Investing in tomorrow

ESG – Challenges and opportunities

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Contents

Foreword

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1

Foreword

In this, the second in our 'Investing in tomorrow' series of reports, we continue to look at the challenges and opportunities presented by the increasing pressure on organisations across all sectors to address Environmental, Social and Governance (ESG) issues.

It is thought the term 'ESG' was first coined at a conference in 2005, but while it may be a 21st century acronym, the concept of ESG is far from new. For decades, indeed centuries, pioneering organisations have been trying to do good and endeavouring to tackle the ills of society. The difference now is that it is not only the pioneering organisations and cash-rich global and national conglomerates who need to consider ESG issues, but every organisation, whatever their size and position in the supply chain.

When it comes to ESG, actions can take many forms and there is no 'one size fits all' approach. What might, for example, be appropriate for a large multi-national company may be wholly inappropriate for a small to medium size business. Organisations also face ESG from different starting points. It is therefore imperative to focus on materiality when identifying the issues an organisation has a responsibility to address and determining the approach the organisation should adopt to make a meaningful difference.

Another theme arising from our conversations with stakeholders and commentators in the ESG arena is the importance of avoiding the pitfall of focussing on one aspect of ESG at the expense of the other two. More often than not issues are interrelated and to focus on a particular 'E', 'S' or 'G' issue in isolation runs the risk of unintended consequences. Awareness needs to be raised that ESG issues cannot each be considered in isolation, but must be considered together.

And the reference to 'together' brings me nicely on to the importance of collaboration. Success across many ESG ambitions is likely to be accelerated if there is a collaborative, joined up approach, whether this be via a large corporate helping the small businesses in its supply chain or, by way of example, collaboration between developers, occupiers and other stakeholders such as local authorities to create sustainable cities.

I hope this report provides information, ideas and inspiration to organisations to act, whatever the size or nature of your business and whatever point on the ESG journey you are on.

James Wood-Robertson
Partner and head of the energy and infrastructure sector – Shoosmiths

Should pension schemes change the world?

- *What impact has ESG had on pension schemes?*
- *Can ESG concerns be squared with acting in the best financial interests of scheme members?*

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2

Should pension schemes change the world

ESG will undoubtedly remain a hot topic of 2022 across all industries, but it is far from new to those involved with the day-to-day running of pension schemes.

Trustees of UK occupational pension schemes have been required by regulations since 2000 to record their approach, if they have one, to the ethical, social, and environmental impact of their investment choices. Since then, ESG has worked its way steadily up the social agenda, and role of pension schemes has expanded over the same time.

In the broadest terms, pension schemes rely on investments to produce the income they need to pay benefits to members in retirement. Some of the UK's largest defined benefit occupational pension schemes are institutional investors with billions of pounds in assets invested in the UK and global economy. It is no surprise then that the government has legislated and regulated to ensure that ESG factors are included in pension scheme investment strategies to help drive forward the ESG agenda.

