International
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Legal Guides

Environmental, Social & Governance Law 2021

A practical cross-border insight into ESG law

First Edition

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

There is no single, overarching piece of ESG legislation or regulation in the UK. Rather, the UK's ESG regime comprises a somewhat disparate array of domestic and EU-derived laws and regulations, many of which are not solely ESG-focused. The main legislative sources are the UK Corporate Governance Code 2018 (the "**UKCGC**"), the directors' duties set out in the Companies Act 2006 (the "**Companies Act**"), the Listing Rules, the Disclosure Guidance and Transparency Rules (the "**DTRs**"), the UK Stewardship Code 2020 (the "**UKSC**"), the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the Climate Change Act 2008 (the "**CCA 2008**"), the Bribery Act 2010, the Corporate Manslaughter and Corporate Homicide Act 2007 (the "**CMCHA**"), the Equality Act 2010, and the Modern Slavery Act 2015 (the "**MSA 2015**"). The UK's ESG legal landscape is therefore fragmented (perhaps reflecting the incomplete overlap between the E, the S and the G), with a wide range of different laws and regulations for all businesses (big and small) to be aware of and comply with.

The CCA 2008, which is the UK's principal climate change statute, has set a revised target of at least a 100% reduction of UK greenhouse gas emissions by 2050 compared with 1990 levels. The bulk of the obligations under the statute are placed on the UK government rather than individual organisations, and the statute also provides for carbon trading for larger organisations.

The UKCGC and the UKSC are both key parts of the UK's corporate governance regime, and are administered by the UK's Financial Reporting Council (the "**FRC**"). Generally, the UKCGC applies to listed companies, and the UKSC applies to institutional investors. The FRC is due to be replaced in 2021 by a new administrative body called the Audit, Reporting and Governance Authority ("**ARGA**"), which will have wider powers than the FRC and is expected, among other things, to scrutinise audit practices more closely, following several recent scandals where companies had been given a clean audit shortly before significant financial difficulties became public.

Pension funds are also subject to additional requirements under pension legislation, including the Occupational Pension Schemes (Investment) Regulations 2005 and the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (the "**Pensions Regulations**"). There are multiple sources of guidelines that supplement the Pensions Regulations, including guidance issued by the Pensions Regulator and organisations such as the Pensions and Lifetime Savings Association.

1.2 What are the main ESG disclosure regulations?

The UK's main ESG disclosure regulations are set out in the Companies Act, the UKCGC and the DTRs.

In particular, section 172 of the Companies Act requires directors of UK companies to have regard (in discharging their duties) to, among other things, the interests of the company's employees, the need to foster business relationships, the impact of the company's operations on the community, the environment and its reputation for high standards of business conduct. However, while these matters must be considered when undertaking the director's primary duty, which is to promote the success of the company for the benefit of its shareholders, they are effectively secondary to that primary duty. In other words, the UK is currently a jurisdiction that effectively mandates shareholder primacy in directors' discharge of their duties, albeit in parallel with a need to consider other stakeholders at the same time.

The Companies Act requires large and medium-sized companies (measured by reference to turnover, balance sheet total and number of employees) to publish an annual strategic report. The report must set out information on various ESG-related items, such as the impact of the business on the environment, disclosures around the company's employees, social, community and human rights issues, and the company's policies in relation to each of those matters. If the company's securities are traded on a particular securities exchange (for example, the Main Market of the London Stock Exchange plc (the "**LSE**")) or if it is a "public interest entity", the Companies Act requires the report to contain a "non-financial information statement". This overlaps considerably with the content requirements already described, but additionally covers respect for human rights, and anti-corruption and anti-bribery matters. Finally, the legislation requires large companies to include a separate statement in their report explaining how, in the financial year in question, the directors took the matters described above into account when fulfilling their duties under section 172 of the Companies Act.

In addition, all companies (except the very smallest) must prepare an annual directors' report. Large companies must include information in their directors' report on how, during the financial year in question, the directors had regard to the need to foster the company's business relationships with suppliers, customers and others and, if the company had more than 250 UK employees in the year, how the directors engaged with those employees. Large companies must typically also include information in their directors' report on the company's greenhouse gas emissions and energy consumption during the financial year in question.

Companies with a premium listing of equity shares (on the Main Market) are required by the Listing Rules to comply with the UKCGC or explain in what respects they have diverged from it (known as the "comply or explain" regime). In particular,

Provision 5 of the UKCGC requires companies to describe in their annual report how their interests and the directors' duties factors have been considered in board discussions and decision making.

The UKCGC also requires a company:

- to employ one or a combination of the following methods to engage with its workforce:
  - a director appointed from the workforce;
  - a formal workforce advisory panel; or
  - a designated non-executive director; or
- to explain what alternative arrangements it put in place and why it considers that they are effective.

Although other publicly traded companies (for example, those traded on AIM, formerly known as the Alternative Investment Market) are not subject to the Listing Rules, the rules of the securities exchange to which they are admitted will likely contain a requirement to report against a recognised corporate governance code. Similarly, very large, non-publicly traded companies (again, measured by reference to turnover, balance sheet total and number of employees) must include a similar "corporate governance statement" in their annual report.

