ESG – The Changing Regulatory Landscape

25 May 2021
Structure

• Overview of ESG
• The Principles for Responsible Investment
• Regulatory developments
• Overview of the EU’s SFDR requirements
• Harmonisation of sustainability accounting standards
• ESG Due Diligence
• Closing thoughts
Overview of ESG
# What is ESG?

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Governance</th>
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<tbody>
<tr>
<td>Climate change</td>
<td>Human rights</td>
<td>Bribery and corruption</td>
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<tr>
<td>Resource depletion</td>
<td>Diversity and inclusion</td>
<td>Executive pay</td>
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<td>Hazardous waste disposal</td>
<td>Child labour</td>
<td>Board diversity and structure</td>
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<tr>
<td>Deforestation</td>
<td>Health and safety</td>
<td>Protection of shareholders interests</td>
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<td>Pollution</td>
<td>Modern slavery</td>
<td>Tax strategy</td>
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<td>Carbon emissions</td>
<td>Employee working conditions</td>
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Key Initiatives

- Paris Agreement - 4 November 2016
- Task Force on Climate-Related Financial Disclosures (TCFD) final report - 15 June 2017
- EC Action Plan on Financing Sustainable Growth - 7 March 2018
Principles for Responsible Investment
Principles for Responsible Investment (PRI)

- Launched in 2006
- Supported by the UN
- Over 3,000 signatories
- Responsible investment:
  - Strategy and practice to incorporate ESG factors in investment decisions and active ownership
- PRI strategic theme 2021-24:
  - Building a bridge between financial risk and real world outcomes
Minimum Requirements to Become a PRI Signatory

1. Responsible investment policy
2. Senior level oversight
3. Internal or external staff implementing responsible investment
4. Initial report
5. Annual reporting thereafter
6. PRI scores firms
The Six Principles of the PRI

01 We will incorporate ESG issues into investment analysis and decision-making processes.

02 We will be active owners and incorporate ESG issues into our ownership policies and practices.

03 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

04 We will promote acceptance and implementation of the Principles within the investment industry.

05 We will work together to enhance our effectiveness in implementing the Principles.

06 We will each report on our activities and progress towards implementing the Principles.
ESG Policy and Procedures

- Governance
- Exclusions and screening
- ESG integration
- Stewardship
- Disclosures
Regulatory Development in the EU

▪ **Sustainable Finance Disclosure Regulation (SFDR)**
  Applied from 10 March 2021.

▪ **SFDR Regulatory Technical Standards (RTS)**
  Sets out detailed requirements for the content and methodology for disclosures under SFDR and is expected to apply from 1 January 2022.

▪ **Taxonomy (Framework) Regulation**
  Seeks to create a new common taxonomy to define when an economic activity is environmentally sustainable and is likely to be phased in from 1 January 2022.

▪ **AIFMD, UCITS and MiFID**
  Proposed amendments to these EU regulations that focus on the integration of sustainability risks into existing organisational and conduct of business rules.
UK’s Roadmap for ESG Regulation – 9 November 2020

- Issue of first sovereign green bond in 2021
- More robust environmental disclosure requirements
- UK will become first country in the world to make Task Force on Climate-Related Financial Disclosures (TCFD) aligned disclosures fully mandatory by 2025
- UK will introduce a green taxonomy – a common framework for deciding which activities are defined as environmentally sustainable
- FCA expected to consult on new rules in H1 2021 and issue final rules H2 2021
- FCA requirements will be phased in from 2022 and apply to most firms in 2023
SEC Risk Alert on ESG – 9 April 2021

- Portfolio management practices inconsistent with ESG disclosures
- Controls inadequate to maintain, monitor and update clients’ ESG-related objectives and restrictions
- Proxy voting inconsistent with advisers stated approaches
- Potentially misleading claims regarding ESG approaches
- Inadequate controls to ensure ESG disclosures and marketing consistent with firms’ practices
- Compliance programmes not adequately addressing ESG issues
- Clear, precise and tailored disclosures aligned with firms’ practices
- Polices and procedures that addressed ESG investing and covered firms’ practices
ESG Timeline

- **General development**
- **EU development**
- **FCA/UK development**

1. **4 November 2016**
   - Paris Agreement comes into force

2. **7 March 2018**
   - European Commission Action Plan published

3. **22 June 2019**
   - The Framework (Taxonomy) Regulation is published in the EU Official Journal

4. **10 March 2020**
   - SFDR Level 1 Regulation applies to relevant firms

5. **H1 2021**
   - FCA expected to publish consultation on proposed rules on sustainable finance disclosures

6. **H2 2021**
   - FCA expected to publish Policy Statement outlining finalised rules on sustainable finance disclosures

7. **January 2022**
   - Taxonomy (Framework) Regulation – expected to be phased in from January 2022

8. **2022-2023**
   - FCA rules implemented for larger firms in 2022, and rolled out for smaller firms in 2023

9. **2025**
   - TCFD aligned disclosures become fully mandatory in the UK by 2025
Overview of SFDR
Application of SFDR

- EU firms

- Non-EU fund managers:
  - Marketing into the EU under NPPRs
  - Acting as delegated investment manager to an EU firm which is subject to SFDR
  - Managing an EU fund structure
  - Under investor pressure to comply with SFDR
  - Part of a global group with an EU entity
  - Opting in on a voluntary basis
SFDR applies to:

**Financial Market Participants**
- An alternative investment fund manager (AIFM)
- An investment firm which provides portfolio management
- A UCITS management company
- Other asset managers or product providers in relation to pensions, qualifying venture capital funds, etc.

