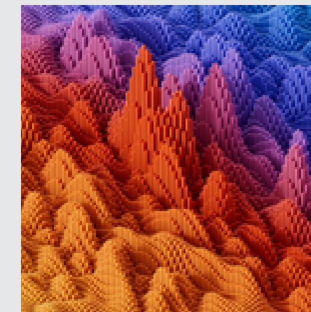
06
EU Corporate Sustainability Reporting and Due Diligence Directives
Dr. Philipp Grenzebach



09
ESG Regulation of Financial Products in The European Union
Frank Müller

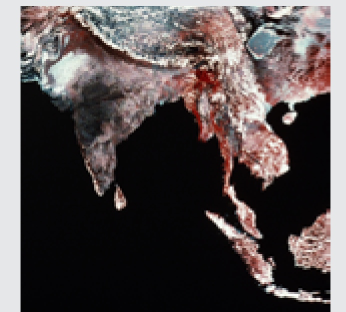
12
Financing the UNSDGS: The Role of Impact Funds
Ranajoy Basu and Fausto Giacomet

16
The EU Green Deal and Value Chains
Ramінta Dereskeviciute and Ludovica Rabitti

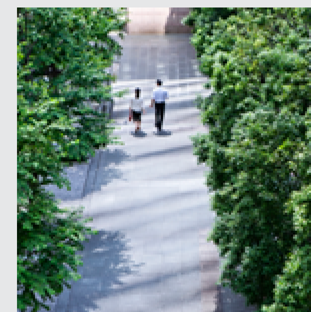


20
ESG In Leveraged Loans
Mark Fine

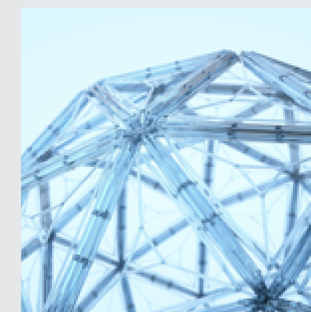
22
The View From France
David Revcolevschi and Claire Chabat



26
The ESG Disclosure Landscape Across Southeast Asia and India
Ranajoy Basu and Siddhartha Sivaramakrishnan



30
New Sustainability Disclosure Rules in Japan
Eric S. Klee and Sayana Kurachi



31
ESG Front & Centre at International Legal Seminar in Tokyo
SPEAKERS: Simon Airey, Jacques Buhart, David A. Cifrino, Siddhartha Sivaramakrishnan, Edward Zaelke

THE RISE OF INTERNATIONAL ESG DISCLOSURE STANDARDS

David A. Cifrino

New regulations expected to be adopted in 2023 will result in exponential growth in the amount of environmental, social and governance (ESG), *i.e.*, sustainability, data generated by reporting companies and available to investors.

The US Securities and Exchange Commission (SEC) is expected to adopt final rules requiring detailed disclosure by companies of climate-related risks and opportunities by the end of 2023. The newly-formed International Sustainability Standards Board (ISSB) is expected to adopt two reporting standards in June: one on climate-related risks, and a second on other sustainability related information. Regardless of how much harmonisation there will be between these and other ESG disclosure standards, it is clear that mandatory, standardised sustainability reporting by corporations will increase significantly worldwide over the next few years.

THE DATA DRIVEN AND RAPIDLY CONSOLIDATING GLOBAL ESG INVESTING ECOSYSTEM

The demand for enhanced ESG disclosure is intense. Globally, overall ESG investing is massive, having grown as much as tenfold in the last decade. Morningstar, Inc. estimated that total assets in ESG-designated funds totaled more than US$3.9 trillion at the end of September 2021. The evolution in ESG investing has been accompanied by exponential growth in the amount and types of data available for ESG investors to consider. The number of public companies publishing corporate sustainability reports grew from less than 20 in the early 1990s to more than 10,000 companies today, and about 90% of the Fortune Global 500 have set carbon emission targets, up from 30% in 2009.

The world's largest asset manager, Blackrock, Inc., noted in a comment letter to the US Department of Labor regarding pension fund regulation that, as ESG data has become more accessible, the firm has developed a better understanding of financially relevant ESG information, and ESG funds that incorporate financially relevant ESG data have become more common. BlackRock stated that its systems for ESG analysis have access to more than 2,000 categories of ESG metrics from various ESG data providers. The firm concluded that, because of the greater volume of ESG-related disclosures by companies and third party ESG vendors, together with advancements in technology, "the use of ESG data to seek enhanced investment returns and/or mitigate investment risks has become more sophisticated."

Much of the ESG data available to investors historically has been obtained through voluntary co-operation, from companies either answering survey questionnaires or publishing sustainability reports based on one or more of dozens of frameworks and reporting standards created by various non-profit organisations active in environmental and social causes. Voluntary disclosure of ESG information over the past three decades has been highlighted by the development of several key reporting standards and frameworks.

The development of the Global Reporting Initiative in the 1990s as a standard reporting framework for corporate social responsibility reporting was a major step in promoting reporting focused on both ESG issues material to a company and that company's external impacts on outside communities and the planet.

The Task Force on Climate-Related Financial Disclosure (TCFD) created in 2017 by the G20's Financial Stability Board, and widely adopted around the world, recommends disclosure regarding climate-related governance, strategy, risk management, and metrics and targets specific to the risks to a company presented by climate change.

The Sustainability Accounting Standards Board (SASB), modeled on the Financial Accounting Standards Board, which oversees generally accepted accounting procedures in the United States, was formed in 2011 with a focus on ESG factors material to a company on an industry by industry basis. SASB has developed standards for 77 industries that identify and measure financially material, decision useful and actionable ESG factors important to long-term value creation.

In 2014, the European Commission adopted a financial directive that requires certain large companies to disclose information on the way they operate and manage social and environmental challenges. The directive was intended to help investors and other stakeholders evaluate the non-financial performance of large companies, and encourage these companies to develop a responsible approach to business. It applies to large public-interest companies and requires information related to environmental and social matters, treatment of employees, human rights, anti-corruption, and board diversity.

> “ Mandatory, standardised sustainability reporting by corporations will increase significantly.

Supplementing the directive, in 2019 the Commission published new climate reporting guidelines for companies that integrate the TCFD's recommendations. To address shortcomings in the Non-Financial Reporting Directive, on 10 November 2022, the European Parliament substantially increased mandatory sustainability disclosure requirements by adopting a new Corporate Sustainability Reporting Directive as discussed in more detail on p.6.

The United States has been far slower than Europe in regulating ESG disclosures. Other than long-standing financial, risk, and litigation disclosure requirements appliable to public companies regarding environmental issues and, since 2020, material aspects of a company's human capital management, there have been virtually no mandatory requirements and only limited regulatory guidance for disclosure on sustainability issues by public companies listed or based in the United States.

In 2010, the US SEC issued guidance to reporting companies on disclosure of material climate-related risks that should be disclosed under existing SEC disclosure rules. Finding that this guidance was insufficient, on 21 March 2022, the SEC proposed new rules to require companies filing reports and securities registration statements with the SEC to provide detailed information about their handling