The UKSC sets out good practice for asset owners and managers when engaging with investee companies. In particular, Principle 4 sets out guidelines on how investors should engage on (among other things) environmental risks (if they think the company's own approach is not adequate).

Similar reporting requirements to those for companies apply to UK Limited Liability Partnerships ("**LLPs**").

The MSA 2015 consolidates previous slavery and trafficking legislation and aims to combat modern slavery in the UK and in UK businesses' supply chains. It requires certain organisations with an annual turnover over £36m to publish (and display on a website) an annual statement setting out the steps taken in the previous year to ensure no slavery or human trafficking is taking place in the company's business or supply chains. There is no deadline for publication, so the potential for enforcement action is low, with (as is common in the UK's ESG legislative landscape for now) the main driver to publish being the risk of reputational damage. However, the UK government has recently taken a proactive role in encouraging companies to publish statements, has announced its intention to legislate for a publication deadline, and is reportedly looking at introducing new enforcement powers.

The CCA 2008 requires organisations to describe how directors have had regard to the Companies Act directors' duties listed above in the context of climate change matters. It also makes provision for other ESG-focused measures, such as the use of energy performance certificates on properties, streamlined energy and carbon reporting ("**SECR**"), and minimum energy efficiency standards.

Pension scheme trustees are required to exercise their powers for the proper purpose of the trust. When it comes to pension scheme investment, this usually means acting in the beneficiaries' best financial interests (in similar vein to company directors' primary duties, as described above). The meaning of best financial interests is, however, open to some interpretation. As in the company context, ESG factors, if financially material, ought to be considered by pension scheme trustees in their investment decision making.

Under the Pensions Regulations, since October 2019, trustees of most occupational pension schemes have been required to ensure that their statement of investment principles ("**SIPs**") sets out their policies on how financially material considerations (including ESG factors) are taken into account in their investment decision making. From October 2020, most occupational pension schemes will also be required to publish their SIPs on a publicly available website in order to increase transparency in this area. Furthermore, under rules published by the UK's Financial Conduct Authority (the "**FCA**"), firms that operate workplace personal pension schemes are required to establish and maintain Independent Governance Committees ("**IGCs**"), which requires them, among other things, to report on their firm's ESG policies.

Notwithstanding the comment above regarding shareholder primacy, the UK's ESG framework (in particular the Companies Act directors' duties, the UKCGC and UKSC) is often cited in other jurisdictions as a good example of legislation that has "moved with the times" regarding corporate governance, stewardship and engagement principles.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

In addition to the UK's laws and regulations, various ESG-related guidelines apply to (or are applied by) UK organisations, including the recommendations of the Task Force on Climate-related Financial Disclosures (the "**TCFD**"), the UN's Sustainable Development Goals (the "**SDGs**"), and the Principles for Responsible Investment (the "**PRIs**").

The LSE has issued guidance that adopts the TCFD recommendations in identifying eight priorities related to climate risk reporting, explaining which ESG issues they see as the most material to the business and explaining how ESG issues may affect their business. The guidance encourages smaller issuers to follow the prescribed criteria, saying "*it is better to start reporting and to improve systems over time than not to report at all*".

UK funds and companies often describe their ESG credentials by reference to the SDGs. The SDGs are a UN initiative that lists 17 development goals that countries can use as a blueprint to "*end poverty, protect the planet and ensure that all people enjoy peace and prosperity by 2030*". The SDGs also refer to 169 associated targets, which are to be measured using 232 indicators of achievement.

In addition, a number of UK investors have signed up to the PRIs, with the bulk of these signatories (72%) being investment managers. The PRIs are six overarching principles to incorporate ESG issues into investment, including at decision-making process level, by disclosing appropriately and by incorporating them into any portfolio companies. The PRIs are described as voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues. The PRIs also explain to organisations how to write a responsible investment policy to assist with improving ESG integration, and organisations are asked to provide evidence of how the policy is being complied with.

UK asset managers, asset owners and service providers can also sign up to the UKSC, the latest version of which was introduced by the FRC in 2020. Organisations must submit a final Stewardship Report to the FRC by 31 March 2021 if they wish to be included in the first list of signatories to the UKSC. The UKSC, which is aimed at asset owners and asset managers, as well as "service providers" (investment consultants, proxy advisors, accountants, actuaries, and data and research providers), sets out various principles and reporting guidelines, which differ depending on the category of organisation. FCA-authorised asset managers are required (under the FCA's Conduct of Business Rules) to "comply or explain" against the UKSC. The Pensions Regulator also encourages adherence to the UKSC.

1.4 Are there significant laws or regulations currently in the proposal process?

The Markets in Financial Instruments Directive II ("**MiFID II**") is due to be amended in 2021 to require financial

advisers to incorporate ESG considerations within their suitability requirements for investments. This change will also be integrated into the Alternative Investment Fund Managers Directive (the "**AIFMD**") and into the regulatory framework for "Undertakings for the Collective Investment in Transferable Securities" ("**UCITS**") funds. Under these amendments, firms will need to take account of their clients' ESG preferences in assessing their investment objectives as part of their suitability assessment, which includes the risk of fluctuation in the value of an investment due to ESG factors. Given that EU laws and regulations will cease to apply in the UK following Brexit, the FCA has indicated that it will seek to mirror these EU directives.