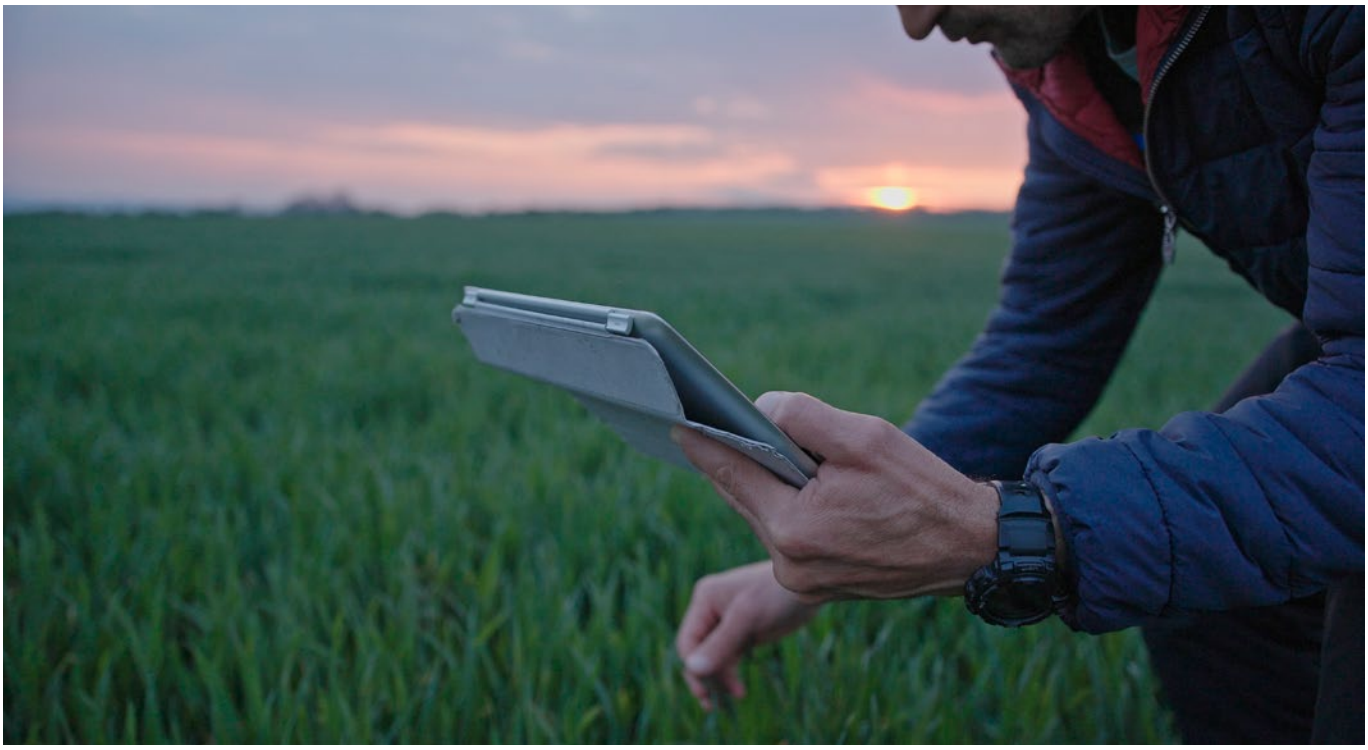
Greater engagement

As a result, trustees have become increasingly engaged in ESG matters – but it is not just because the law requires them to. Pension schemes do not exist in a vacuum and, as the general public also becomes increasingly engaged with ESG, trustees have been obliged to pay more attention to the impact of the collective consciousness on their schemes. For a growing number of people, the way in which their pension savings are invested is an important factor, and in recent years trustees have seen more interest in ESG-friendly investment options from their members.

None of this means that trustees – or other pension providers – are free to make investment decisions based on personal views or the perceived morality of certain investments. Trustees of occupational pension schemes have wide statutory investment powers but they are also subject to onerous investment duties. When it comes to ESG, those duties can often feel at odds with one another: a duty to consider ESG friendly investments, which might not always generate the same returns as their non-ESG counterparts, might seem contradictory to a duty to act in the best financial interests of members.

Understanding the investment obligations placed on trustees can be a difficult task in itself and balancing these competing obligations can be even less clear cut, especially when you consider that many trustees are volunteers, not pensions or investment specialists. Trustees are required to take, and understand, professional investment advice to help them look beyond general or personal perceptions of what might be deemed 'good' and 'bad' investment options, and consider carefully whether the ESG matter in question is a financially material consideration for their scheme.

"In recent years trustees have seen more interest in ESG-friendly investment options from their members."



Held to account

Careful consideration alone, however, is not enough. Trustees are held to account by a regulatory requirement to include their policy on financially material ESG matters in publicly available investment statements – and, if they have a policy on ESG considerations that are not financially material, they must include that too.

A good example of this consideration process in practice is tobacco. In 2010, the government set up the National Employment Savings Trust (NEST). This was to facilitate automatic enrolment, a scheme under which eligible jobholders can be automatically put into membership of a pension scheme by their employer as part of the initiative to encourage earners to save for retirement. NEST is used by thousands of UK employers and, at the end of 2021, it had 10.8m members and over £23 billion net assets under management. It is a huge scheme with investment clout.

In June 2019, NEST announced that it would be removing tobacco from its entire investment portfolio. That decision was not, however, based on any judgment on the part of the people in charge at NEST that smoking has disastrous health or social consequences. Rather, it was based on the calculation that stricter worldwide regulation of tobacco products, aggressive government-led legal action against tobacco companies and falling smoking rates made tobacco a poor investment for NEST's members. Of course, those factors are all driven by these and other well-known problems within the tobacco industry, but those problems alone might not have been sufficient drivers for the investment decision. NEST had to go further and consider the impact of these problems on the future viability of tobacco related investments for the scheme.