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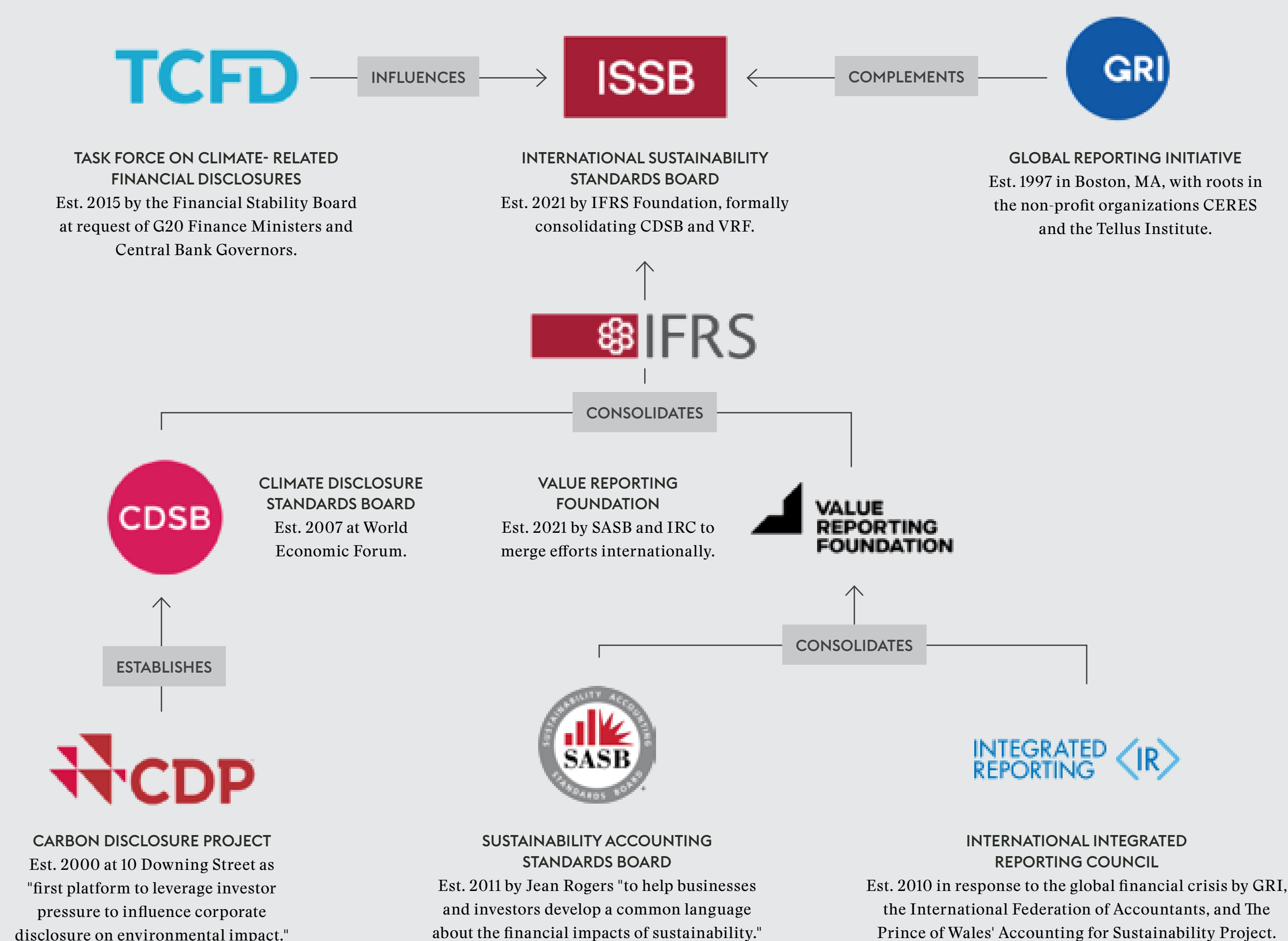
of climate related risks and opportunities, including climate-related governance, strategy, risk management, metrics, and goals based on the TCFD framework. The proposed rules will also require companies to measure and disclose greenhouse gas (GHG) emissions in accordance with the GHG Protocol methodology, the most widely known and voluntarily used international standard for calculating GHG emissions.

The SEC proposal notes that several jurisdictions have already adopted disclosure requirements in accordance with the TCFD's recommendations, including Brazil, the European Union, Hong Kong, Japan, New Zealand, Singapore, Switzerland, and the United Kingdom.

CONSOLIDATION OF THE ESG ECOSYSTEM

In November 2021, the International Financial Reporting Standards (IRFS) Foundation—which administers the IFRS financial accounting standards that are used in most jurisdictions other than the United States—announced the formation of the ISSB to develop a comprehensive global baseline of sustainability disclosure standards. The ISSB will sit alongside the IRFS International Accounting Standards Board, and it can be expected that jurisdictions that require financial reporting based on IFRS standards will also require sustainability reporting under ISSB standards. As depicted in the graphic below, there is a rapidly accelerating consolidation into the ISSB of the most internationally significant existing global sustainability disclosure frameworks and standards, including those of the SASB.

Taken together, this consolidation of the ESG disclosure ecosystem, the continued enhancement and standardisation of ESG data, and the analyses it promises to yield, should enable market participants to more precisely evaluate when ESG factors are relevant to the creation of long-term value, which in turn can facilitate more confident ESG investment decisions.



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> There is also increasing regulation designed to mitigate "greenwashing".

NEW REGULATIONS ADDRESSING GREENWASHING

In addition to this massive and widespread regulatory momentum to require greater volume, consistency, and reliability of corporate ESG disclosures, there is also increasing regulation designed to mitigate "greenwashing" where the potential social and environmental benefits of a fund's ESG investment strategy are overstated or even nonexistent.

In Europe, the Sustainable Finance Disclosure Regulation (SFDR) has, since 2021, required EU investment firms to disclose their approach to the consideration of ESG factors in their investment decisions, and to make disclosures for investment products that take into account ESG factors. As discussed in more detail on p.9, the SFDR sets forth the following disclosure categories into which financial products must fall:

- Funds that address ESG risks but have no sustainability goals (Article 6 funds)
- Funds that promote ESG characteristics (Article 8 funds)
- Impact funds that have intentional and measurable sustainability objectives (Article 9 funds).

The SEC has pending proposed anti-greenwashing rules applicable to investment firms. These provide that only funds with an ESG purpose would be permitted to label themselves as such. The new rules would also require mandatory disclosures for ESG-focused funds to enable outside parties to confirm whether or not a purportedly ESG-focused fund is in compliance with its stated investment purpose.

Similar to the SFDR, these new rules would create three categories of ESG funds:

- Integration Funds, which would be required to disclose how ESG factors are incorporated into their investment process, plus any non-ESG factors
- ESG-Focused Funds, which identify ESG factors as a significant or principal consideration and are therefore required to make a more detailed disclosure
- Impact Funds, which seek to achieve a particular ESG impact and are required to disclose how the fund measures progress towards its stated objectives.

The categorisation of ESG funds on a standardised basis under new European and US funds regulations can be expected to significantly mitigate the problem of inconsistent terminology and nomenclature as to what is and isn't fairly categorised as an ESG investment. This will potentially facilitate more definitive conclusions on the financial performance of various ESG investment strategies.

DAVID A. CIFRINO
Counsel
Boston
dcifrino@mwe.com

EU CORPORATE SUSTAINABILITY REPORTING AND DUE DILIGENCE DIRECTIVES

Dr. Philipp Grenzebach

The European Union has taken significant steps to ensure consistent EU-wide sustainability reporting and effect real change in companies' behaviour.

THE CORPORATE SUSTAINABILITY REPORTING DIRECTIVE

The Corporate Sustainability Reporting Directive (EU) 2022/2464 (CSRD) came into force on 5 January 2023. It requires companies to provide information regarding their sustainability strategy, and environmental, social, and governance issues. This information includes, for example

- The company's sustainability objectives, strategies, and policies
- The main risks to which the company is exposed in relation to sustainability issues
- The due diligence process in place for identifying and handling sustainability issues
- The primary actual or potential adverse impacts (Principal Adverse Impacts) relating to the company's value chain, the measures taken to prevent any actual or potential adverse impacts, and the outcome of those measures
- The role of administrative, management and supervisory bodies in relation to sustainability issues.

The European Financial Reporting Advisory Group (EFRAG) has been appointed technical advisor to the European Commission and is responsible for developing the European Sustainability Reporting Standards (ESRS). The first set of ESRS was approved by EFRAG on 15 November 2022 and consists of 12 intersectoral standards. The Commission now has to adopt the ESRS drafts or revise them before they can be applied to companies under the scope of the CSRD.

The CSRD goes further than the existing Non-Financial Reporting Directive (NFRD) and will extend its reach over four stages to apply to the following businesses:

- As of 1 January 2024: all EU companies that are already subject to the NFRD, and non-EU companies listed on a regulated market in the European Union within the definition of large companies (see below) but with more than 500 employees
- As of 1 January 2025, all EU companies regardless of capital market orientation, that exceed two of the following three size criteria (large companies):
  - Annual average of 250 employees
  - A balance sheet total of more than €20 million
  - Annual revenue of more than €40 million
- As of 1 January 2026, all small and non-complex credit institutions and captive insurance undertakings; and listed small and medium-sized enterprises (SMEs), including non-EU companies listed on a regulated market in the European Union, with the exception of micro-companies. According to Directive 2013/34/EU, companies are considered "small" rather than "micro" if they exceed two of the following criteria:
  - 10 employees
  - €350,000 balance sheet total
  - €700,000 net revenue.
- As of 1 January 2028, non-EU companies with annual net revenue at the consolidated or individual level in the European Union of more than €150 million for each of the last two consecutive financial years, and at least one subsidiary (either a large EU company or an SME) or an EU branch that generated an annual net revenue over €40 million in the preceding financial year

The NFRD rules will continue to apply to companies until the relevant stage of the CSRD comes into effect. Reporting at group level will still exempt the subsidiaries from their own reporting obligations, as long as the subsidiary refers to the group report.

Reports must be provided in a machine-readable format that will support the tagging of sustainability information in the future. This is also intended to establish compatibility with a European Single Access Point—a central register for digitally prepared reports—that is yet to be developed. The sustainability information must also be externally verified, initially with limited assurance.

The CSRD outlines minimum penalties for non-compliant companies, and provides a process for the investigation, but the Member States are left to determine the actual penalties for violations.

CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE

In February 2022, the European Commission adopted a proposal for a Directive on Corporate Sustainability Due Diligence (CSDDD). The stated aim of this Directive is to

- Encourage sustainable and responsible corporate behaviour
- Anchor human rights and environmental considerations in companies' operations and corporate governance.
- Ensure companies address the adverse impacts of their actions, including in their value chains inside and outside Europe.

The legislative proposal is currently making its way through the European Parliament committee process and receiving comments and amendments.

> "The CSRD goes further than the existing NFRD and will extend its reach over four stages.

