Baker McKenzie.

Bite-size Briefings

July 2021 Ed. No. 8

A series of briefings that take a "bite-size" look at international trends in different jurisdictions, drawing on Baker McKenzie's expert financial services practitioners.

Bite-size Briefings: Environmental, Social and Governance (ESG) regulation

This edition takes a bite-size look at the different rates of progress of environmental, social and governance (ESG) regulation and voluntary standards across the European Union, Hong Kong SAR, Japan, Singapore, the United Kingdom and the United States. The 2015 Paris Agreement on Climate Change specifically identified finance as having a key role in mitigating the effects of global warming, as large-scale investments are needed to significantly cut emissions. Nor, of course, are financial institutions themselves immune from the effects of climate change, as their prudential soundness and ability to meet long-term commitments will be jeopardized if the value of their capital is impacted. The COVID-19 pandemic has provided a significant impetus to the adoption of ESG regulation and voluntary standards, although the industry's progress is being slowed by a lack of common and consistent international standards over disclosure and classification. What was, initially, (largely) voluntary is becoming essential to win business and is, increasingly (especially in Europe), subject to legal and regulatory imperative, as exemplified by the number of jurisdictions proposing to make mandatory the Task Force on Climate-related Financial Disclosures (TCFD).

EU

The EU is currently at the forefront when it comes to sustainable finance. Against the backdrop of the European Commission's **action plan** on sustainable finance of March 2018, the EU adopted two key legislative pieces: the EU Taxonomy **Regulation** and the EU Sustainable Finance Disclosure **Regulation** (SFDR).

EU Taxonomy Regulation

The EU Taxonomy Regulation entered into force on 12 July 2020. It establishes the framework for the EU taxonomy by setting out the conditions that an economic activity has to meet in order to qualify as environmentally sustainable. The taxonomy is a classification system, establishing a list of environmentally sustainable economic activities. It is an important enabler to scale up sustainable investment and to implement the European Green Deal, whose aim is to make Europe climate neutral by 2050. In particular, by providing appropriate definitions to companies, investors and policymakers on which economic activities can be considered environmentally sustainable, it is expected to create certainty for investors, protect private investors from greenwashing, help companies to plan the transition, mitigate market fragmentation and eventually help shift investments to where they are most needed. Most of its provisions will apply from 31 December 2021.

SFDR

The SFDR applies from 10 March 2021 and introduces obligations on "financial market participants"[1] (FMPs) to disclose how they integrate ESG factors into their processes. The SFDR affects both firms and the investment products they market. Its overarching aim is threefold:

i. Prompting financial services providers that manage clients' assets or that advise clients on investments to integrate ESG into their processes and to inform their clients on ESG matters, which also include identifying ESG risks relating to investments.

ii. Creating a harmonized regulatory framework to ensure a level playing field across the financial services sector enabling investors to compare ESG factors when assessing investment opportunities.

iii. Requiring transparency from firms regarding their ESG policies through pre-contractual disclosure requirements, disclosures on their website and periodic reporting.

Importantly, not only businesses within the EU are affected by these disclosure requirements. All those offering financial products on the European market (e.g., US investment advisers marketing funds in the EU under the national private placement regime of a member state, which is a regime that allows, among others, non-EEA asset managers to market and distribute investment funds in the EU under certain conditions) and those falling under the EU's **Non-Financial Reporting Directive** (NFRD) will have to comply. This includes large public-interest companies with more than 500 employees, such as listed companies, banks and insurance companies.

Main consequences for FMPs

The EU Taxonomy Regulation and the SFDR affect FMPs in the following key areas:

- **Publish written policies:** FMPs should draft policies on how they integrate sustainability risks in their investment decision-making process. For these purposes, a "sustainability risk" is any ESG event or condition that could cause a material negative impact on the value of an investment.
- **Due diligence processes on sustainability:** FMPs must publish on their websites a statement of how they take into account "adverse impacts" on "sustainability factors" in their investment decision-making and a statement on what due diligence they do to understand those risks. If not, they must explain why they have taken this approach ("comply or explain").
- **Pre-contractual disclosures:** FMPs must describe in the pre-contractual information how they integrate sustainability risks into their investment decisions, as well as an assessment of the likely impact on the client's returns.
- **Website disclosures:** A lot of the information referred to above must be made available by the FMPs on their websites. Any information to be included in the periodic reports (see next bullet) must also be published there.
- **Periodic reporting:** Last, the FMPs must also report on financial products that promote sustainable characteristics or that have a sustainable objective.