The FCA has proposed new requirements for premium-listed Main Market companies to state in their annual report whether they comply with TCFD-aligned disclosures, and to explain any non-compliance.

The pending Environment Bill (expected to become law by the end of 2020) will provide the UK government with powers to create new regulations on air quality, water usage, waste disposal and resource management, biodiversity, and environmental risk from chemical contamination. It will create a new, non-departmental public body (the Office for Environmental Protection) to act as an environment watchdog. The Bill has, however, already been criticised for failing to make the watchdog sufficiently independent of government and for a lack of enforcement powers.

In October 2020, new rules will come into force that place more onus on trustees of occupational pension schemes to disclose their engagement activities with asset managers.

The Agriculture Bill, which is designed to replace the EU's Common Agriculture Policy for UK farmers following Brexit, has proposed a new land management system for UK farmers aimed at maximising the potential of land for producing high-quality food in a more sustainable way.

The EU Taxonomy report from the Technical Expert Group on Sustainable Finance (the "**Taxonomy Report**") is expected to come into force by the end of 2020. The report provides performance thresholds for identifying environmentally sustainable economic activities and has been heralded by the EU Commission's vice-president as "the single most important piece of legislation" aimed at the markets that can help governments meet emission targets.

To qualify, a project or business activity must (1) make a substantial contribution towards one of six climate change and environmental goals, (2) avoid significant harm to other environmental objectives, and (3) meet certain social and governance safeguards related to responsible business practices.

The report's terms of reference provide examples of each of the three components of ESG, which are likely to be used as a reference point for other regulations and ESG reporting, including:

- Environmental: "climate change mitigation, climate change adaption, the sustainable use and protection of water and marine resources, the transition to a circular economy, waste prevention and recycling, pollution prevention and the protection of healthy ecosystems."
- Social: "investments that contribute to tackling inequality, that foster social cohesion, social integration and labour relations or investments in human capital or economically or socially disadvantaged communities."
- Governance: "companies with sound management, employee relations and tax compliance."

1.5 What significant private sector initiatives relating to ESG are there?

The private sector initiatives relating to ESG are largely those described at 1.3 above, namely using the PRIs or SDGs to report on ESG in investments.

In addition, the UK Investment Association has devised a Responsible Investment Framework (the "**RIF**") which was launched in November 2019. The RIF categorises and provides standard definitions for the different components of responsible investment. Investment managers have been encouraged to adopt the RIF to help highlight "the UK's role as a global leader within the [areas of] sustainability and responsible investment".

The UK Sustainable Investment and Finance Association (the "**UKSIF**") is a membership organisation for firms in the finance industry. UKSIF describes its role as informing, influencing and connecting UK finance, policymakers and the public to achieve a vision of a fair, inclusive and sustainable financial system that works for the benefit of society and the environment.

Climate Action 100+ is a five-year initiative (from 2018) led by investors to engage larger greenhouse gas emitters and other companies worldwide that have significant opportunities to drive the transition to cleaner energy and to help achieve the goals of the UN 2015 Paris Agreement on climate change.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Investors and asset managers in the UK are focusing increasingly on ESG, which in recent years has become very much a "hot topic" in the UK. Historically, many larger investors would often state (both publicly and privately) that ESG-focused investments would come at a financial cost.

However, that perception appears to have been displaced in the UK, with a majority of ESG funds reporting parity with or outperformance of the wider market over one-, three-, five- and 10-year periods. Historically, a lack of data on ESG-focused funds' performance has previously made many investors nervous, but there are now multiple reports indicating that ESG funds may have outperformed their non-ESG peers, leading to a significant recent increase in the number of ESG funds in the UK. For example, "responsible investment" has grown over 40% from 2014–2020 and this figure seems set to continue to increase.

The Pensions Regulations described in 1.1 above for pension schemes, which have considerable influence as major investors in the UK markets, have led to an increased provision of more ESG-friendly investments, as fund managers are put under pressure by pension funds to invest in more ESG-conscious investments.

There has been noticeable growth in the UK of entire firms that invest only in ESG or on "impact grounds", as well as specific "sustainable" funds within wider financial institutions. Asset managers are now being trained on how to invest in a more ESG-conscious way and on the upcoming regulations (see 1.4 above) that will apply to them.

2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

While it is clearly an over-simplification to divide ESG consciousness purely on grounds of age, the general perception is that younger, "millennial" (and even "Gen Z") investors, consumers and stakeholders are more ESG-conscious than their "baby boomer" and other forebears, and have generated a greater demand for responsible investment. These younger generations of investors and other stakeholders have tended to place greater importance on, for example, climate change, global

warming, social justice and other non-financial imperatives than their predecessors. Given the inevitability of wealth transfer to these generations over time (as well as a desire to move – and be seen to move – with the times), organisations have been driven to act competitively in demonstrating their ESG credentials.

The younger, more ESG-conscious generations are also making up an increasing proportion of the workforce in large UK corporates, often encouraging (or forcing) organisations to strengthen their internal ESG measures, such as increased employee engagement, better employee benefits (for example, maternity and paternity leave), improving waste reduction, and more extensive recycling. It is also noteworthy that the "older" generations within (and, generally, at the top of) UK businesses appear, for the most part, to have embraced ESG initiatives and to be willing to adapt their organisations and business practices accordingly.

