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ADVOCATES AND LEGAL CONSULTANTS

The Changing Tide: ESG revolution ushering in a new era of green regulation

Change is coming. The total value of assets under management in ESG (environmental, social and governance) funds has grown at a compound annual growth rate of more than 70% over the past five years. Environmental considerations refer to climate change mitigation and adaptation and social considerations refer to issues such as inequality, inclusiveness, and labour relations. Governance of public and private institutions plays a fundamental role in ensuring the inclusion of social and environmental considerations in decision-making processes.

A UN initiative in 2004 led to the publication of a report entitled "Who Cares Wins" which originally coined the term "ESG" and made the case that embedding such factors in capital markets makes good business sense and leads to more sustainable markets and better outcomes for societies. Growth since then has been staggered. Institutional investors were initially reluctant to embrace the concept as they considered that their fiduciary duty was limited to the maximisation of shareholder value irrespective of environmental or social impacts. But as the times have changed so have attitudes towards ESG.

As of 2018, ESG investing was estimated at over $20trn in AUM, or around a quarter of all professionally managed assets around the world. The broad market for sustainable investing has witnessed a further surge in 2019 and shows no sign of abating: investment flows into US open-end and exchange-traded sustainable funds surpassed $4bn for the third quarter in a row.

In Europe, Mr Robert Ophèle the chairman of the AMF, the French financial regulator, has just last week urged the EU to move faster on setting common standards for ESG investing to prevent widespread "greenwashing". The explosion of interest in ESG and the absence of EU-wide rules governing what constitutes a sustainable fund has left the EU vulnerable to diverging practices that could undermine responsible investing. Mr Ophèle argues that minimum standards are "crucial to avoid the concept of ESG being watered down".

The European Commission is already on the case. In 2016 it established a high-level expert group on sustainable finance, which delivered an interim report in July 2017 and a final report in January 2018. Its recommendations form the basis of an action plan on sustainable finance which was adopted by the Commission in March 2018 and which sets out a comprehensive strategy to further connect finance with sustainability.

In May 2018 the Commission adopted a package of measures implementing several key actions. These include:

- A proposal for a new EU Regulation on the establishment of a framework to facilitate sustainable investment. The regulation will establish the conditions and framework to gradually create a classification system (or “taxonomy”) on what can be considered an environmentally sustainable economic activity;

- A proposal for a new EU regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (on the activities and supervision of institutions for occupational retirement provisions). The regulation will introduce disclosure obligations on how institutional investors and asset managers integrate ESG factors into their risk management processes. Additional Commission delegated acts will specify requirements on integrating ESG factors into investment decisions as part of institutional investors’ and asset managers’ duties towards investors and beneficiaries; and
- A proposal for a regulation amending the benchmark regulation which will create a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, which will provide investors with better information on the carbon footprint of their investments.

In addition to the above, the Commission has also been seeking feedback on delegated acts under MiFID II and the Insurance Distribution Directive to include ESG considerations into the advice that investment firms and insurance distributors offer to individual clients. The Commission also intends to clarify how asset managers, insurance companies and investment or insurance advisors should integrate sustainability risks, and where relevant, other sustainability factors into their business. It has signalled that it will do so either by amending existing delegated acts, under the UCITS Directive, AIFMD, MiFID II, Solvency II and the IDD Directive or by adopting new delegated acts under the same Directives.

It is obvious that as our impact on the earth’s climate becomes ever clearer, more and more regulatory action will be taken to combat the mitigate the effects of climate change throughout all areas of the economy. If you are interested in understanding how future sustainable finance regulations might impact your business or would like advice on how to prepare for the future, please do not hesitate to contact one of our Investment Services lawyers.