The move away from tobacco was a significant financial decision for NEST which, at the time, had over £40m in tobacco-related investments. But NEST is not alone. We have helped some of our clients consider whether it is reasonable to remove tobacco-related investments from their portfolio for the same reasons, and we are starting to see similar conversations among trustees in relation to climate change and climate-related investments. Take investment in the fossil fuel industry, for example, which is still common in pension scheme portfolios. As more viable alternatives to fossil fuels become available and the UK moves along its journey to net zero, we expect more trustees to consider whether their fossil fuel related investments remain appropriate, not least as the threat of punitive taxation may undermine the viability of the industry.

Climate change

Climate change is only one of many ESG factors. However in pensions – and elsewhere – it has in many ways become a separate, though still inextricably linked, topic. In a July 2021 consultation on climate-related reporting regulations for pension schemes, Guy Opperman, the UK pensions minister, described climate change as "the defining challenge of our time" and expressed a clear expectation that pension schemes are to act as a leading force in implementing climate-related recommendations made by the Task Force on Climate-related Disclosures. Those regulations are now in force and require the country's largest schemes to make annual climate change disclosures, and whilst smaller schemes are not expected to comply with them (for now at least), the Pensions Regulator expects to see all schemes considering the risks and opportunities presented by climate change going forwards.

When we talk to our trustee clients about ESG, and in particular about climate change, we often hear the question "is it really our job to change the world?". Much to their relief, the short answer is no, but the practical reality is slightly more nuanced. The Pensions Regulator's view is that, regardless of whether they are caught by the legal requirements, trustees should exercise effective stewardship in relation to climate change, and as time goes on, more of the investment options traditionally seen in pension scheme portfolios could follow the same path as tobacco.

So, whilst trustees do not have to change the world, they cannot sit back and do nothing. Trustees must start to work proactively with their advisers – their investment consultants and their lawyers – to understand and consider the relevant and irrelevant factors when making ESG-related decisions.

"Pension schemes are to act as a leading force in implementing climate-related recommendations."

Shaping ESG through proptech

- *What is the role of data as an ESG enabler?*
- *How is proptech impacting ESG strategies?*

Author:

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3

Shaping ESG through proptech

Consumers and investors alike are demanding increased transparency and sustainable commitments from property developers. That means a growing pressure to consider the environmental and social impact of development projects.

We know proptech can help developers make faster decisions, but the right tech can also help them make more sustainable decisions. Here are four ways it can help.

1

Repurpose existing buildings

The real estate sector consumes 40% of the world's energy and as an industry we need to take action to start cutting this drastically. Much of the emissions from buildings come from the initial build – not just the ongoing running. Sustainable construction methods, such as having renewable and recyclable materials, can help with this. However, it can be more effective to repurpose existing buildings – and make them more energy efficient during the process.

With changes like the expansion of permitted development rights and the creation of use class E, using proptech to find viable sites for conversion can have a huge impact compared with starting from scratch.

2

Embrace mixed-use developments

Another way to cut down on the need for new builds is through embracing multi-use.

Remote and hybrid working patterns mean that local high streets are getting more attention and consumers are demanding more of an experience from these spaces. Mixed-use developments are also a space-conscious way of cultivating a better sense of community and they encourage people to shop locally – with the bonus of cutting down on traffic emissions.

They are also a sustainable choice for developers – like a yoga studio that transitions into a restaurant at night underneath a block of residential units, cutting the need for three separate buildings. Incorporating renewable energy sources into these mixed-use buildings could also be a good investment for the future – for example, turning the otherwise unused roof of a warehouse into a small-scale solar panels farm.

Wandering around hoping you bump into those sites is not scalable, but proptech is making it easier to find those all-important opportunities.

3

Build the right buildings in the right place

It is not always possible to repurpose existing structures, so sometimes building new homes is the best option – but they must be in the right place. Location is key, not just from a demand perspective, but also from a sustainability standpoint.

Building new homes in or near existing towns and cities makes it more likely that there will be good transportation links – so cutting emissions from private vehicles – and key infrastructure already in place – so reducing emissions from building new roads, sewer systems and so on. Finding available land in these prime locations is a constant challenge for developers, but access to ownership, policy and planning data can help developers unlock more opportunities.