Providers of debt finance have also begun to place a greater emphasis on ESG investments, again particularly in those seeking to reduce or reverse climate change.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

In the UK, the principal ESG regulators are the FCA, the European Commission (for EU financial services such as MiFID II, the AIFMD and the UCITS Directive), the UK government, the FRC (to be replaced by ARGA as described in 1.1 above), regulators of securities exchanges (for example, the LSE), the Registrar of Companies (Companies House), and the Pensions Regulator.

The UK's environmental regulators are the Environment Agency, the Scottish Environment Protection Agency, and Natural Resources Wales (the "**Environmental Regulators**"). The Environmental Regulators are able to issue fines for failure to comply with environmental laws and regulations such as water treatment and discharge, waste disposal, packaging regulations, oil discharge and the management of environmental permits.

In March 2020, the FCA released a Consultation Paper to enhance climate-related disclosures by listed issuers (on a "comply or explain" basis) consistent with the TCFD recommendations. Under the proposal, all commercial companies with a UK premium listing (i.e. Main Market companies subject to the UK's highest regulation and corporate governance standards) would be required to include a statement in their annual financial report setting out (1) whether they have made disclosures consistent with the TCFD recommendations, (2) instances where they have not followed the TCFD recommendations (and why), (3) instances where they have included disclosures in a document other than their annual financial report (and why), and (4) where in their annual report (or other relevant documents) the various disclosures can be found. The FCA places particular emphasis on the TCFD's recommended disclosures on risk management and governance, stating that only "on an exceptional basis" should companies not disclose these items. After the consultation period, these new requirements are likely to take effect for accounting periods beginning on or after 1 January 2021, with the first reports published in compliance of the rule being published in 2022.

2.4 Have there been material enforcement actions with respect to ESG issues?

Much of the UK's regulation in relation to ESG compliance is relatively new, and many of the regimes are "comply or explain" rather than "comply or face sanctions". There have not been many material enforcements to date. As more section 172 statements (described in 1.2 above) are published and as new regulations come into force, we may see increased regulator action (and abilities to impose sanctions) in relation to non-compliance.

The Environmental Regulators are the most active of the UK's ESG regulators, and have issued a total of 746 penalties since 2010 totalling £110.5m. The largest penalty issued to date was in March 2017: a £20.36m fine to Thames Water for repeated raw sewage pollution into the River Thames. However, the typical average penalty size is under £18,000. The Environmental Regulators are also able to issue fines in connection with climate change issues, which often relate to failure to comply with the greenhouse gas emissions trading scheme.

Under the CMCHA, organisations can be found guilty of corporate manslaughter – a criminal offence that results from serious management failures amounting to a gross breach of duty of care. While the suitability of the legislation has recently been questioned as convictions have been relatively rare (there have been fewer than 30 since the regime was introduced in 2007), the criminal sanctions for breach (and the associated reputational damage) mean that organisations are invariably focused on ensuring that adequate measures are in place to ensure compliance with associated health and safety legislation as well as to avoid any possible breach of the CMCHA.

Whilst there has been no material enforcement to date, under the MSA 2015, the UK Home Office has been writing to organisations that have failed to publish their modern slavery statement on time, threatening action. Again, potential reputational damage is currently a greater risk here than legal ramifications. We have encountered companies that have either failed to publish their statement on time and have then been given a grace period within which to publish their statement, or that have been able to explain to the Home Office why the rules are not applicable to them (for example, if the turnover threshold is not met).

The UK Advertising Standards Authority (the "**ASA**") has banned multiple adverts in the UK, often for being misleading in relation to environmental claims. Whilst not a direct ESG enforcement action, this is often described in the media as a "greenwashing" attempt by the company in question (i.e. misleading information being disseminated by an organisation so as to present an (inaccurately) environmentally responsible public image). Again, a ban by the ASA usually leads to negative press and associated investor issues. Examples of businesses that have had adverts banned by the ASA in recent years include Ancol Pet Products, BMW, Fischer Future Heat, Ryanair and Shell.

The UKSIF has recently issued a report analysing pension ESG issues, following the introduction of the increased disclosure requirements under the Pensions Regulations (described in 1.1 above), which found "an appallingly poor rate of compliance with the ESG regulations". Of the SIPs they were able to review, "policies were thin, non-committal and suggest that [pension] trustees are not adequately interrogating their investment manager's approaches to financially material ESG factors". They also flagged that a significant number of pension schemes have failed to comply with their obligations and have not published their SIPs.

Given the lack of major enforcement actions to date, some critics argue that ESG-related litigation, including against governments and public bodies (such as the regulators) for failing to act, as well as against companies to claim damages, may prove in future to be a more effective way of holding businesses to account and forcing them to change their practices.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

ESG litigation has not yet taken off in the UK in the same way as in the US (and is currently very rare), though this could be set to change in the near future.

Investors are increasingly reviewing the ESG credentials of publicly listed companies as part of their decision to invest. This has led to ESG-related disclosures in annual reports and prospectuses of these entities being put under greater scrutiny, and an increased risk of investor and activist claims if disclosures are inaccurate.