The Directive is intended to harmonise rules across the EU Members States, as binding due diligence legislation has already been implemented in France (*Loi de Vigilance*, 2017) and Germany (the *Lieferkettensorgfaltspflichtengesetz*, 2021).

Scope

Under the proposal, the Directive will apply to EU companies that meet one of the following criteria:

- More than 500 employees on average and a net worldwide turnover of more than €150 million in the last financial year
- More than 250 employees on average and a net worldwide turnover of more than €40 million in the last financial year, provided that at least 50% of this net turnover was generated in one or more of the sectors identified as high-impact, such as:

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– Textile manufacturing
– Agriculture, forestry, and fisheries
– The extraction, wholesale, and processing of mineral resources.

The Directive will also apply to companies outside the European Union that either

- Generated an EU net turnover of more than €150 million in the financial year preceding the last financial year; or
- Generated an EU net turnover of between €40 million and €150 million in the financial year preceding the last financial year, provided that at least 50% of that net worldwide turnover was generated in one high impact sector.

> “The Directive is intended to harmonise rules across the EU Members States.

Duties

The Directive takes a somewhat soft approach as initially it will simply require companies to implement certain procedures, in particular

- Identifying actual or potential adverse impacts (Article 6)
- Preventing and mitigating potential adverse impacts, bringing actual adverse impacts to an end, and minimising their extent (Articles 7 and 8)
- Establishing and maintaining a complaints procedure (Article 9)
- Monitoring the effectiveness of due diligence policies and measures (Article 10)
- Publicly communicating this due diligence (Article 11).

The legislation does not provide for directly regulating, sanctioning, or stopping any behaviour that may be identified as problematic as the result of the mandatory due diligence process. The requirements under Articles 7 and 8 will, however have a significant impact on companies.

These Articles require companies to follow a path of escalating measures with regard to identifying potential adverse human rights or environmental impacts, including the development and implementation of a prevention action plan, and seeking contractual assurances from direct business partners and subsequent monitoring. The Directive prioritises engagement with the problematic aspect of a value chain over termination. The CSDDD takes into account the indirect nature of business relationships with third party suppliers, but expects that a company is able to stop actual adverse impacts in its own operations and in subsidiaries.

Companies will have to show that they are establishing dedicated compliance functions to monitor the implementation and effectiveness of their due diligence measures. These measures will need to include periodical assessments of the operations of subsidiaries and established business relationships, creating a link with the CSRD.

Enforcement

The CSDDD is expected to be enforced through public supervision and private litigation and contract law.

EU Member States will be required to establish supervisory authorities to carry out investigations on their own initiative or based on substantiated complaints, and must provide for effective sanctions for infringements.

As part of the drive to minimise harmful behaviour, Member States must permit the termination of contracts and allow victims to sue for compensation of adverse impacts. The Directive also provides for the development of model contracts to help companies shape their contractual relationships.

Member States will be required to provide rules governing the civil liability of companies for damages arising as a result of their failure to take reasonable steps to reduce harmful practices. And, although the draft Directive currently stops short of resolving questions on what constitutes reasonably adequate measures, it takes account of the fact that they will arise.

National legislation will also have to modify rules on the duty of care of managing directors, as the responsibility for due diligence will be assigned to the company's directors.

DR. PHILIPP GRENZEBACH
Partner
Düsseldorf
pgrenzebach@mwe.com

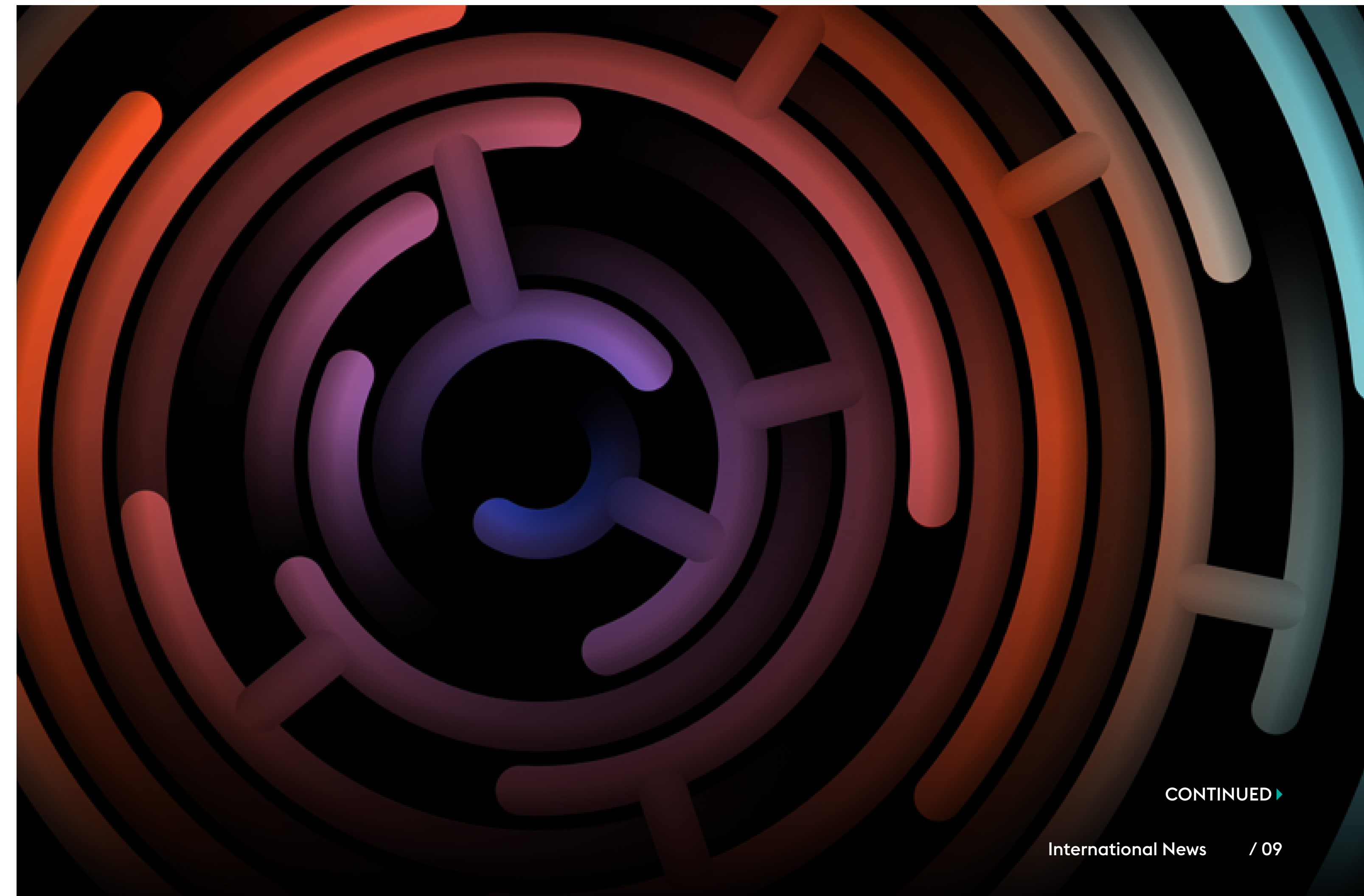
ESG REGULATION OF FINANCIAL PRODUCTS IN THE EUROPEAN UNION

Frank Müller

The European Union has prioritised defining what is “sustainable”, and preventing greenwashing.

As a result of the 2015 Paris Agreement and the United Nations Sustainable Development Goals, which entered into force almost simultaneously, the European Union put sustainability issues high on the political agenda. In the March 2018 Action Plan on Financing Sustainable Growth, the European Commission set out 10 measures to steer capital flows toward a more sustainable economy. The financial system is to play a key role and will be comprehensively restructured so that private capital can be specifically channelled into sustainable investments.

Measures outlined in the Action Plan include promoting investment in sustainable products, considering sustainability in financial advice, embedding sustainability in risk management, and clarifying the sustainability obligations of institutional investors and asset managers. The Commission's priority, however, is a common understanding of the term “sustainable”, so the development of a uniform



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classification (taxonomy) of sustainable activities within the European Union is the most important measure of the Action Plan. This is accompanied by the Sustainable Finance Disclosure Regulation ((EU) 2019/2088) (SFDR), which enables investors and stakeholders to invest their capital taking sustainability considerations into account.

THE TAXONOMY REGULATION

The EU Taxonomy Regulation for Sustainable Investments ((EU) 2020/852) came into force on 1 January 2022. It contains—in simplified terms—criteria for determining whether or not an economic activity can be classified as environmentally "sustainable". The Taxonomy Regulation lays the foundation for an EU framework that integrates environmental, social and governance (ESG) considerations into the financial system.

At the moment, however, the Taxonomy Regulation only regulates criteria for environmentally sustainable economic activities and defines environmental objectives that are considered sustainable, such as climate change mitigation or climate change adaption. It does not include a defined label for sustainable financial products, nor obligations for financial market participants to launch or invest in sustainable products. The taxonomy for social and governance aspects are still pending.