[1] This is a new definition in the financial vocabulary and broadly means any financial service provider that manages or invests clients' money and/or markets financial products. It includes banks, MiFID II investment firms, UCITS and AIF ManCo's, etc.

What is next?

Both the EU Taxonomy Regulation and the SFDR empower the European Commission to adopt rules to specify how local regulators and FMPs must comply with the requirements in both regulations. Accordingly, some delegated "Level 2" legislation and other implementing measures are in the pipeline for the months and years to come.

Most notably, on 21 April 2021, the European Commission adopted an ambitious and comprehensive sustainable finance package. It constitutes a new milestone in the EU's agenda on sustainable finance and consists of the following:

- When adopted, the **EU Taxonomy Climate Delegated Act** will classify which activities best contribute to mitigating and adapting the effects of climate change. The Delegated Act is a living document and it will continue to evolve over time, in light of developments and technological progress.
- The new proposed **Corporate Sustainability Reporting Directive** will ensure that companies provide consistent and comparable sustainability information. It will extend the EU's sustainability reporting requirements to all large companies and all listed companies. Companies will have to report on how sustainability issues, such as climate change, affect their business and the impact of their activities on people and the environment.
- **Six amending delegated acts** will ensure that financial firms, such as advisers, asset managers or insurers, include sustainability in their procedures and their investment advice to clients. Once scrutinized by the European Parliament and the Council they are expected to apply as of October 2022.

Hong Kong SAR

Efforts in Hong Kong to promote and develop green and sustainable finance have been ongoing for some time but have seen a significant increase in pace and clarity in the last 12 months.[2] We highlight some of the important longer-standing initiatives along with the key aspects of the more recent strategic plan published by the cross-regulatory steering group.

Longer-term initiatives

Longer-term initiatives have included the following:

- In 2018, the Securities and Futures Commission's (SFC) published its "**Strategic Framework** for Green Finance."
- In 2019, the Hong Kong Monetary Authority (HKMA) published its key **measures** on sustainable banking and green finance.
- In 2020, the Green and Sustainable Finance Cross-Agency Steering Group (CASG) was created to accelerate the growth of green and sustainable finance in Hong Kong and support the government's climate strategies. The group comprises the SFC and the HKMA as co-chairs with the Financial Services and Treasury Bureau, Hong Kong Exchanges and Clearing Limited, the Insurance Authority and the Mandatory Provident Funds Schemes Authority all participating.

[2] Please refer to our earlier alert available at: Hong Kong: Green and sustainable finance — How governmental authorities are navigating climate risks (**globalcompliancenews.com**).

- In June 2020 the HKMA launched its "White Paper on **Green and Sustainable Banking**" which outlined nine guiding principles to assist authorized institutions (AIs) in developing a governance framework and strategy for managing the relevant risks and opportunities (including, among others, developing an approach to disclose climate-related information). This was followed in July 2020 by the issue of a **circular** highlighting best practices by majors banks to which other AIs were encouraged to have regard when developing their own plans.
- In October 2020, the SFC launched its **consultation** on the Management and Disclosure of Climate-related Risks by Fund Managers. The proposed changes include an amendment of the Fund Manager Code of Conduct to require fund managers to consider climate-related risks in their investment and risk management processes as well as to make appropriate disclosures to meet investor demands and combat greenwashing. The SFC also proposed, among other measures, to establish baseline requirements and enhanced standards for larger fund managers to improve the comparability of information across different fund managers enabling investors to make more informed decisions. The consultation conclusions are still pending and will need to be watched carefully for further development.
- In December 2020, the HKMA **announced** that it would be undertaking a climate risk stress test involving AIs in 2021.