We envisage that there will be an increase in large class actions from investors against companies that inaccurately describe their ESG credentials. Shareholder activism has increased, particularly in the oil and gas and, increasingly, finance sectors. Activist investor groups (such as ShareAction) have given individual or smaller ESG-conscious investors a greater voice and held various firms to account by proposing resolutions, publishing articles on issuer non-compliance with ESG regulations and guidance, and providing rankings for both countries and organisations (such as banks).

For example, at BP's 2019 AGM, two special resolutions in relation to climate change issues were requisitioned by shareholder groups organised by Climate Action 100+ and Follow This. One of these resolutions proposed that BP include, in its annual report from 2019 onwards, a progress report describing how its business strategy is consistent with the objectives of the Paris Agreement on climate change, supported by information relating to relevant capital expenditure, metrics and targets. This resolution was passed at the AGM with the support of 99% of shareholders, evidencing the importance to investors of ESG credentials and their disclosures to the public. Other examples of companies whose shareholders have requisitioned resolutions with respect to environmental matters include Barclays, BHP Group and Royal Dutch Shell.

A further risk associated with litigation or regulatory enforcement is the effects of such an intervention, in particular for listed companies given the potential for it to cause a rapid drop in the company's share price, in turn prompting shareholders to bring action against the company to recover the losses suffered as a result of the decline in value of the stock. Such "securities litigation" originated in the US but has been on the rise in the UK in recent years, partly due to the increase in third-party litigation funding and insurance, as well as active claimant law firms and claims management companies seeking out these types of claims.

Such claims can be made under section 90A of the Financial Services Markets Act 2000 ("**FSMA**"), which states that, if an issuer makes an untrue or misleading statement or a dishonest omission in published information (other than listing particulars or prospectuses) – such as in its annual report and accounts – it can be liable to investors who need to prove that they acquired, continued to hold, or disposed of shares in reliance on the relevant statement or omission. As at the date of writing, this section is largely untested in the UK courts in relation to ESG matters, and there are some doubts as to how easy it would be to prove reliance (other than by reference to a sustainable investment's fund or other ESG-conscious investor's documented ESG goals or principles) and then accurately quantify the loss suffered by the investor. Once again, however, the very fact of a claim (rather than damages stemming from one) may be damaging to a company's reputation, so businesses will need to continue to tread carefully in this area.

2.6 What are current key issues of concern for the proponents of ESG?

A key issue for ESG proponents is inconsistency. As a basic example, there is no universally agreed definition for the underlying elements of each component of "E-S-G", which continues to hinder effective ESG legislation and enforcement both in the UK and more widely. While efforts are being made to improve this situation (see, for example, the Taxonomy Report at 1.4 above), the varied requirements under the legislative framework (which, as noted in 1.1 above, is fragmented), and the differing guidance suggestions on reporting and disclosures, there is often a lack of consistency across companies' ESG disclosures. This can in turn lead to investors inadvertently excluding or even including issuers on the basis of their ESG reporting (especially if an algorithm or program is being used to review ESG disclosures).

Another major concern for proponents of ESG is "greenwashing". Given the lack of consistency across regulations and guidelines and the currently limited number of enforcement actions (and shareholder claims) with respect to ESG disclosure matters, there is a clear risk that many companies may have overstated their ESG efforts. Historically, media reports have largely focused on "greenwashed" products or lines rather than entire companies (as described at 2.4 above in relation to ASA bans). This may change, however, as larger and less ESG-conscious companies are required to disclose how they take ESG factors into account. In addition, fund managers are using the UN's SDGs to describe some investments as "sustainable" or "ESG-conscious" without providing clear evidence of the positive impact they have generated. Certain funds are described as "ESG funds", yet they simply exclude certain types of investments, such as tobacco and arms (with very few excluding fossil fuel investments), rather than actually analysing investments' specific "E-S-and-G" credentials. The nuanced differences between "sustainable investing", "impact investing" and "ESG investing" can also lead to confusion for investors.

The difficulties for investors in assessing an issuer's ESG credentials in detail can hinder effective ESG investment. Technological advances have begun to assist analysts in this area, for example, by including certain global ESG issues as requirements in investments (such as access to clean water, or alignment with the Paris Agreement on climate change). A significant amount of capital in UK so-called "sustainable investments" is in fact invested in passive tracker funds, which follow the movements of a particular index such as the FTSE 100, a significant proportion of which is made up of oil and gas companies. The result is that passive, sustainable investment funds are (at present) unlikely to make a significant impact on specific ESG goals for investors, and can arguably be used by funds to overstate their ESG credentials. Some investors would argue that a fund that is invested in finite natural resources (such as oil and gas) could not be an ESG investment, whilst others might claim that, as many traditional fossil fuel companies look to diversify their offerings and become more sustainable, investing in these companies is actually helping this process of change and so is the very definition of an ESG-conscious investment. Again, the inconsistency is not helpful to those seeking to promote ESG issues. The FCA is currently consulting on how to tackle greenwashing and reduce the overly broad application of "green" investment labels.

3 Integration of ESG Into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

The responsibility for ESG issues varies depending on the size and type of the organisation, but largely the responsibility will fall to the board of directors of a company, and to the managers within a fund. As explained in 1.2 above, the Companies Act places requirements on the directors of a company to promote the success of the company for the benefit of its shareholders, including the requirement to have regard to various ESG-related factors, and larger companies are required to disclose how these factors were taken into account in the decision-making process.