According to the Taxonomy Regulation, an economic activity is considered to be environmentally sustainable if it makes a substantial contribution to at least one of the following six environmental objectives and doesn't significantly harm any of the other five (the Do No Significant Harm criteria):

1. Climate change mitigation
2. Climate change adaption
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

Establishing an accepted taxonomy is a mammoth project, so the environmental objectives of the Taxonomy Regulation, and the precise criteria for when economic activities must meet the environmental objectives, are coming into force in succession. Since the beginning of 2022, objectives 1 and 2—climate change mitigation and adaptation—have come into force. On 1 January 2023, the other four environmental objectives were added, but their exact criteria are currently still open.

THE SUSTAINABLE FINANCE DISCLOSURE REGULATION

The SFDR came into force on 10 March 2021. The Regulation aims to ensure the transparent disclosure of the sustainability of financial products and prevent "greenwashing", in particular by reducing information asymmetries. Investors in financial products will receive standardised, comparable information on the sustainability aspects of financial products and their providers. The SFDR is also intended to increase investors' awareness of sustainability aspects in investments. To avoid greenwashing, asset managers are prevented from claiming that their products are sustainable or ESG-friendly if they cannot justify that claim.

In order to achieve these goals, the SFDR differentiates between financial products that

- Have no sustainability goals (Article 6 funds)
- Promote, among other things, environmental or social characteristics (Article 8 funds)
- Have sustainable investment as an objective (Article 9 funds).

The Regulation imposes pre-contractual information and subsequent reporting obligations on the providers of financial products, depending on the type of product. The SFDR does not stipulate any qualitative requirements for financial products, instead it simply requires the provision of information on the sustainability of financial products. The specification of any kind of ambition level is not covered by the SFDR.

RELATIONSHIP BETWEEN THE TAXONOMY DIRECTIVE AND THE SFDR

While the SFDR requires disclosure by financial market participants with respect to only certain information, the scope of the Taxonomy Regulation is broader. The classification system contained in the Taxonomy Regulation is intended to establish clear criteria throughout the European Union as to which economic activities can be considered sustainable. At present, there is only an overlap to the extent that, under the SFDR, information must also be provided on the percentage of investments in a product that meet the criteria of the Taxonomy Regulation.

> "The Taxonomy Regulation lays the foundation for an EU framework.

CURRENT MARKET PRACTICE

Although it is not the aim of the SFDR to introduce minimum thresholds for sustainable products, the categories into which financial products fall are being regarded as a kind of "product label". Funds are being marketed as being Article 8, or Article 9, *etc.*, even though the SFDR does not sufficiently specify what criteria must be met for a product to fall under Article 8 or 9.

There is a corresponding desire in the market for qualitative standardisation by the regulator and/or local supervisory authorities, which would help avoid any civil law or supervisory law risks resulting from greenwashing.

OUTLOOK

The implementation of the Taxonomy Directive and the SFDR is a major undertaking and the European Union is already falling behind on its own ambitious schedule. In practice, this means, for example, that fundamental questions of regulation are still unresolved, even though there are already detailed requirements for reporting obligations. The difficulty of classifying economic activities as sustainable is exemplified by discussions on the question of whether or not nuclear energy or fossil gas are to be classified as sustainable.

The question hanging over the SFDR is whether it should in future serve its actual purpose of creating comprehensive transparency in financial products, or should be successively expanded into a regulation on labelling. If the latter, clear definitions of and requirements for Article 6, 8, and 9 products would be necessary, and the relationship between the SFDR and the Taxonomy Regulation would have to be realigned.

It is likely, given the current status of the project, that the regulation of ESG disclosures will occupy the European Union and business for many years to come. The increasingly obvious progress of climate change means, however, that there is no alternative other than to transform the existing financial and commercial systems.

FRANK MÜLLER
Partner
Frankfurt
fmueller@mwe.com

FINANCING THE UNSDGS: THE ROLE OF IMPACT FUNDS

Ranajoy Basu and Fausto Giacomet

The ambition of the United Nations Agenda for Sustainable Development (UNSDGS) is laudable but staggering: the estimated required funding is US$176 trillion. Impact funds could be the solution to this mammoth financial challenge.

The 2030 UNSDGS, adopted in September 2015, is based around 17 sustainable development goals, such as alleviating poverty (Goal 1), providing quality education (Goal 4) and taking climate action (Goal 13).

The only way to try to get near the US$ trillions necessary to achieve these goals is through the aggregation of funding from the widest possible sources—philanthropists, development finance institutions, multilateral development banks, institutional and retail investors—and the widest range of financial instruments. These include impact funds, "performance based" impact bonds, and other innovative financial mechanisms that catalyse public and private sector partnerships towards targeted environmental and social interventions.

In brief, impact funds are funds set up with a defined intent to contribute to measurable impact alongside a financial return. According to Preqin, as of May 2022 there were 495 funds actively marketed as impact funds, around a third of which were still fundraising.

The characteristics of each impact fund are likely to reflect what is common for the type of institution that set it up. For example, impact funds launched by private equity firms include carried interest provisions as a common remuneration mechanism for the industry, and may link a portion of the remuneration of the managers to relevant environmental, social, and governance performance metrics of the investments in addition to financial metrics. Impact funds launched by multilateral organisations and non-governmental organisations are more likely to rely on a considerable level of concessionary capital through grant funding to bring additional investors on board.

Impact funds can pursue investment strategies from a range of different asset classes. On the debt side, an impact debt fund can, for example, provide dedicated long-term debt facilities or grants in the case of "blended finance" facilities either directly to corporates and specific projects, or to financial institutions, which then onlend to the population being targeted for the impact.

On the equity side, a private equity impact fund would look to acquire an ownership stake in selected impact-driven companies. These would be actively managed and monitored during the lifetime of the investment to ensure that they achieve targeted outcomes, whilst also incorporating impact considerations (balanced with the private equity firm's fiduciary considerations) when investments reach exit stage.

UK LEGAL AND REGULATORY FRAMEWORK OF IMPACT FUNDS

The legal and regulatory framework of impact funds in the United Kingdom is very new. At the time of writing, the key piece of that framework is Consultation Paper 22/20 (CP 22/20) published in October 2022 by the Financial Conduct Authority (FCA). If implemented, it is expected that most of the rules set out in CP 22/20 will begin to apply from the third quarter of 2024.

CP 22/20 sets out the FCA's proposals for defined labels for sustainable investment products. These include a "sustainable impact" label for products that aim to achieve a "positive, measurable contribution to real world sustainability outcomes" alongside a financial risk/return objective.

To be able to use the "sustainable impact" label, firms will need to comply with a number of requirements, including making consumer-facing product disclosures and pre-contractual disclosures; providing ongoing sustainability-related performance information; and submitting a sustainability entity report outlining how the firm overall is managing sustainability-related risks and opportunities. For firms that don't want to use the CP 22/20 investment labels for their products, CP 22/20 sets out naming and marketing rules restricting the use of certain sustainability-related terms.

> "Given the size of the funding needed to tackle the UNSDGs, financial ingenuity will be key.

Despite Brexit, the European Union's Sustainable Finance Disclosure Regulation ((EU) 2019/2088) (SFDR) (see p.9) also remains significant in the United Kingdom as funds launched in the UK will need to comply with the SFDR to be marketed in the European Union. Even if a UK firm does not intend to market its funds in the EU, or to manage EU funds, that firm may decide to voluntarily comply with the SFDR because of investor pressure.

The SFDR contains two categories of financial products that are directly relevant to impact funds:

- Article 8 funds, which promote, among other things, environmental or social characteristics
- Article 9 funds, which have sustainable investment as an objective.

Impact fund managers may prefer to set up their fund as an Article 8 fund rather than Article 9, owing to the less onerous disclosure requirements under Article 8. As a result, it is common to see an impact fund set up as an Article 8 fund, with a minimum level of investments in sustainable investments. This is commonly referred to as an "Article 8+" fund.

IMPACT FUNDS FROM MULTILATERAL ORGANISATIONS

Outside the UK and EU regulatory environments, impact funds can also be launched as unregulated funds by entities such as multilateral organisations.

Unregulated funds may not even have a governing law clause, as they are governed by a charter entered into

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by the relevant entities establishing the fund ("hosted funds"). As a result, these funds are highly bespoke and, rather than complying with the regulatory requirements of a particular jurisdiction, they instead incorporate detailed provisions to reflect the relevant requirements of the founders and to create a workable partnership amongst the involved parties.

STRUCTURING AN IMPACT FUND

Under the simplest structuring option, donor funding is allocated to an escrow account and is only released when the relevant impact metrics are achieved.

As structures get more complex, bespoke solutions become the norm. These generally depend on the investors, managers, and sectors involved in each case. The flexible nature of these funds can prove very effective in aggregating funds from different types of contributors, which brings together opportunities for both the public and private sector to finance positive change through partnerships.

A number of impact funds incorporate blended finance structures, which allow investors with different risk-return profiles ("impact first" or "return first") to opt for the level of risk they are comfortable with. In order to accommodate different parties' risk-return profiles, impact funds can set different tranches, using a junior tranche to de-risk the senior tranche, prompting a bigger investment amount than would otherwise be possible.