There is also the green belt, which we know is a contentious issue, but our research shows that unlocking just one percent could free up enough land for over 400,000 homes. In reality, by its nature, green belt land is often near urban hubs (and not necessarily all that green), meaning that expanding those existing urban hubs, rather than building a new town further out, can have a lower carbon footprint in the long run.

Having open data to analyse means that developers and local authorities can spot these opportunities and make data-backed decisions that can have a real impact.

4

Work with like-minded professionals

Collaborating with individuals and companies with shared values is a great way of ensuring a wider impact, and the industry is seeing an increase in green investors, who will only invest in net zero development projects or those with similar commitments.

Increasingly, developers are having to demonstrate their ESG goals and sustainable credentials to secure funding. This has a ripple effect and helps to keep environmental and social factors front of mind for the industry.

Cultivating the right ESG credentials could open up entirely new avenues – and the right tech can help to make the right introductions.

Wandering around hoping you bump into those sites is not scalable, but proptech is making it easier to find those all-important opportunities.

The charge on sustainability

For all the points listed above, data is an invaluable resource to help make them a reality. And this is just the beginning. Even greater data visibility will help get more homes built and foster a stronger renewables sector so we can all start making changes now, at this pivotal moment, that will benefit generations to come.

At LandTech, we believe that democratised data – opening up the once-hidden corners of the profession for use by everyone – is going to help the industry to unlock new, better ways of working. We started with LandInsight, helping people to find the right off-market land, then added LandFund to help excellent projects secure finance.

Technology will not fix everything. There are still planning problems, construction issues and competing priorities to deal with. But it can offer a huge step in the right direction.

Embracing change in the energy sector

- *How the energy sector looking beyond the 'E' of ESG?*
- *What are the barriers to more rapid change?*

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4

Embracing change in the energy sector

"Something is definitely changing," says Gianluca Gramegna, head of ESG at ERG, itself a company that has undergone a significant transformation from an oil company when it was originally formed 80 years ago to now being the leading renewable energy business in Italy.

It is now among the top ten onshore wind operators in Europe. "When it comes to market sentiment towards climate change, the push for change is higher than it has ever been from consumers, governments and industry, with investments into ESG becoming more prevalent and the voices more vociferous."

In particular, one notable shift in the market is the emergence of social and governance as equal factors to environmental in discussions around corporate responsibility. "About 10-12 years ago, we were only focusing on very broad environmental factors," says Claudio Pirani, ESG team at ERG. "Only in the last two years have social and governance aspects risen in importance to the point that they are now a consideration in company evaluations. Each of the E, the S and the G are all of equal importance – that has been a big change in the last few years."

Essential component

This heightened focus on ESG is also evident in the fact that it is now an essential component of ERG's business strategy, setting a foundation for the delivery of a tangible contribution to the creation of social value and achievement of the United Nations' strategic development goals. Lynette Purves, head of UK legal affairs at ERG, says: "ESG is at the core of our business plan. We have set a carbon neutrality target of 2025 for both direct and indirect emissions. We have set a contribution of 1% of revenue to local communities and education for future generations. We are rolling out a number of inclusivity and diversity initiatives across our business and we have linked the long- and short-term remuneration of our senior management to the achievement of these ESG objectives."

However, the type of bold transformation undertaken by ERG from oil into renewable energy and the embracing of ESG principles, whilst a great example of the diversification that needs to happen, is arguably not happening fast enough across the energy sector. Claudio Pirani says: "There are still problems with assets that rely on coal and gas. The adoption of renewable sources needs to happen quicker than it is currently and governments need to do more to support this change."

Shoosmiths has been working with ERG in relation to the build out of the Evishagaran Wind Farm in County Derry, the first subsidy free wind farm in Northern Ireland.

Evishagaran will have a capacity of 46.8 MW and, alongside its Craiggore wind farm, it will have an estimated annual production of about 254 GWh, equivalent to the needs of more than 75,000 households, with about 120 kt of CO_2 avoided per year.

> "The adoption of renewable sources needs to happen quicker than it is currently."

Barriers to progress

Nowhere is this more apparent for a renewable energy company than in the permitting process which, for Lynette Purves, is one of the prevailing barriers to progress for the sector. "There is a drive to build more renewables projects but the permitting process for planning permission is very long and uncertain. This is the main barrier to the development of major-scale renewable projects."