The responsibility for addressing ESG issues is often delegated to specific individuals or committees with greater ESG expertise, key operations executives, and those within the organisation's legal, regulatory and compliance responsibilities (such as the general counsel or members of the in-house legal team). Organisations may also outsource the work to consultants to help develop the strategy and plan for implementation in the first instance.

ESG strategies were often previously called CR (corporate responsibility) or CSR (corporate social responsibility) strategies. Some organisations may still have a CSR committee, which is likely to be tasked with ensuring compliance with the business's ESG obligations and objectives.

The role of the management body in setting and changing the strategy of an entity in relation to ESG issues is key, in particular so that others involved in implementing the strategy appreciate its importance and understand the key drivers behind it. As noted in 2.2 above, while ESG issues are often perceived as being driven by younger generations of stakeholders, typically those at the top of an organisation are (at present) not "millennials", so the buy-in of business leaders and managers is crucial for the success of ESG initiatives.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees?

As discussed in 1.2 above, directors have an obligation under the Companies Act to "have regard" to various stakeholder constituencies (for example, employees), albeit in the context of discharging their primary duty to promote the success of the company for the benefit of its shareholders.

Investors are placing a growing importance on workforce engagement, often seen as the key component of the "S" in ESG, meaning that the interests and concerns of companies' employees are being considered more and more in boards' decision-making processes.

Recent amendments to the UKCGC require listed companies to adopt one of three workforce engagement methods (as explained in 1.2 above). It is open to a board not to adopt any of these measures and instead to choose its own arrangements and explain why they are effective. The majority of FTSE 350 companies have opted to appoint a non-executive director. The reference to "workforce", rather than employees, in the UKCGC ensures that part-time and flexible employees and agency workers are included within this engagement framework.

Board committees are often used – particularly audit and risk committees – to consider specific ESG matters. In addition, some entities will establish a dedicated sustainability, ESG or health and safety committee to provide oversight of all ESG matters and report to the board on these issues. Such dedicated committees provide for the ability to have an allocated budget and, perhaps more helpfully, to set or alter the company's agenda to align with changing ESG trends or requirements and to recommend changes to the board. There is, however, currently no requirement in the UK to have an ESG committee. As described above, many companies will already have a CSR committee, which may well address some of the ESG aims of an organisation.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

Under section 430 of the Companies Act, directors of certain listed companies must prepare a directors' remuneration report for each financial year of the company. This contains a retrospective overview of the director's remuneration for the previous financial year (the "**DRR**"), together with a forward-looking policy which sets out the framework and limitations for future remuneration for directors (the "**DRP**"). The DRR is subject to a non-binding shareholder vote each year, whilst the DRP must be put to a binding vote of the shareholders at least every three years.

There is currently no legal requirement to link remuneration or incentives to ESG metrics, but it is likely that more ESG-conscious organisations may decide to go beyond their legal obligations in this regard, and we are beginning to see organisations creating links between achievement of certain ESG outcomes and remuneration.

The PRIs (see 1.3 above) explain how to link ESG factors to remuneration to ensure that executive management can be held to account for the delivery of sustainable business goals. It is more difficult in some sectors than others to recognise which ESG factors affect long-term financial performance. For example, in industries typified by high energy usage, it is easier to see that reducing greenhouse gas emissions leads to reduced energy usage and reduced costs; whereas measuring consumer satisfaction or workforce engagement is much more complicated, and companies will need to be clear on any metrics or methodologies used in such areas.

The UKSC obliges signatories to consider, among other things, "diversity, remuneration and workforce integration". Given the recent implementation of this code, it is likely that ESG-linked remuneration will become more prevalent in the future, especially as a result of the increasing public importance being placed on the "S" factors in ESG during the COVID-19 pandemic, as further described at 6.1 below.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

Various funds publicly committed to integrating ESG into their daily operations and investment processes by becoming signatories to the PRIs and publishing statements setting out their approach; for example, by providing detail on the board oversight and committee structure (as described in 3.2 above) and explaining how ESG is integrated into the investment process.

Investment managers who integrate ESG into their systems and processes tend to publicise this, but an internal cultural acceptance of ESG investing is harder to evidence or quantify.

ESG reporting has become more of the norm for fund managers, with the majority signed up to PRI reporting. It has been reported that it takes managers on average between two and four weeks to report in accordance with the PRIs.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

In the public markets in particular, providers of equity and debt finance are relying increasingly on both externally and internally developed ESG ratings. There has been accelerated growth in recent years of ESG rating agencies (such as FTSE ESG, Sustainalytics, Refinitiv and MSCI), which assess and rate global companies based on their ESG performance. This can involve reviewing issuer's annual accounts and reports for ESG-related topics.

As described in 2.6 above, the lack of consistency on reporting and levels of description in these disclosures can inadvertently hinder (or even bolster) a company's ESG rating. The lack of consistency in rating methodologies also leads to unreliability and a lack of comparability in the market (with the same company sometimes being seen as both ESG-friendly by some ratings agencies and harmful to ESG by others), which impairs debt and equity finance providers' ability to make accurate comparisons. Given the difficulty in quantifying or giving a score to many ESG factors due to their intangible nature (in particular, in relation to social and, perhaps surprisingly, governance goals), the use of third-party agencies and automated programs has been criticised for not digging deeply enough into what precisely companies are actually doing (as distinct from what they say they are doing) to improve their impact on ESG issues.