On the "patient capital" side of the transaction, a range of parties can be involved, such as development finance institutions, multilateral development banks, and philanthropists. On the less risky side of the deal, more traditional (return-seeking) investors can join in. These include private equity houses, pension funds, and the non-philanthropic arms of family offices.

Bringing the relevant institutions together over the same framework, and properly structuring the layers of risks, are key to the success of an impact fund, The relevant co-financing framework agreement will contain highly scrutinised eligibility criteria, so only transactions that meet those eligibility criteria can be co-financed by the relevant parties in the framework agreement.

Other benefits of blended finance fund structures are the better impact reporting metrics and synergies they facilitate. Private investors who are potentially inexperienced in impact metrics and reporting can benefit from the experience of more knowledgeable players.

LOOKING AHEAD

There is a promising future for impact funds as investors and regulators become more experienced and demanding, and fund managers incorporate more robust standards, particularly against the risks of "greenwashing" or "impact washing".

Given the size of the funding needed to tackle the UNSDGs, financial ingenuity will be key. We are likely to see a rolling pool of funds offering first or second-loss guarantees to attract the private sector to invest in hard-to-insure risks, and the development of funds for impact so investors get access to funds across a range of regions and sectors, all wrapped up in a single portfolio. The key is in ensuring that exposure is diversified and overall risk is reduced, resulting in a greater potential for the aggregation of funding.

RANAJOY BASU
Head of Structured Finance
and Sustainable Finance
London
rbasu@mwe.com

FAUSTO GIACOMET
Associate
London
fgiacomet@mwe.com

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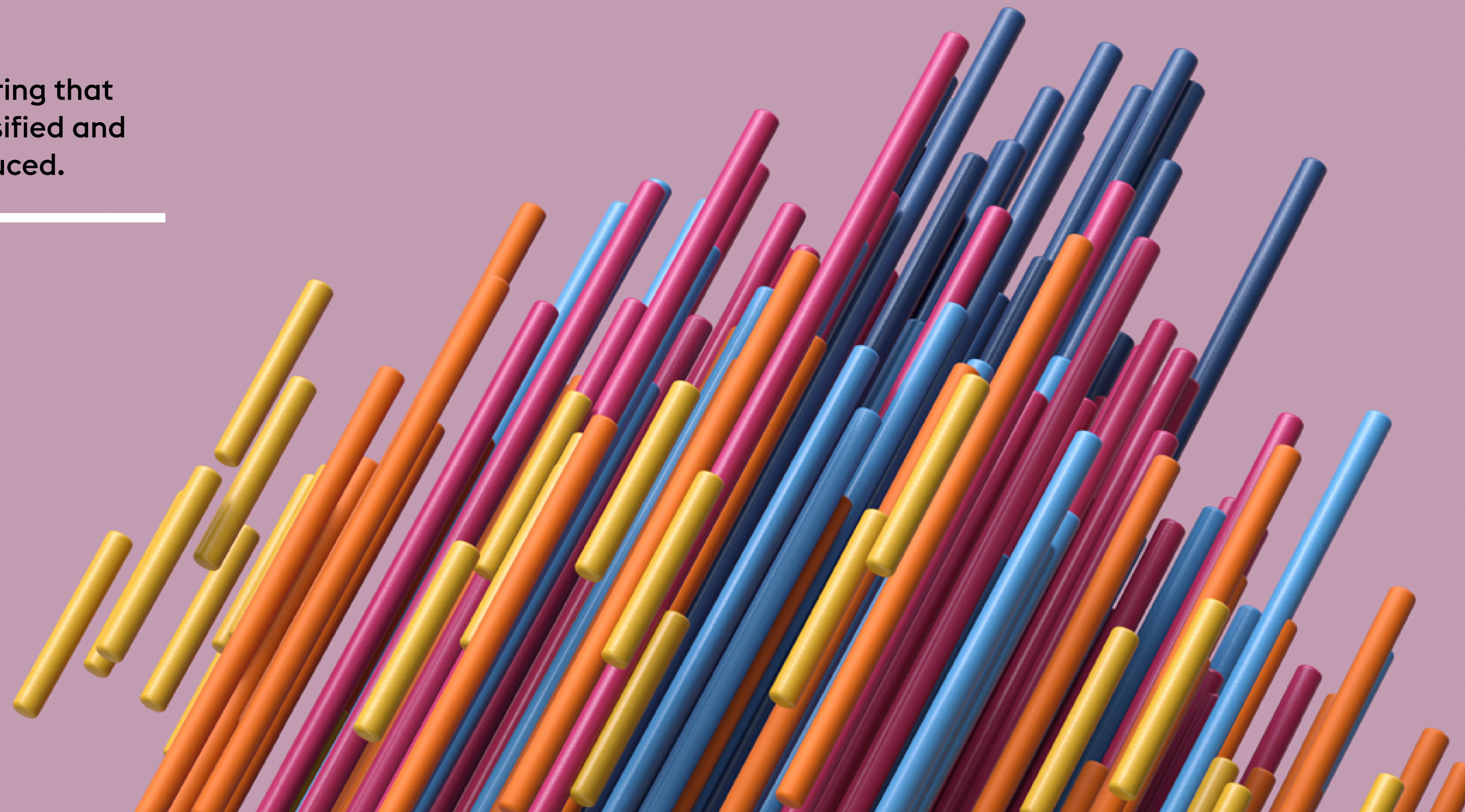

THE EU GREEN DEAL AND VALUE CHAINS

Raminta Dereskeviciute and Ludovica Rabitti

Commitments made by EU Member States and various industries to combat climate change and transition to sustainable business models are driving a new era for value chains.

In order to achieve climate neutrality by 2050, the European Union has set out an ambitious legislative agenda packaged as the European Green Deal.

A myriad of existing environmental laws are being amended and new regulations are in the pipeline. These will impose stricter compliance standards for products traded within the European Union and require supply chains to deliver on efficiency, greener technologies, and traceability of products and activities, while improving communication between parties within the supply chain.

In the past, the European Commission concentrated on regulating the impact of isolated activities, such as setting targets and requiring reports on emissions for industrial operators, restricting the use of specific hazardous substances, and mandating special packaging or disposal for certain products. The Green Deal aims to redesign supply chains by focusing on the value created throughout the chain, and obliges businesses to have an entire-lifecycle perspective.

> **Now is the time for businesses to comment on the impact of the Green Deal proposals.**

All businesses will need to comply, but certain industries, such as electronics, textiles, automotive, chemicals, heavy industry, and construction will have to make profound changes in a very short space of time. While the operational level will absorb the initial costs in order to go "greener" and become "more circular", every party within the chain will have to think strategically about—and report on—the impact of the changes instigated by the Green Deal on the company's overall adherence to environmental, social, and governance (ESG) issues.

With no current certainty over which new rules will make it into EU law and when will they start to apply, now is the time for businesses to comment on the impact of the Green Deal proposals by taking part in related public consultations and impact assessments.

SCOPE OF THE GREEN DEAL

The Green Deal is vast, covering areas such as food, energy, CO_2 emissions, finance, industry, and chemicals. Each of its key policy initiatives or "strategies" focuses on broad objectives and, in line with the Green Deal's holistic approach, covers multiple industries and value chain steps.

The Circular Economy Action Plan, which was adopted in March 2020, targets sustainable design, production, use, and disposal of products. Its proposed measures target product groups with resource-intensive value chains that have a high potential for circularity, including the following:

- Electronics and information and communication technology products are required to last longer, be more energy efficient, and be easier to reuse and recycle. The right to repair proposal was adopted in March 2023 and we can expect to see an EU-wide take-back scheme for mobile phones and other devices.
- Numerous sustainability requirements are expected for the manufacture of batteries and vehicles. These will likely include recyclability, ethical sourcing of raw materials, and monitoring of carbon footprint. Electric vehicles will also be affected by a revision of the rules on end-of-life.
- New measures for packaging will result in the reduction of packaging waste and elimination of polymers or hazardous materials. New requirements for labelling will increase transparency.
- The EU Strategy for Plastics in the Circular Economy aims to reduce plastic in the environment with a comprehensive set of initiatives, including a regulation on microplastics pollution; new REACH restrictions on microplastics; an EU policy framework for biobased, biodegradable, and compostable plastics; and a new directive on single use plastic products.
- A number of new measures will be introduced to tackle fast fashion pollution, promote the re-use and recycling of textiles, and enhance the disclosure requirements on circularity and sustainability. Textiles will also likely be brought within the scope of the EcoDesign Directive, and a revision of the Waste Framework Directive may extend producers' responsibilities to textile manufacturers.

Circular Economy initiatives will also include revised requirements for the construction industry, and food/water consumption. Further product groups, such as steel and cement, will be covered in the future, depending on their environmental impact and circularity potential.