One area of industry that reflects this change in emphasis is the ratings market, where the agencies are now placing an increased focus on the ESG performance of companies. Gianluca Gramegna says: "In our recent ESG plan, we acknowledged that we have to evaluate from a different perspective to be accepted by the various ratings agencies, which are now changing how they rate companies."

Measurement

Claudio Pirani says on this point: "In terms of measurement, environmental factors are easier to capture, for example CO2 emissions versus revenue. However, even these figures can be skewed if one company sells at a retail price and another at a wholesale price. The metrics can be misleading. Social and governance factors are harder to standardise but the ratings market is trying to find ways to do this such as through measuring the independence of the board, the diversity of senior positions and engagement with local society. However, even these are open to interpretation because such metrics do not in themselves result in a benefit for wider society and require a qualitative understanding of the context in which they are delivered to really assess their social impact value. Nevertheless, standardisation is definitely coming."

> Social and governance factors are harder to standardise but the ratings market is trying to find ways to do this."

The overall theme is one of contrasts – of positive progress at a business level tempered by slower progress at a governmental level. There is mounting evidence that the mood is changing within boardrooms despite the macro challenges that endure. Nonetheless, the direction of travel is getting clearer despite the realisation that major barriers exist further down the road. As Claudio Pirani says: "Everybody knows what is needed, but often it is difficult to reach it."

Planning with a social conscience

- *How is PSED impacting planning policy?*
- *What is 'inclusive design'?*

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5

Planning with a social conscience

The fundamental purpose of the planning system is to contribute to the achievement of sustainable development. This involves balancing three interdependent objectives: economic, social and environmental.

While the role of planning in promoting economic growth and protecting and enhancing the environment is comparatively well established and understood, in recent years the social objective and the need to support strong, vibrant and healthy communities has increasingly come to the fore. A tangible manifestation of this is the impact that the public sector equality duty (PSED) has had both on planning policy making and decision taking. The PSED is set out in s149 of the Equalities Act 2010 and provides that, when exercising its functions, a public authority must:

- Have 'due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct that is prohibited by or under the Act
- Advance equality of opportunity between persons who share a relevant protected characteristic and persons who do not share it
- Foster good relations between persons who share a relevant protected characteristic and persons who do not share it

The relevant protected characteristics include age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, and sex and sexual orientation.

Case law

There is now a burgeoning body of case law which evidences the impact that the PSED has had on planning. The case of R (on the application of Danning) v Sedgemoor District Council [2021] EWHC 1649 (Admin) confirms that application of the PSED is not simply a question of ticking the box marked ‘equality implications’, it must be undertaken in substance and not merely in form.

Regeneration projects offer particular challenges when it comes to ensuring that those with protected characteristics are not unduly disadvantaged. For example, in R. (Buckley) v Bath and North East Somerset Council [2018] EWHC 1551 (Admin), planning permission had been granted to a registered social housing provider for the redevelopment of a housing estate resulting in the net loss of 204 affordable houses. A long-term resident of the estate sought judicial review of the decision. In the High Court, Lewis J decided that the council had failed to comply with the PSED by not paying due regard to the impact of the demolition of existing homes and adapted dwellings on elderly and disabled residents.

It is important therefore that the social objective is given appropriate weighting when planning for ‘levelling up’. For example, while investment in transport necessarily features in plans to bring regional public transport connectivity “significantly closer to the standards of London”, any benefits should be achieved without exacerbating health inequalities and any differential impacts on those with a protective characteristic should also be properly considered.

Inclusive design

Finally, it is worth mentioning inclusive design – the notion that places should be planned to reflect the diversity of people who use them and should not impose barriers of any kind – is becoming hard-wired into planning practice and policy.

A common thread running through these examples is the need for developers, policy makers and decision takers to come to a proper understanding of the social impacts of what is being proposed. This can only be gained through meaningful consultation and engagement with those who will be affected.

> “Places should be planned to reflect the diversity of people who use them.”

Unintended consequences

- *What have been the unintended negative consequences of ESG policies?*
- *What can businesses learn from policymakers' mistakes?*

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6

Unintended consequences

Balancing ESG factors is difficult not only for businesses, but also for policymakers and legislators. Focusing too closely on one area can have unintended negative consequences in other areas. How can this be avoided?

It goes without saying that government policy and legislation are key drivers for behavioural change and investment decisions among businesses. Policy and legislation can even create entire markets, such as the carbon market. However, sometimes a focus on a particular issue can have unintended consequences in other areas.