Strategic Plan

In December 2020, the CASG **announced** the publication of its "**Strategic Plan** to Strengthen Hong Kong's Financial Ecosystem to Support a Greener and More Sustainable Future." The Strategic Plan has contributed to greater clarity regarding the way in which Hong Kong will seek to achieve carbon neutrality by 2050 and, more importantly, areas where financial services providers may potentially see further regulation and be affected as efforts move forward. The Strategic Plan contains six core focus areas, these are:

1. Strengthen the management of climate-related financial risks to consolidate Hong Kong's position as a global risk management center.
2. Promote the flow of climate-related information at all levels to facilitate risk management, capital allocation and investor protection.
3. Enhance capabilities of market participants and raise awareness among the public.
4. Encourage innovation and explore initiatives to facilitate capital flows toward green and sustainable causes.
5. Capitalize on the opportunities presented by the Mainland to develop Hong Kong into a green finance center in the Guangdong Hong Kong-Macao Greater Bay Area (GBA).
6. Strengthen regional and international collaboration.

The CASG has also agreed upon five near-term action points for implementation. These are:

i. Climate-related disclosures aligned with the TCFD **recommendations** will be mandatory across relevant sectors no later than 2025.

ii. Aim to adopt the Common Ground Taxonomy, which will be developed by mid-2021 by the International Platform on Sustainable Finance Working Group on Taxonomies co-led by China and the EU.

iii. Support the International Financial Reporting Standards Foundation's proposal to establish a new Sustainability Standards board for developing and maintaining a global uniform set of sustainability reporting standards.

iv. Promote climate-focused scenario analysis to assess the impacts on financial institutions under different climate pathways.

v. Establish a platform to act as a focal point for financial regulators, government agencies, industry stakeholders and academia to coordinate cross-sectoral capacity building, thought leadership and as a cross-sectoral repository of green and sustainable finance resources in addition to the Sustainable and Green Exchange.

We will continue to monitor developments in Hong Kong as the Strategic Plan and other initiatives are expanded and implemented by the Hong Kong government.

Japan

While Japan has adopted several generally applicable laws to promote ESG objectives, there is currently no mandatory legal and regulatory framework specifically regulating financial institutions and/or financial products with regard to ESG disclosure, ESG investment, financing or other activities. Instead, Japan has used soft law to promote ESG investment activities by institutional investors and public companies.

Japanese administrative authorities, such as the Japanese Financial Services Agency (JFSA), have issued several guidelines to help a broad range of financial institutions and market participants align their activities with international ESG standards. These guidelines include the Basic Guidelines on Climate Transition Finance, the Guidelines for Investor and Company Engagement and the Green Bond Guidelines.

Among these, the Japanese Stewardship Code (SS Code) prepared by the JFSA and the Japanese Corporate Governance Code (CG Code) prepared by the Tokyo Stock Exchange were recently amended to meet ESG expectations.

In March 2020, the SS Code was amended to encourage institutional investors to include sustainability and sustainable growth in their investment policies and to take into account nonfinancial factors in their investment management strategies.

The highlights of the June 2021 amendments to the CG Code are:

- Companies should take appropriate measures to address sustainability issues, including social and environmental matters (Principle 2.3).
- Companies should appropriately disclose their initiatives on sustainability when disclosing their management strategies, and listed companies should collect and analyze data on climate change and enhance the quality and quantity of disclosure based on the TCFD recommendations (Supplementary Principle 3.1.3).

Lack of ESG disclosure rules

Companies, including financial institutions, must disclose financial information in accordance with the Financial Instruments and Exchange Act and the Companies Act. However, there are no laws that directly impose disclosure of ESG-related information. Nevertheless, many Japanese financial

institutions have voluntarily chosen to adopt international standards, such as those recommended by the TCFD and the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI) Standards or the International Integrated Reporting Council (IIRC) framework.