In the private markets, in which investors typically invest in businesses that are not otherwise rated, market participants are largely relying on internally developed policies and procedures that are largely informed by the codes, policies and reports mentioned above. Additionally, they are seeking support from external ESG consultants and advisors to inform investment decisions, rather than publicly available ratings.

4.2 Do green bonds or social bonds play a significant role in the market?

Green bonds are bonds issued by companies or governments to fund green, social or sustainability projects. They include a variety of financial products, most commonly the green infrastructure bond, a bond issued to refinance built and operating low-carbon infrastructure, such as offshore wind turbines and grid connections. The bonds help access the large volumes of capital that are (and will be) required for the transition to a low(er)-carbon future.

There are different types of green bonds, including mainstream green bonds (issued in relation to environmentally friendly business activities), social bonds (for issuers with activities designed to achieve social outcomes), sustainability bonds (combining environmental and social aims – not to be confused with sustainability-*linked* bonds, as explained in 4.3 below), SDG bonds (for business activities that promote the SDGs), and the more niche blue bonds, forestry bonds and climate bonds.

These bonds can be issued by financial institutions, governments and, more commonly, companies to finance or refinance green projects. Green bonds tend to follow disclosure norms known as the "Green Bond Principles", which are published by an executive committee of investors, issuers and underwriters with the International Capital Market Association ("**ICMA**") as secretariat and are internationally accepted norms. These also form the basis of the Green Loan Principles published by the UK Loan Market Association ("**LMA**") in 2018.

The LSE set up a dedicated "Green Bond Segment" in 2015 and has a dedicated Sustainable Bond Market which aims at championing "innovative issuers in sustainable finance and improves access, flexibility and transparency for investors".

Green bonds are playing an increasing role in the market and, although they and sustainability-linked bonds do not yet form a significant part of the market (as described in 4.3 below), this seems likely to change in the coming years. Unlike other European governments, the UK government has not yet said that it will issue a sovereign green bond (and has been criticised for this), but the UK government's 2019 Green Finance Strategy includes objectives such as "greening finance" and "financing green", so this may change in future.

4.3 Do sustainability-linked bonds play a significant role in the market?

The use of sustainability-linked bonds has yet to become mainstream in the UK market (particularly when compared to other European countries that have historically been more proactive in addressing climate change in the debt markets in particular), but their use is gradually increasing, from 2.8% of the total bond market in the first quarter of 2020 to 4% at the time of writing (according to UK credit rating company Moody's). These bonds appear to be producing similar returns to more traditional bonds and are likely to continue to be used more widely as the UK economy attempts to recover from the economic and other effects of the COVID-19 pandemic (as further discussed at 5.1 and 6.1 below).

The main differences between sustainability-linked bonds and traditional bonds are the disclosure and marketing requirements for the issuer, plus the economics of the bond being linked to a specific set of key performance indicators that are known as sustainability performance targets ("**SPTs**").

In the ICMA's Sustainability-Linked Bond Principles, sustainability-linked bonds are described as focusing on incentivising the issuer's efforts on improving its sustainability profile by aligning the bond terms to the issuer's performance against mutually agreed, material and ambitious, predetermined SPTs. The use of proceeds (i.e. purpose of the bond) is not a key determinant for these bonds in the same way as it is in green bonds.

Whilst sustainability-linked bonds have yet to emerge as a product of choice for issuers, we envisage their use may become more prevalent in the near future.

4.4 What are the major factors impacting the use of these types of financial instruments?

The lack of a centralised database and standardisation of ESG data in the EU and the UK creates the same problems for issuers of these bonds as for equity finance providers and other market participants.

The UK's Green Finance Strategy is aimed at addressing these problems by outlining some key actions, including working with the British Standards Institution to develop sustainable finance standards. It seems likely in the UK that investor pressure and regulation will increase, pushing market participants towards the use of ESG financial products. We therefore anticipate that the use of these financial instruments will continue to accelerate.

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

The Green Bond Principles (referred to in 4.2) published by ICMA set out certain procedural standards that are largely consistent across the sustainability-linked bond sphere. These voluntary standards are aimed at encouraging the issuer of the bond to:

- disclose the type of projects that the bond will be used for, which should only be limited to a list of eligible green projects;
- describe the process of determining which projects will receive allocations;
- describe how proceeds from the financing will be managed (including any reinvestment); and
- report on how the proceeds were allocated and on key performance indicators of the issuer's selected investments.

It is also recommended (but not compulsory) that an issuer obtains a third-party opinion or certification on the sustainability of its bond offering.

As described above, these processes are not currently regulated in the UK by the government or any other regulator any more (or less) stringently than a traditional bond, and there are no specific laws or regulatory frameworks in the UK mandating the sustainability credentials of issuers. Most sustainability-linked bonds are issued largely for reputational reasons. However, ironically, the greatest risks associated with these bonds can be reputational. This is in part due to increased public and media interest in these bonds, and the scrutiny placed on them and the underlying projects, to ensure they are not being used by either the bond holder or the issuer to greenwash their ESG credentials (as discussed in 2.4 and 2.6 above).