The Chemicals Strategy for Sustainability, which supports the objectives of environment protection and waste reduction, will focus on promoting the sustainability of critical chemicals and banning the most harmful chemicals from consumer products (unless deemed "essential"), including per- and polyfluoroalkyl substances.

The Farm to Fork Strategy aims to make fundamental changes throughout food production supply chains, including waste management, improved animal welfare, and a reduction in the use of harmful

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> Green Deal initiatives should result in value chains making significant changes.

pesticides. One initiative focuses on driving investment and innovation in organic farming, while the agri-food promotion policy aims to increase the competitiveness of EU farm, food, and drink products.

The Zero Pollution Action Plan is an overarching initiative to reduce pollution levels by 2050 and to reduce greenhouse gas (GHG) emissions. Actions include

- A Carbon Border Adjustment Mechanism to prevent production tourism, *i.e.*, carbon leakage
- The EU Hydrogen Strategy to stimulate hydrogen innovation
- The clean energy for all Europeans package, consisting of eight new laws aimed at decarbonising EU energy and improving co-ordination between multiple EU energy providers
- The Offshore Renewable Energy Strategy, which sets targets to scale-up the generation, distribution, and use of offshore renewables
- Setting a binding target for renewable fuels of nonbiological origin used as a feedstock or energy carrier
- Expanding the EU Emissions Trading System (ETS) which will affect the power, energy intensive industry, maritime, and aviation sectors, amongst others; and making free ETS allowances conditional on investments in cleaning up industrial processes
- Setting a maximum limit on the GHG content of the energy used by ships.

There are multiple other initiatives, such as the Renovation Wave strategy to increase energy efficiency in buildings, the Strategy for Sustainable and Smart Mobility to redevelop the transport sector, and the Biodiversity Strategy to protect nature and reverse the degradation of ecosystems.

The list is vast and expanding daily, so businesses should make the regular monitoring of proposed laws a priority.

IMPACT ON INDUSTRY

Irrespective of whether or not the Green Deal will materialise in full, behaviour by both consumers and investors is already driving changes in international value chains, and the voluntary early adoption of measures aligned with the proposals will likely result in economic value and competitive advantage.

There will be various funding options available to finance this transformation, but with funding comes due diligence and reporting obligations - see p. 6 and p. 9.

Green Deal initiatives should result in value chains making significant changes in the way they operate across all stages, from how products are designed (including sourcing materials and their availability), transported, and processed, to how they are distributed to consumers and ultimately disposed of. Companies will be required to disclose information on traceability and the efficiency of their value chains to the regulators, other parties in supply chains, and consumers. As many product value chains are international in nature, the impact of the Green Deal will be felt extraterritorially.

EU regulators are aware that the changes demanded by the Green Deal follow the disruption already caused by COVID-19 and Russia's invasion of Ukraine. To encourage the competitiveness of businesses operating in the European Union, various mechanisms will be introduced aimed at measuring compliance with existing and future environmental requirements. For example, companies will be prevented from making unsubstantiated claims to deceive consumers into believing a product is environmentally friendly.

All industries in the European Union will also need to adapt to the new GHG emission requirements. This may be particularly challenging for industries such as metals and mining owing to some of the value chain being tied to specific geographical areas where natural resources are present. These industries may therefore end up being penalised as a result of the higher CO_2 emissions required to move raw materials from their source location to processing facilities, which may ultimately make processing operations in the European Union less viable.

Businesses with complex international supply and value chains have already dedicated substantial human and financial resources to keep up with the global transformation to a circular economy. They will need to continue to monitor the progress of proposed legislation and engage early with EU regulators to be alert to potential changes and identify available financing opportunities. In addition, they will need to keep customers and investors informed in order to secure any competitive advantage available from being at the forefront of the Green Deal revolution.

RAMINTA DERESKEVICIUTE
Counsel
London
rdereskeviciute@mwe.com

LUDOVICA RABITTI
Associate
London
lrabitti@mwe.com

ESG IN LEVERAGED LOANS

Mark Fine

Whether it be through general reporting requirements or economic incentives, ESG provisions based on sustainability performance targets reflect the strong regulatory and market forces at play.

With more focus on environmental, social and governance (ESG) issues across asset classes, it is unsurprising that leverage finance has also increasingly focused on ESG. According to Reorg, 50% of the European leveraged loans in 2022 included sustainability linked features.

Borrowers and lenders have an equally heightened desire to demonstrate a commitment to ESG progression, as their own investors and limited partners are focusing more on ESG and require enhanced reporting. This ties in with the heightened international regulatory oversight outlined in this issue, which is driving companies to increase their reporting generally, and which continues to grow, as shown by the Corporate Sustainability Reporting Directive (EU) 2022/2464 (CSRD) coming in to force in January this year (see p. 6).

As regulation increases, investors will seek more information.

There are, however, still significant challenges when using ESG as a metric for investment. In private debt, for example, lender education and diligence processes are relatively light on ESG specifics, and targeted diligence is rarely commissioned. Specific sectors may require certain environmental reports, but these aren't generally common. This gap at the diligence stage hinders the creation of more uniform reporting requirements and can be at odds with investors who require asset managers to demonstrate that they have considered certain ESG-related diligence on investments.

To date, there are no market standard provisions for loan documentation. On 23 February 2023, the Loan Market Association published its updated green, social, and sustainability linked loan principles, and accompanying guidance. These principles and guidance were developed to create high level frameworks of voluntary recommended market standards to promote consistency. Each principle sets out five components to enable market participants to understand the characteristics of sustainability linked-loans.

ESG-related provisions are intended to incentivise companies to improve the performance of certain areas of the business. These are often judged against key performance indicators (KPIs) that may be set at the time of closing or agreed post-closing.

> "There are, however, still significant challenges when using ESG as a metric for investment.

Usually, the biggest incentive is an economic one. The introduction of an "ESG margin ratchet" is now common: when borrowers hit certain KPIs, a small reduction in the margin (around five to 15 basis points) is available. There may be a requirement to meet all metrics or, alternatively, a tiered approach, where meeting multiple targets potentially results in higher reductions.

Agreeing the actual KPIs is sometimes the hardest part of the process, with many companies relying heavily on generic metrics, usually relating to governance. The social aspect of ESG often focusses on equality and diversity and may include certification as to positions on modern slavery, human rights, and labour standards. Other criteria include actively requiring the company's employees to participate in local community projects or internal training. Some loans will allow for internal confirmation as to levels of success, whilst others will require third party verification.

Commentators argue that for the ratchet to have teeth and act as a real incentive for change, it needs to work both ways, such as a small increase in pricing coming into effect where KPIs are not met. At the same time, however, lenders are still willing to offer one-way economic incentives as a driver for companies to make substantive change.

Financial incentives are not the only option for investors keen to take a proactive approach to ESG. Some, for example, oblige borrowers to complete ESG questionnaires on an annual basis as a prerequisite of the credit approval process. Given the lack of conformity as to ESG reporting requirements and the contents of these reports, it is not surprising, however, that such provisions have not made their way into loan documents as regularly as the ratchet.

As the leverage finance market continues to develop, it seems likely that both sponsors and credit funds, together with their investors, will have a significant say in how ESG factors will feature in loan documentation in the future.

MARK FINE
Partner
London
mfine@mwe.com

THE VIEW FROM FRANCE

David Revcolevschi and Claire Chabat

France provides an interesting case study on the likely national impact of the European Green Deal and the Action Plan on Financing Sustainable Growth.

Listed companies in France have long been subject to reporting and disclosure requirements designed to promote corporate social responsibility and, more recently, sustainable growth and sustainable finance, in the interests of shareholders and stakeholders. Since the implementation of the 2014 EU Non-Financial Reporting Directive (NFRD) into French law in 2017, only large companies listed on the regulated Euronext Paris market have been obliged to publish non-financial information (in a statement included in the management report) and information on their diversity policy as it applies to the board of directors.
There have also been a number of other national legislative obligations covering gender representation and equality.

While investors expect listed companies to adhere to corporate governance codes, companies listed on the Euronext Paris may, but are not obliged to, follow a code of corporate governance under the French version of the Anglo-US "comply or explain" principle. If they do not follow the code, they are required to explain why they opted out. If they do follow the code but don't comply with certain of its recommendations, they are similarly required to explain themselves. Companies listed on the Euronext Growth multilateral trading facility may also refer to a code of corporate governance under the same "comply or explain" principle.

In light of the EU Corporate Sustainability Reporting Directive (EU) 2022/2464 (CSRD) (see p. 6), which amends and significantly enhances companies' reporting requirements under the NFRD, there is currently intense interest and debate on how the CSRD will be implemented into French law at the latest in 2024 and how it will further affect companies and investors in France.

The CSRD extends the scope of the companies covered by the NFRD to all large and all listed companies, requires the audit of reported information, and strengthens the standardisation of reported information in line with soon-to be adopted European Sustainability Reporting Standards (ESRS) to foster the publication of quality and comparable environmental, social, and governance (ESG) data.