Interest in ESG issues, both in the UK and globally, has increased dramatically in recent years. In the UK at least, one of the reasons for this is the government amending the Climate Change Act 2008 in 2019 to require the UK to achieve net zero carbon emissions by 2050. Following this change, a number of organisations have pledged their own net zero goals. While these pledges are to be welcomed, those making them need to be careful not to see net zero as the be-all and end-all of all things ESG-related.

Climate change policy

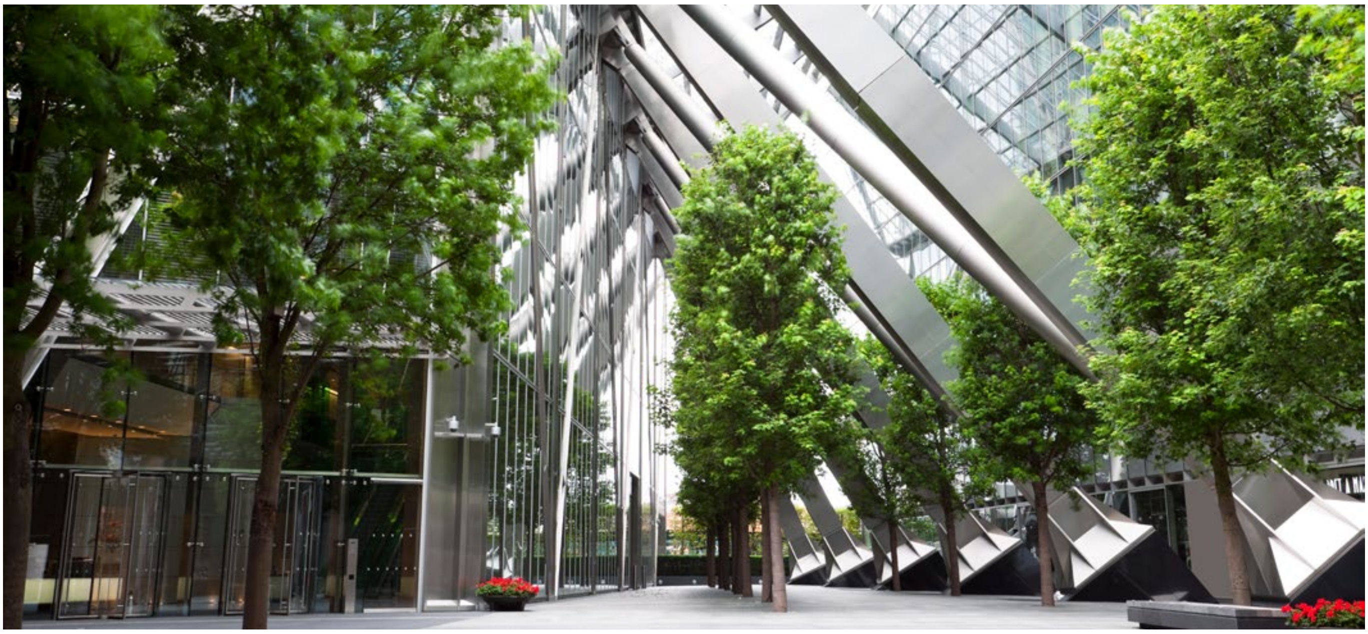
UK climate change policy and legislation over the last few decades have included some well-intentioned but ultimately poorly thought-through and implemented policies and laws that have had a negative impact in other areas. Arguably, the most tragic of these has been the tightening of energy efficiency requirements for buildings under Part L of the Building Regulations 2010, which resulted in the installation of combustible cladding on high-rise residential buildings.

Other examples of unintended negative consequences of climate change policies include:

- Incentivising drivers to switch from petrol to diesel cars through a change to Vehicle Excise Duty taxation policy in 2001. Diesel engines emit lower CO2 emissions than petrol engines, but higher NOx emissions and (at least in the case of older diesel engines) particulate matter, which have contributed to deteriorating air quality in urban areas.
- The flawed implementation of the Renewable Heat Incentive scheme in Northern Ireland in 2012 led to a massive overspend and, ultimately, to the resignation of the First Minister and the collapse of the power-sharing arrangement in the Northern Ireland Assembly in 2017. The scheme was intended to encourage businesses to switch from using fossil fuels for heating to renewable sources of energy such as biomass, but allowed applicants to claim payments for 20 years for heating empty buildings.