Public and private initiatives to promote ESG-related activities and beyond

Japan's Government Pension Investment Fund (GPIF), the world's largest pension fund, has lead the way in expanding ESG investment by ratifying the Principles for Responsible Investment (PRI) in 2015. Moreover, GPIF's rules have recently been amended to allow it to invest in assets other than securities, and GPIF must take ESG considerations into account. As a result, investment in and finance of sustainable projects by asset owners and institutional investors have been steadily increasing.

The Japanese Bankers Association is also very active on ESG-related investment and financing, and Japanese banks actively participate in sustainable finance transactions. The Japanese "megabanks" have placed sustainability at the center of their strategy and have committed to promote ESG in their activities through carbon emission reduction pledges and sustainable investment and financing frameworks. As Prime Minister Yoshihide Suga declared in October 2020 that Japan must become carbon neutral by 2050, it is more than likely that ESG-related investment will further accelerate in Japan.

Singapore

Singapore launched the **Green Plan 2030** to advance the national agenda on sustainable development, reflecting its commitment to global climate action (Singapore **signed** the Paris Agreement on 22 April 2016 and ratified it on 21 September 2016). The key pillars identified in the Green Plan include the green finance ecosystem, expressed as the **Green Finance Action Plan** (GFAP) with initiatives and targets implemented by the Monetary Authority of Singapore (MAS), such as:

- strengthening financial institutions' (FIs) resilience to environmental risks
- developing markets and financial solutions
- harnessing technology for trusted and efficient financial flows

MAS has articulated the GFAP through actions in several areas, including:

- the Environmental Risk Management Guidelines to drive **banks**, **insurers** and **asset managers** to integrate environmental risk considerations in their financing and investment decisions and to promote new opportunities for green financing
- a **grant** to (i) support corporations to obtain green and sustainable loans, which covers the expenses of engaging independent sustainability assessment and advisory service providers to validate the green and sustainability credentials of the loan, and (ii) encourage banks to develop frameworks for green and sustainability-linked loans for small and medium-sized enterprises
- the **Green Investments Programme**, where MAS will place USD 2 billion with selected asset managers that demonstrate a commitment to drive regional green efforts out of Singapore and contribute to MAS' other green finance initiatives

FIs should take note of the recent measures, undertaken by MAS in its function as central bank and regulator, to strengthen FIs' resilience against environmental risks by:

- enhancing environmental risk management
- promoting high-quality sustainability related disclosures

Enhancing environmental risk management: MAS' guidelines on environmental risk management apply to all FIs and the guidelines set out MAS' expectations for FIs to assess, monitor, mitigate and disclose environmental risks such as:

- climate change
- pollution
- loss of biodiversity
- changes in land use

MAS convened the **Green Finance Industry Taskforce** (GFIT) with representatives from FIs and chaired by the CEO of HSBC Singapore to drive this initiative with the private sector. GFIT has issued an **implementation handbook** on best practices in environmental risk management. In the second half of 2021, MAS will review the FIs' progress in implementing the guidelines and publish an information paper to share best practices and areas for improvement. By the end of 2022, MAS intends to conduct stress tests under a range of climate change scenarios developed by the Network for Greening the Financial System.

Climate-related disclosures: The Environmental Risk Management Guidelines will require all banks, insurers and asset managers to make climate-related disclosures from June 2022, in accordance with well-regarded international reporting frameworks, such as the TCFD recommendations. In addition, MAS is anticipating a baseline global sustainability reporting standard to be agreed upon soon, and MAS has stated that it will **consult** the financial sector later in 2021 on the imposition of legally binding mandatory climate-related disclosures by FIs against a single, internationally aligned standard. Together with the Singapore Exchange (SGX), the roadmap will be phased to prioritize listed entities and larger financial institutions, which will be expected to align their climate-related reporting to the TCFD recommendations.