**Financial Advisers**
- An investment firm that provides advice
- An AIFM which provides investment advice
- UCITs Manco that provides investment advice
- Insurance intermediaries providing insurance advice

**Financial Products**
- Portfolios managed by MiFID managers
- AIFs
- UCITs
- Pension’s products, schemes, etc.
SFDR defined terms

▪ **Sustainable investment**
  ▪ An investment in an economic activity which:
    ▪ Contributes to an environmental or social objective
    ▪ Does not significantly harm any environmental or social objectives
    ▪ The investee company follows good governance practices

▪ **Sustainability risk**
  ▪ An environmental, social or governance event or condition which, if it occurs, could cause a material negative impact on the value of an investment.

▪ **Sustainability factors**
  ▪ Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
SFDR disclosure obligations

Disclosures required at both

- Entity level
- Product level

To be made:

- On an entity's website
- In the pre-contractual information for a financial product
- In periodic information provided to investors
Pre-contractual Disclosures

- Describe in pre-contractual disclosures:
  - How sustainability risks are integrated into investment decisions or advice
  - The likely impacts of sustainability risks on the returns of the financial products made available or advised on
Website Disclosures – Entity Level

- Information on:
  - Policies for the integration of sustainability risks in the investment decision-making process
  - How principal adverse impacts of investment decisions on sustainability factors are considered: **Comply or Explain**
  - How remuneration policies are consistent with the integration of sustainability risks (this information must also be provided within firms’ remuneration policies)
Website Disclosures – Entity Level

- **Principal Adverse Impacts: COMPLY**
  - Relevant adverse impacts
  - Policies on identification and prioritisation of adverse impacts
  - Actions taken to address principal adverse sustainability impacts
  - Engagement policies
  - Adherence to responsible business codes and internationally recognised standards
Website Disclosures – Entity Level

- **Principal Adverse Impacts - EXPLAIN:**
  - Statement that the firm does not consider the adverse impacts on its investment decisions on sustainability factors
  - Explanation, and whether and when firm intends to comply
Website Disclosures – Product Level (Article 6)

- Assessment of the likely impacts of sustainability risks on the returns of financial products made available or advised on: comply or explain

- **COMPLY:**
  - Name each financial product and provide the firm’s assessment of the likely impact of sustainability risks on return

- **EXPLAIN:**
  - State that the firm doesn’t assess the likely impacts of sustainability risks on the return of the financial product
  - Explain why sustainability risks are not relevant for the returns of the financial product
Website Disclosures-Product Level

- All Article 8 and Article 9 financial products
- Description of the environmental or social characteristics or the sustainable investment objective
- Methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including the data sources used
- Screening criteria for the underlying assets
- Relevant sustainability indicators for measurement of the environmental or social characteristic or the overall sustainable impact of the financial product
Harmonisation of Sustainability Accounting Standards
ESG Reporting

External
- Central banks
- Investors
- Customers
- Public interest
- Societal trust
- Brydon Review

Optional
- UN Global Compact and SDGs
- Task force for Climate-Related Financial Disclosures
- Carbon Disclosure Project
- Climate Disclosure Standards Board
- Global Reporting Initiative
- International Integrated Reporting Council
- Sustainability Accounting Standards Board

Required
- Companies act
- Strategic report guidance
- EU non-financial reporting directive
- SECR
- Corporate Governance Code
- IFRS
Growing pressure on standardisation

- The European Commission is revising its Non-Financial Reporting Directive
- The International Organization of Securities Commissions (IOSCO) has set out its intention to accelerate the harmonization of sustainability standards
- The U.S. Securities and Exchange Commission (SEC) has amended its rules to enhance human capital disclosures
- The International Financial Reporting Standards (IFRS) Foundation has formed a working group to accelerate convergence in global sustainability reporting standards
- The International Federation of Accountants (IFAC) has called for the creation of an International Sustainability Standards Board to sit alongside the International Accounting Standards Board (IASB) under the auspices of the IFRS Foundation
Harmonisation of Sustainability Accounting Standards

- Global sustainability and integrated reporting organisations launch prototype climate-related financial disclosure standard
- World Economic Forum (WEF) issued a whitepaper on Common Metrics and Consistent Reporting of Sustainable Value Creation
ESG Due Diligence

- Structures approach to identify risks
- Based upon WEF whitepaper
- Tailored by industry, materiality and key areas of focus
- Initial red flag review
- Deep dive on key risk areas
- Present mitigation strategies and opportunities for improvement
- Data and data owners is biggest issue
- External assurance recommended
Closing Thoughts
Summary

- ESG becoming increasingly important
- Driving sustainable economic growth and making positive change
- Firms need to consider their approach to ESG
  - Policies and procedures
  - Disclosures that align with policies and what happens in practice
- Regulatory environment evolving over the next few years
How can we help?

- Advising on ESG matters, including SFDR and FCA requirements in the future
- Assistance with ESG policies
- ESG toolkit
- Training
- ESG due diligence
- ESG Disclosures Advisory
Questions
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