EXISTING DISCLOSURE REQUIREMENTS AND EXTRA-FINANCIAL REPORTING

France has well-established market practices that aim to integrate sustainability issues and concerns, not least because first corporate social responsibility (CSR), then ESG considerations have already been integrated into commercial and civil law. Article 1833 of the French Civil Code was amended in 2019 to note that a company must be "managed in its own corporate interest, taking into consideration social and environmental issues related to its business operations."

CSR reporting became integral to French commercial, environmental, and employment laws as a result of the implementation of several EU directives. EU companies listed on regulated markets, such as the more than 800 companies listed on Euronext Paris, have therefore been required to publish information related to environmental matters; social matters and the treatment of employees; human rights; anti-corruption and bribery; board diversity (in terms of age, gender, educational, and professional background); and the compensation policy for corporate officers. This CSR information is disclosed in the annual management report, in the corporate governance report, or, with respect to large companies, in the extra-financial performance statement.

> "France has well-established market practices that aim to integrate sustainability issues and concerns.

Under the "comply or explain" principle, listed companies that adhere to a code of corporate governance (French issuers may refer to the Afep-MEDEF or Middlenext codes) can either: i) comply with its recommendations, most notably to create a CSR committee (with a role to play on "say on climate" resolutions), establish ESG training for board members, and ensure fairness and gender balance at all levels; or ii) explain why these actions haven't been undertaken. Since 2021, large companies have been under a legal obligation to take measures to achieve a balanced representation of men and women at board and/or executive level.

Having identified sustainable finance as a priority in 2010, the French financial markets authority (AMF) actively monitors the information provided to investors. This includes information provided by companies on their strategies for combating climate change; information relating to the classifications introduced by the Sustainable Finance Disclosure Regulation ((EU) 2019/2088) (SFDR), (see p. 9), the main provisions of which started to apply in March 2021; and information produced in periodic reports under disclosure requirements implemented in January 2022.

In a recent report, for example, the AMF suggests that, while equity funds promoting sustainable characteristics (Article 8 of the SFDR) and pursuing a sustainable investment objective (Article 9) have a

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lower exposure to fossil fuel industries than funds without a sustainability scope (Article 6), Article 8 or Article 9 bond funds have, counterintuitively, a higher exposure to fossil fuel industries than their Article 6 equivalents. This may have to do with the fact that these bond funds have a higher proportion of green bonds or sustainability-linked bonds in their portfolio.

> "The French financial markets authority actively monitors the information provided to investors.

EXTENDED DISCLOSURE AND REPORTING UNDER THE CSRD

The existing mandatory disclosure regimes and reporting requirements under French law are expected to be amended based on the provisions of the CSRD, the SFDR (which applies until the CSRD is implemented), and the EU 2020 Taxonomy Regulation.

As the EU Commission's principal mechanism to address "greenwashing", the Taxonomy Regulation (see p. 9) sets out criteria for determining if an activity is environmentally sustainable, including whether the activity contributes to, or does not significantly harm, one or more specified environmental objectives. The Taxonomy Regulation, effective in stages since January 2022, requires further disclosures in addition to those set out in the SFDR.

All companies listed on the regulated market (except micro companies) will be under more stringent and harmonised reporting obligations in order to improve the availability and quality of ESG disclosures. Under the principle of "double materiality"—how the business is impacted by sustainability issues and how the business' activities impact society and the environment—companies will have to report detailed information on their material sustainability risks, opportunities, and impacts under the ESRS.

Listed companies will also have a substantive duty to undertake due diligence to identify, prevent, mitigate, and account for external harm resulting from adverse human rights and environmental impacts caused by the company's own operations, its subsidiaries, and in the value chain. It is the responsibility of corporate directors to implement sustainability due diligence.

The extra-financial performance statement will be replaced with the "sustainability" report, which will be made according to the ESRS and notably will include materiality assessments, carbon footprint reduction measures, environmental impact reduction, and ESG forward-looking statements.

Sustainability information will be located in a dedicated section of the issuers' mandatory management report. Companies will have to prepare their reports, including the sustainability statement, in an xHTML electronic format. The sustainability information will also have to be marked in accordance with a to-be-adopted digital taxonomy to enable compatibility with the forthcoming European Single Access Point, and will be audited by statutory auditors or independent assurance providers under European and sustainability assurance standards.

THE IMPACT OF ENHANCED DISCLOSURE AND REPORTING

In a bid to accelerate the transition to new investment standards, Euronext has launched the Eurozone ESG Large 80 Index, which is designed to identify companies with the lowest governance ratings (such as those doing business incompatible with the UN Global Compact or involved in coal, tobacco, or controversial weapons), and the 80 most virtuous companies in terms of energy transition within their respective sectors.

As a result of the wealth of information being generated by the many new reporting obligations, and the obvious commercial advantages inherent in being seen to be doing "good" business, France has an increasing number of third-party impact evaluators appointed on transactions. There are also numerous ESG consultants specialising in structuring impact metrices in relation to "pay for performance" financial arrangements, or to help issuers and/or investors with benchmarking, traceability, and scoring of extra-financial data.

The shift from voluntary CSR reporting and performance to mandatory ESG reporting on financial and extra-financial data and value-making is well under way. International funds, particularly from Europe and the United States, are accelerating the standardisation of disclosures by publicly listed companies.

While these legislative and regulatory changes may not clearly distinguish impact finance from sustainable finance, or provide a clear definition of what actually constitutes a sustainable investment, they do at least ensure that financial market participants' needs in terms of ESG data are met to comply with their own reporting obligations.

DAVID REVCOLEVSCHI
Partner
Paris
drevcolevschi@mwe.com

CLAIRE CHABAT
Associate
Paris
cchabat@mwe.com

THE ESG DISCLOSURE LANDSCAPE ACROSS SOUTHEAST ASIA AND INDIA

Ranajoy Basu and Siddhartha Sivaramakrishnan

As Environmental, Social and Governance (ESG) considerations become increasingly prominent in Southeast Asia and India, companies need to make additional efforts to identify and address ESG considerations, and boards must scrutinise ESG implementation closely.

The ESG regulatory and transactional environment in Southeast Asia and India continues to evolve quickly. Sustainability standards are becoming mandatory in corporate and financial reporting, social and labour standards are being enhanced across the region, and green and sustainable financing flows remain strong.

Investors are demonstrating increasing willingness to challenge board directors on their companies' climate performance and scrutinise climate risk management disclosures and emissions reduction plans. Key government policy initiatives include supporting energy transition, reducing environmental barriers to trade, and strengthening environmental risk management.

CLIMATE AND SUSTAINABILITY REPORTING IN ASIA

The recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD), created in 2017 by the G20's Financial Stability Board, are recognised as the leading standard in climate reporting. Following the announcement of the TCFD's reporting mandate in October 2021, there has been a surge in global regulatory activity.

In the United States, for example, the Securities and Exchange Commission (SEC) recently proposed new rules based on the TCFD framework that will govern and mandate emissions and climate risk disclosures (see p. 2).

This global regulatory movement comes as a result of significant voluntary uptake by companies. Around 3,400 companies worldwide have pledged to support the TCFD and, of these, at least 1,120 companies in Asia have voluntarily adopted the TCFD recommendations. Asian governments have also adopted and implemented their own mandatory disclosure regimes and reporting requirements based on the TCFD framework.

HONG KONG AND SINGAPORE

The new ESG reporting requirements for Hong Kong and Singapore will impact companies doing business in Asia.

Since 2013, the Hong Kong Exchanges and Clearing Limited (HKEX) has required listed companies to report on their ESG and sustainability information alongside their annual reports. In 2021, HKEX published an update to its Environmental, Social and Governance Reporting Guide, to include more ESG aspects and implement mandatory and "comply or explain" disclosure requirements. In December 2021, the Hong Kong Monetary Authority released a supervisory policy manual for climate risk management, which aims to enable authorised financial institutions (AIs) to integrate climate considerations into their governance, strategy, risk management, and disclosures. The hope is that this approach will afford AIs better resilience against climate risks.

The Singapore Exchange (SGX) announced climate disclosure rules in December 2021. SGX introduced

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a phased approach to mandatory reporting based on the TCFD recommendations. At present, climate reporting is mandatory for issuers in financial services, as well as the agriculture, food, forest products, and energy industries. Other issuers must report on a "comply or explain" basis. From 2024, mandatory climate reporting will also extend to the materials, construction, and transportation industries.

INDIA

The Securities and Exchange Board of India requires the top 1,000 listed companies to prepare annual Business Responsibility and Sustainability Reports (BRSRs) and disclose those reports on the Ministry of Corporate Affairs portal (the MCA21 portal). These will then be used to prepare a Business Responsibility-Sustainability Index. BRSRs are not mandatory for companies outside the top 1,000; instead, there are "Comprehensive" and "Lite" versions for listed and unlisted companies, respectively. Notably, the SEBI BRSR circular doesn't currently mention BRSR Lite, the MCA21 portal, nor the Business Responsibility-Sustainability Index in its current circular.

The BRSRs aim to consolidate India's decade-old reporting framework, under which reports lacked detail and quality. BRSRs require far more detail than the previous regime: 20 reported data points across three sections and nine principles. The new framework adopts the United Nations (UN) Sustainable Development Goals and is benchmarked to other global ESG reporting frameworks, including TCFD.