United Kingdom

Regulating sustainability and ESG remains a core focus area for the UK government, which will host COP26 in October 2021, and the chancellor has instructed financial regulators to consider climate change and the government's commitment to achieve a net zero economy by 2050 when discharging their functions. The pace of legislative and regulatory change on sustainability continues to accelerate: the UK government's commitment to meet its net zero target by 2050 and position itself at the forefront of green finance has spawned a number of initiatives, in particular:

- issuing its first green bond in September 2021
- introducing new environmental disclosure standards
- introducing climate-related financial disclosures applicable to nearly all financial services market participants becoming mandatory by 2025
- implementing a green UK taxonomy

The EU, however, is undoubtedly setting the legislative marker in this area, with core regulations on a green taxonomy and ESG disclosures continuing to apply on a rolling basis, and a consultation

underway on proposals to expand the disclosure regime further, so firms in the UK are increasingly having to navigate ever more disparate regimes.

The extent to which the UK's regulatory and legislative developments will diverge from the EU's regime remains to be seen. Neither the EU's Taxonomy Regulation nor the SFDR took effect before the end of the Brexit transition period and, as a result, they were not comprehensively onshored into UK law; nevertheless, both remain relevant for certain UK firms doing cross-border business in the EU, or where group compliance policies or investor pressure leads to voluntary implementation. This means that uncertainty around potential divergence from the EU is a core concern for UK firms, given overlapping and potentially incongruent requirements. However, the government has maintained its intention to take the scientific metrics in the EU taxonomy as its basis and adapt if deemed necessary for the UK market. Industry groups have been vocal in support for a UK strategy that remains aligned with the EU, at least in the short term, to provide certainty to market participants, while urging the UK government to provide clarity on its approach to the SFDR. A new Green Technical Advisory Group (GTAG), formed in early June 2021, has been established to provide independent, nonbinding advice to the government on developing and implementing a green taxonomy in the UK context, with initial recommendations expected in September 2021.

Most recently, the Financial Conduct Authority (FCA) has launched **consultations** on expanding climate-related financial disclosure requirements to asset managers, life insurers and FCA-regulated pension providers, as well as certain **issuers** of standard listed equity shares, and is seeking views on other topical ESG issues in capital markets. The FCA will also be introducing a new ESG Sourcebook for rules and guidance on climate-related disclosures, which is likely to expand over time to include new rules and guidance on other climate-related and wider ESG topics. The Bank of England has also launched the 2021 Climate Biennial Exploratory Scenario, which will test the resilience of the UK financial system to the physical and transition risks associated with different climate pathways.

United States

Investors increasingly are directing capital to sustainable investment strategies that reflect ESG factors. This substantial growth in ESG investing is occurring against the backdrop of an evolving regulatory environment. The U.S. Securities and Exchange Commission (SEC) has **solicited** public input and is now evaluating the many submissions received and is considering rules regarding issuer disclosure of, at least, climate risks and human capital. This process is playing out alongside a very public disagreement between the SEC Commissioners on the topic, even as new SEC Chair Gary Gensler attempts to move this important part of the regulatory agenda forward.

The SEC's regulatory framework is based largely on disclosure, rather than prescriptive rules designed to drive specific conduct. The ESG space is no different. As a result, the current debate around the SEC's approach to sustainable investing focuses largely on whether the SEC should mandate specific ESG disclosure, particularly for public companies. On 7 July 2021, the SEC's Asset Management Advisory Committee (AMAC) made **recommendations** to the SEC designed to improve data and disclosure used for ESG investing, to improve transparency for investors, and enable better verification of investment products' ESG strategies and practices. The AMAC stopped short of recommending that the SEC adopt specific mandated disclosure of material ESG matters through rulemaking or that it require the adoption of third-party standards (akin to GAAP) by which corporate issuers disclose material ESG risks. Instead, the AMAC recommended that the SEC encourage issuers to adopt a framework to disclose material ESG matters, or explain why they choose not to do so, and that the SEC accelerate its study of third-party SEC disclosure frameworks. It is not clear that

the SEC will follow AMAC recommendations to go slowly, particularly given SEC Chair Gensler's stated goal to improve consistency and comparability in issuer disclosures to make it easier for investors to evaluate U.S. issuers and also to evaluate U.S. companies against their foreign counterparts.