While the electrification of road transport is now also a key policy in both the UK and the EU, with proposals to ban the sale of new petrol and diesel cars and vans from 2035, concerns have been raised about the environmental and social impacts of the mining of materials used to produce electric vehicle batteries, such as cobalt and lithium. There is also currently a shortage of recycling facilities for waste lithium-ion batteries.

> "Government policy and legislation are key drivers for behavioural change and investment decisions."



Learning from mistakes

So, what can businesses looking to implement effective ESG strategies learn from policymakers' mistakes? How can they avoid falling into the trap of adopting a tunnel vision focus on achieving their net zero goals at the expense of other ESG-related matters?

First, awareness is needed that ESG issues cannot each be considered in isolation, but must be considered together.

Second, comprehensive and robust impact assessments are needed. An example of this is the approach taken by the EU Taxonomy Regulation (Regulation (EU) 2020/852), which is the first of its kind in aiming to address multiple environmental goals, as well as social and governance objectives. The Taxonomy Regulation defines which economic activities can be considered as 'environmentally sustainable', with the definition of that term including not only environmental objectives, but also social elements. The six environmental objectives identified are: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and protection and restoration of biodiversity and ecosystems.

Environmentally sustainable

For an economic activity to be considered environmentally sustainable, it must contribute substantially to one or more of the environmental objectives, do no significant harm to any other environmental objective, and also comply with minimum social safeguards (the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the International Labour Organisation's (ILO) declaration on Fundamental Rights and Principles at Work, the eight ILO core conventions and the International Bill of Human Rights).

Tackling climate change is undoubtedly one of the most pressing challenges currently facing humanity. Businesses have a key role to play in meeting that challenge by adopting and achieving their own net zero goals; however, in doing so they need to ensure that they do not negatively impact on other environmental objectives or social safeguards, or compromise their standards of governance.

Climate-related disclosures for asset managers by the FCA

- *What rules govern ESG investment?*
- *How do the regulations impact asset managers?*

Author:

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7

Climate-related disclosures for asset managers by the FCA

Climate change presents financial risks, and the Financial Conduct Authority (FCA) is aligned with the UK government's efforts of using regulation to move towards a sustainable economy. For fund managers, climate change can negatively impact investment values, but there is also demand by investors for a greater range of ESG funds.

However, one must not ignore the 'S' and the 'G', as social and ethical expectations such as governance, diversity and inclusion play an important role in managing financial risks and have also become an area of interest for investors.

When it comes to the regulation of funds, the FCA aims to enhance transparency so that investors can identify whether a fund meets their needs. An important accountability mechanism is to set measurable targets, which lead to market integrity as more structured disclosures enable better informed investment decisions by investors.

"The sector still lags behind other industries in respect of material and component parts being dismantlable and reusable."

Impact on asset managers

The ESG disclosure requirements come from different regulations and have the following impact on asset managers:

- If a fund pursues ESG it needs to ensure that references to ESG in its name, policies, strategy and holdings are consistent, not misleading and hold substantive meaning. These should also be clear and accessible to investors.
- Where non-financial objectives are measured or referenced in fund documents, these need to be carefully considered and articulated in a fair, clear and non-misleading way.
- Fund managers must have adequate mechanisms in place to ensure the effective exercise of voting rights in investee companies, in accordance with a fund's investment objectives.
- Fund managers are to validate and confirm whether they are in scope of the disclosure requirements, such as those in the ESG sourcebook, and to consider information requests that may come from EU financial services firms where there may be cross-border application of EU regulation.
- Firms should consider their exposure to external ESG ratings and data to ensure that there is appropriate governance around this.

Some of these regulations come from the Task Force on Climate-related Financial Disclosures (TCFD). The TCFD recommendations were driven by the Financial Stability Board (FSB) and set out climate-related financial disclosures to provide a standardised approach to ESG reporting. At a high-level, the ESG sourcebook sets out the following requirements:

- Annual public disclosure of climate-related reports on how climate-related risks and opportunities are factored in when managing or administering investments.
- Annual public disclosure of product-level reports to indicate a baseline of comparable disclosures. In client communications (such as annual fund reports and periodic client reports) that have an annual reporting deadline, a firm is to include its TCFD product report, or a reference and hyperlink to the report.