> "The BRSRs aim to consolidate India's decade-old reporting framework.

INDONESIA

The Indonesian financial services authority, Otoritas Jasa Keuangan, requires publicly listed companies to prepare a sustainability report, made either separately or as part of their annual report.

JAPAN

Japan's Financial Services Agency is working on a proposal for mandatory climate risk disclosure and updated disclosure guidelines. See p. 17 for more details.

MALAYSIA

The Malaysian Joint Committee on Climate Change is developing an ESG Disclosure Guide for small and medium-sized enterprises to help improve the quality of, and access to, information on the resilience of businesses to ESG-related risks.

PHILIPPINES

The Philippines Securities and Exchange Commission has issued requirements for publicly listed companies to submit an annual sustainability report under a "comply or explain" approach. This is expected to be extended to other types of corporations, to improve coverage and quality of reporting.

THAILAND

Since 2022, it has been mandatory for all publicly listed companies to report their ESG performance via a separate filing within three months of the publication of the company's financial report.

VIETNAM

Vietnam has signed the UN's One Strategic Framework for Sustainable Development Cooperation. This agreement outlines how the UN and the Government of Vietnam will co-ordinate on Vietnam's sustainable development, and focuses on social development, responding to climate change, disaster resilience, and ensuring environmental sustainability.

OTHER CONSIDERATIONS

In addition to these country-specific requirements, the International Capital Market Association's Green Bond Principles, which provide guidelines for green, social, and sustainable bonds and facilitate transparency on behalf of investors around green credentials, will impact cross border Asia financings.

Businesses will also need to pay attention to enhancing human capital management in light of Asia's young and growing workforce.

Companies and investors should, however, take this opportunity to actively seek out new ESG-driven business opportunities across Southeast Asia and India, particularly in the energy transition, electric transportation, and sustainable manufacturing and construction sectors. The number of Asian countries that have issued or plan imminently to issue green bonds is a trend that will catalyse the growth of the market.

Laura-May Jones also contributed to this article.

RANAJOY BASU
Head of Structured Finance and Sustainable Finance
London
rbasu@mwe.com

SIDDHARTHA SIVARAMAKRISHNAN
Partner
Singapore
siddharthas@mwe.com

NEW SUSTAINABILITY DISCLOSURE RULES IN JAPAN

Eric S. Klee and Sayana Kurachi

New mandatory sustainability disclosure rules have come into effect for all companies listed in Japan.

On 31 January 2023, Japan enacted a mandatory sustainability disclosure rule for companies listed on the stock exchange in Japan, including foreign companies. Companies must make the required disclosures in their Annual Securities Registration Statements (ASRS) and Annual Securities Reports (ASR) for the financial years ending on or after 31 March 2023. Sustainability disclosures should include environmental, social, employee, human rights, anti-corruption, anti-bribery, governance, cybersecurity, and data security policies and activities, to the extent material to the company.

Under the Sustainability Perspective and Measures section of the ASRS and ASR, companies are required to disclose information on the following areas:

- Governance: the processes, controls, and procedures in place for monitoring and managing sustainability-related risks and opportunities
- Risk Management: the processes in place for identifying, assessing, and managing sustainability-related risks and opportunities
- Strategy: initiatives launched by the company to address sustainability-related risks and opportunities that may affect management policies and strategies over the short, medium, and long term
- Index and Target: the indices used to assess, manage, and monitor performance with respect to sustainability-related risks and opportunities over time.

The Governance and Risk Management sections are mandatory. The Strategy, and Index and Target sections need only be completed to the extent deemed material to the company, except for the human capital and diversity-related strategies, indicators, and targets, which must be disclosed.

These disclosures are required on a consolidated basis, including all the submitting company's subsidiaries, even those located outside Japan. The Japan Financial Services Agency (FSA), the regulatory agency responsible for reviewing sustainability disclosures, has stated that if the submitting company has a parent company listed on a foreign stock exchange, the company must still disclose information about the submitting company and its consolidated subsidiaries. However, if the submitting company determines that the parent company's disclosure is similar to the required Sustainability Disclosure requirements in Japan, the company can use the same disclosure and simply include any supplemental information required under Japanese law.

Companies are required to disclose human capital and diversity information in the Status of Employees section of the ASRS and ASR. Mandatory disclosures include the percentage of female workers in management positions, the percentage of male workers taking childcare leave, and the wage difference between male and female workers.

> “Companies are required to disclose human capital and diversity information.

Although companies may disclose these statistics on a stand-alone basis, they are encouraged to consolidate all disclosures to assist investors with investment decisions.

As noted on p 4, the International Sustainability Standards Board (ISSB) is currently developing an international baseline for sustainability disclosure, the first protocols of which are expected to be finalised later this year (see p. 2). It is worth noting that the publication of these standards will likely prompt the FSA and the Sustainability Standards Board of Japan to require more detailed disclosure requirements in the future.

ERIC S. KLEE
Counsel
New York
eklee@mwe.com

SAYANA KURACHI
Visiting International Attorney
New York
skurachi@mwe.com

McDERMOTT FOCUSES ON ESG DURING JAPANESE INTERNATIONAL SEMINAR HELD IN TOKYO

In January this year, McDermott hosted its 10th International Legal Seminar in Tokyo, on issues of the most concern to Japanese companies.

Paris partner Jacques Buhart led a team of lawyers from across McDermott's international network, providing insight into key issues such as international compliance and enforcement, data privacy and cyber security, and intellectual property. Given the challenges presented by the fast moving evolution of environmental, social, and governance (ESG) regulation worldwide, this was a major focus of the Seminar and touched on many of the themes discussed in this issue of *International News*.

London Partner Simon Airey teamed up with Jacques Buhart to speak on ESG regulation in the United Kingdom and European Union. Although there is some divergence between ESG regulation in the UK and EU, there is still much in common.

In the United Kingdom, regulation with respect to modern slavery, pay transparency and environmental impact are expected to be priorities in the near future, alongside a focus on new standards and enforcement to tackle “greenwashing.”

In 2022, the European Commission adopted important proposals requiring EU and

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non-EU companies to conduct sustainability and human right due diligence for the whole group and their value chains. These proposals are expected to enter into force in 2025. The companies that are likely to fall into the scope of these rules should consider implementing effective measures to mitigate the risks or prevent harm to human rights and the environment. In addition, in some EU Member States, including France and Germany, national legislation on sustainability due diligence has already entered into force.

Siddhartha Sivaramakrishnan from McDermott's Singapore office spoke on the rapidly evolving ESG regulatory and transactional environment in Southeast Asia and India. He noted that sustainability standards are being incorporated into corporate reporting, social and labour standards are being enhanced across the region, and green and sustainable financing flows remain strong.

Key governmental policy initiatives include supporting energy transition, reducing environmental barriers to trade, and strengthening environmental risk management. There is also an increasing spotlight on enhancing human capital management in light of Asia's young and growing workforce. Strategic and financial investors should continue to see ESG-driven business opportunities in Southeast Asia and India in the energy, transportation, manufacturing, and construction sectors in particular.

Because the focus on ESG presents not just risks and compliance obligations but also opportunities for investment, Los Angeles partner Edward Zaelke spoke on the various alternative energy development incentive opportunities included in the 2022 US Inflation Reduction Act (IRA).

Edward noted that Japanese investors and manufacturers are likely to directly benefit from the IRA in various ways, including technology development and manufacturing, increases in the length and availability of tax credits, and direct payment by the US Government of tax incentives that can benefit Japanese companies. The IRA is the first renewable energy incentive that favours US equipment in the production of renewable energy. Despite its obvious purpose of supporting US domestic policy, its benefits are extensive enough to create significant opportunities for Japanese investors, manufacturers, and developers.

Boston counsel David Cifrino outlined the differences, from both historical and forward-looking perspectives, between corporate social responsibility (CSR) and corporate sustainability/ESG. He noted that while CSR initiatives often operate only at the margins of the business, ESG is the investor perspective on corporate sustainability, with a focus on financially-material, decision-useful, and actionable environment, social, and governance factors that drive long-term value creation.

On governance, investors are evaluating how well boards of directors identify material sustainability factors, analyse and incorporate sustainability issues into long-term strategy, consider long-term sustainability trends in capital allocations, and incorporate sustainability drivers into performance evaluations and compensation programs. It is vital that companies' external reporting clearly articulates the influence of sustainability issues on long- and short-term strategies.

Finally, David pointed out that, while the United States is only beginning to mandate sustainability disclosures on topics such as climate risk and human capital management, on the international level, the new International Sustainability Standards Board has been created to sit alongside the existing International Accounting Standards Board, which administers the International Financial Reporting Standards.

ESG, IMPACT & SUSTAINABILITY

How you manage ESG issues has a significant impact on your business' standing and reputation with investors and other important stakeholders, and on your bottom line.

To better position your business for long-term value creation, we offer experienced and knowledgeable legal counsel for establishing and maintaining effective ESG practices.

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