On the asset management side, AMAC's recommendations prefer the use of best practice guidance, in contrast to more prescriptive approaches which could be "counter-productive given the early state of the evolution of ESG investing [and that] strong rulesets might, at this point, freeze development of investment and measurement approaches in this investing style." These best practices would align with the taxonomy developed by the Investment Company Institute (ICI) ESG Working Group, as well as providing a clear description of each product's strategy and investment priorities, for example, a description of non-financial objectives (i.e., environmental impact or adherence to religious requirements).

In addition to disclosure, the SEC is also focused on updating its "Names Rule" which is designed to ensure that names of mutual funds and other registered investment products accurately reflect the types of assets in which a fund is invested.

Meanwhile, the SEC Examination and Enforcement Division staff have announced their intent to focus on identifying what they view to be inaccurate or incomplete disclosure on ESG-related issues, and on misconduct involving the management and sale of ESG investment products by asset managers and financial intermediaries. Here, the SEC's Division of Examinations (EXAMS) recently issued a **Risk Alert** sharing its observations from recent examinations on how investment advisers, registered investment companies, and hedge funds approach ESG investing. Due to concerns about retail investor confusion from the lack of ESG defined standards, it is increasingly important for firms to "clearly and consistently" explain how they define such terms - i.e., how they name and describe investment objectives, and market funds and investment strategies. Firms also need to maintain records to show how they have implemented ESG investment processes in a manner consistent with those definitions. EXAMS and Enforcement do not need to wait for new rulemaking. Together with the newly created Climate and ESG Task Force at the Division of Enforcement, they can utilize the existing more general anti-fraud principles governing false or misleading statements to existing or prospective investors, among other provisions.

Contacts

European Union

Olivier Van den broeke
Associate
olivier.vandenbroeke
@bakermckenzie.com

Steffi Illegems
Associate
steffi.illegems
@bakermckenzie.com

Hong Kong SAR

Karen Man
Partner
karen.man
@bakermckenzie.com

Aaron Dauber
Knowledge Lawyer
aaron.dauber
@bakermckenzie.com

Japan

Akiko Hosokawa
Partner
akiko.hosokawa
@bakermckenzie.com

Wataru Inagaki
Associate
wataru.inagaki
@bakermckenzie.com

Michaël Tiralongo
Associate
michael.tiralongo
@bakermckenzie.com

Singapore

Stephanie Magnus
Partner
stephanie.magnus
@bakermckenzie.com

Sek Cheong Yong
Knowledge Lawyer
sek.cheong.yong
@bakermckenzie.com

United Kingdom

Caitlin McErlane
Partner
caitlin.mcerlane
@bakermckenzie.com

Kimberly Everitt
Knowledge Lawyer
kimberly.everitt
@bakermckenzie.com

United States

Jennifer L. Klass
Partner
jennifer.klass
@bakermckenzie.com

Amy J. Greer
Partner
amy.greer
@bakermckenzie.com

One Global Financial Services Regulatory Team

The financial services industry is undergoing sweeping changes driven by regulatory developments, rapidly advancing technology and continued consolidation in the sector. The far-reaching impact of financial reforms, intricacies in their implementation, and conflicting regulations in different jurisdictions can expose businesses to unforeseen risk.

Our global team provides financial institutions guidance on navigating through regulatory complexities in both established and emerging markets. Our lawyers have long-standing relationships with financial services regulators, and are experienced in helping financial institutions deliver financial services efficiently and cost-effectively in a compliant manner.

From set-up and structuring, new business and product offerings, operational support as well as representation in non-contentious and contentious matters, we apply our industry knowledge and regulatory expertise to deliver result-oriented and compliant solutions for all types of financial institutions including banks, insurance companies, payments companies, securities firms and asset managers.

bakermckenzie.com

© 2021 Baker McKenzie. All rights reserved. Baker & McKenzie International is a global law firm with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner or equivalent in such a law firm. Similarly, reference to an "office" means an office of any such law firm. This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.