Further remedies

Following its Asset Management Market Study – which was published in 2017 and looked into whether competition is working effectively in the asset management sector and investors are getting value for money – the FCA published FCA PS 19/4 – 'further remedies'. This requires a fund's ESG components to be articulated clearly in the fund's name, objectives, investment strategy and holdings. Additionally, ESG covers both financial and non-financial aspects of a fund, and therefore disclosure of the latter is important from the perspective of the consumer for them to measure whether a fund is meeting non-financial objectives. The fund should be clear on the measurement of how non-financial objectives are met.

The FCA's 2019 feedback statement on climate change and green finance, (FS) 19/6, addresses the FCA's concern about the risk of greenwashing by firms through the overuse of buzzwords referencing 'green products'. This may mislead investors, which in turn could undermine confidence in the green sector. Therefore, ESG references in a fund's name should align with the fund's investment objectives, amongst other things. Any other fund-related documentation, including marketing material, should also be screened for such language.

Stewardship approach

The FCA supports arrangements for effective stewardship across the institutional investment community. Stewardship can be summarised as engagement with investee companies – through monitoring and interaction – as well as exercising voting rights attached to shares. This approach to stewardship ties in with the provisions in the requirements in the Shareholder Rights Directive as amended by SRD II, where relevant provisions have been included in the FCA's Conduct of Business (COBS) sourcebook. The territorial scope is broad as investments in shares of investee companies in regulated markets outside the UK (which include EEA and certain non-EEA markets) require disclosure.

Authorised fund managers are required to develop and publicly disclose an engagement policy – or provide a reason why they have not – so that investors can better exercise stewardship.

Where ESG factors are included as part of a firm's investment decisions when investing in an investee company, disclosure to certain institutional investors is required.

> "The fund should be clear on the measurement of how non-financial objectives are met."

Cross-border application

Under the Sustainable Finance Disclosure Regulation (SFDR), certain EU financial services firms are required to disclose sustainability information about their investments. Such disclosures are made in pre-contractual disclosures, reports and on the firm's website. SFDR can still apply to UK firms where UK fund managers market funds into the EU or where in-scope EU firms delegate portfolio or risk management to a UK domiciled fund manager.

The FCA issued discussion paper (DP) 21/4, which looks to implement sustainability disclosure requirements and sustainable investment labels, and the FCA is considering two levels of disclosure, including a consumer-facing layer of disclosure with ESG-related information and a detailed underlying entity-level and product-level disclosure aimed at institutional investors. A sustainability labelling and classification system is also proposed, which ties in to the FCA's agenda of combatting greenwashing.

ESG data and ratings providers

ESG ratings are rankings of the environmental, social and governance performance of companies or financial instruments. These form a benchmark for judgments.

Different ESG ratings agencies diverge on aspects of sustainability and their efforts may not always be comparable. Therefore, with little clarity and alignment on definitions, this may affect investment processes. A clear understanding of such ratings, in addition to ensuring transparency of the methodologies around such ratings, is becoming a key point of focus for the FCA. In line with the report by the International Organisation of Securities Commission (IOSCO) on this topic, we can expect due diligence requirements on ESG ratings and data products, public disclosure and transparency in ESG ratings and data products (including their methodologies and processes) and conflicts of interest requirements.

What is Shoosmiths up to on ESG?

8

What is Shoosmiths up to on ESG?

- Click here to learn more about the Shoosmiths Foundation.
- Click here to learn more about Shoosmiths' approach to diversity and inclusion.
- Click here to learn more about Shoosmiths' approach to social mobility.
- Click here to learn more about Shoosmiths' ESG priorities and the progress it is making.
- Click here to read our ESG blog, SHOUTback.
- Click here to read our annual ESG report and 2022 United Nations Global Compact report.
- Click here to read about Shoosmiths signing the Green Pledge, a global initiative to minimise the environmental impact of arbitration.
- Click here to read Shoosmiths FY21 Impact Report.
- Click here to read about Shoosmiths' SBTi approved emissions reduction targets.

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9

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- Grace Manning-Marsh, Planning and environmental specialist – LandTech
- Claudio Pirani, ESG team – ERG
- Bob Pritchard, Legal director – Shoosmiths
- Lynette Purves, Head of UK legal affairs – ERG
- Julian Richards, Partner – Shoosmiths
- James Wood-Robertson, Partner – Shoosmiths
- John Palmer, Partner – Shoosmiths

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