5 Impact of COVID-19

5.1 Has COVID-19 had a significant impact on ESG practices?

Yes. COVID-19 has undoubtedly led to a significant increase in the importance investors and firms are now placing on ESG practices in the UK. While the pandemic has already changed the world in many ways, its impact on ESG may be one of the most important changes for those UK businesses that are able to make it through the inevitable economic turbulence.

In particular, the "S" in ESG has been propelled forward (as discussed in 6.1 below), partly due to the detailed level of press coverage of businesses' ESG practices during the pandemic and partly due to the need for a greater private sector response in assisting with these measures.

It has recently been argued that the reason for the outperformance of corporate bonds and equities with high ESG ratings during the COVID-19 crisis has been better governance within these entities, including a greater emphasis on external factors and stakeholders, which has in turn prepared these types of investments better for shocks such as COVID-19. While it is too early to say whether this is a correct assessment of those businesses' performance, the trend does appear to be striking.

The UK government acknowledged in August that "much has changed" due to the impact of COVID-19 on the economy and stated "now is the time to ask whether the government can seize the opportunity presented by the crisis to further green the economy to achieve net-zero by 2050".

Suggested (although as yet unconfirmed) policies to assist with the recovery of the UK economy in a more ESG-conscious way include a specific government fund dedicated to reskilling citizens for work in the renewable energy, clean tech, and built environment sectors, as well as further government investment in these areas.

The government has reportedly asked local authorities to submit, as a matter of urgency, "shovel-ready" infrastructure ideas that will both "[support] green recovery" and "[drive] up economic growth and jobs". The roundtable on green recovery is likely to discuss these issues.

6 Trends

6.1 What are the material trends related to ESG?

As described at 2.2 above, there has been a significant surge in the UK in recent years in increasing ESG efforts, both from the general public, investors and the UK government itself.

That said, Brexit is likely to affect the UK's legal framework in relation to ESG, as the UK has recently delayed committing to implement the EU's green finance rules (per the Taxonomy Report discussed at 1.4 above). These rules would create a world-first "green gold standard" and are aimed at preventing greenwashing. Whether the UK chooses to implement similar or identical rules or standards remains to be seen.

The UK government has expressed a wish to create 2 million "green collar" jobs in the UK by 2030. The UK chancellor, Rishi Sunak, is reportedly planning measures to create a "green industrial revolution", which (as described at 5.1 above) could potentially include a government fund dedicated to reskilling workers to work in cleaner industries.

More organisations (including universities and business schools, as well as larger financial institutions) are increasing training modules on ESG. Furthermore, the increasing weight organisations are placing on ESG and the time needed to comply with regulations and principles has led to an increase in ESG-specific jobs, most of which tend to be taken by "millennials" who (as discussed at 2.2 above) have tended to exhibit a greater interest in this area than the generations before them (although, as noted above, one's age is of course by no means a hard and fast determinant of commitment, or lack thereof, to ESG).

Both investors and media outlets are placing a greater emphasis on the social part of ESG, as "human capital" stories have increased throughout the COVID-19 pandemic, with significantly more media attention than before being placed on how companies are treating their staff and judging more generally how they perform throughout the crisis.

In conjunction with the resurgence of the US (and global) Black Lives Matter movement, the UK has seen in 2020 increased protests against racial injustice, which (among other factors) have led various companies and firms of differing sizes to reconsider their internal diversity and inclusion efforts (within the "S" of ESG), and to look closely at whether employees are being adequately supported specifically during the pandemic and, more generally, in the longer term. Various companies have made public statements about their efforts in this regard, including by signing up to charters or commitments to increase diversity.

Notwithstanding the above, however, there have also been reports that, in April 2020, around 27% of organisations had put all or most of their diversity initiatives on hold as a result of the COVID-19 pandemic, including sponsorship of external events and programmes. This appears at odds with the increased focus on ESG initiatives, and it is to be hoped that businesses continue to prioritise diversity initiatives at least as much after the pandemic (if not more) than was the case before.

6.2 What will be the longer-term impact of COVID-19 on ESG?

Much remains to be seen as, at the time of writing, the UK government is beginning to re-strengthen restrictions and the worst of the pandemic may not be over. The inevitable economic downturn is likely to have both negative and positive effects on ESG. Organisations may have less time and funds available to dedicate to ESG matters, and may (not unreasonably) be more focused on survival in the short term. However, as discussed above, greater public and media interest may prompt organisations to ensure they do not fall short in ESG areas, given the possibility of adverse publicity (and therefore adverse financial effects, such as investors pulling investments if ESG measures are not met). COVID-19 is generally being viewed in the UK as a long-term catalyst for ESG, as it has increased awareness, both within the UK and globally, of worker health and safety, income inequality and wider social issues.

On the whole, we believe it is likely that there will continue to be a greater emphasis in the UK on ESG in the longer term (for those businesses that survive the pandemic) – in particular, an acceleration of the emphasis on "social" issues as a result of COVID-19. How businesses treat their employees and all other stakeholders (for example, their supply chain and business partners) seems likely to become ever more important, and public disclosures and metrics (which will be ever more closely analysed) are likely to become the norm.

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