CLIFFORD

CHANCE

GROWING THE GREEN ECONOMY

ADDRESSING THE SUSTAINABILITY CHALLENGES AND OPPORTUNITIES

GROWING THE GREEN ECONOMY
INTRODUCTION

The severe warnings on climate change are starkly documented. The Report by the Intergovernmental Panel on Climate Change (IPCC), and other reports demonstrate why urgent action to meet the goals of the Paris Agreement is needed.

Almost every day new stories appear on how climate change is affecting our planet, from huskies swimming in arctic meltwater to wild fires in California. The public are taking notice and taking action, as exemplified in the protests by global school children started by Greta Thunberg and the Extinction Rebellion. Indeed, the term Climate Emergency has entered the common lexicon. However, while environmental risks have taken centre stage there is a growing recognition and understanding that the net must be cast wider – action to protect the planet and facilitate the transition to the low/zero carbon economy must take into consideration social goals, such as access to education, housing, and jobs, and must be sustainable and "just" in the broadest sense. Governments, legislators and regulators understand this and are beginning to respond accordingly.

Not surprisingly much of the legislative effort to date has been focused on the financial system and facilitating at pace the transition to a low carbon and sustainable economy. The European Union has taken the lead on this, and review and analysis of its Sustainable Finance Action Plan is included in a number of articles in this publication. The creation of a sustainable "taxonomy" forms the centrepiece of this plan. However, there is an increasing emphasis on non-financial entities and the requirements that are beginning to be expected of them; in particular, much more detailed disclosure on how environmental, social and governance (ESG) factors are monitored, how these are incorporated into corporate strategies and how they impact on financial performance. These expectations are being placed on corporates both by legislation, such as the EU Non-Financial Reporting Directive, and by shareholder activism and non-legal recommendations, such as those published by the Task Force for Climate related Financial Disclosures. Financials and corporates alike are also likely to be spurred to action by the increasing risks that flow from an inadequate response to ESG issues, demonstrated by a growing number of claims being brought against different entities across the globe.

Consequently, the scope of this publication is much wider than our earlier publication, Greening the Financial System, which primarily discussed trends in green financing. It reflects the breadth and depth of the impact of these environmental and sustainable factors. We look at the impact of regulatory and legislative sustainability changes on, amongst others, corporates, banks and asset managers. We look at the rise of climate change litigation and consider how potential claims are likely to increase. And we examine again the developments in "green" and sustainable financial products across the world.

In short, what we are seeing now means no one can be complacent that it remains 'business as usual'. We are not complacent. Clifford Chance is committed to the UN's 2030 Agenda for Sustainable Development, managing our own footprint and contributing to the development of a more sustainable world. The ESG and sustainability agenda must be embraced and shaped. And while we recognise that there are risks we also see opportunities for our clients. We look forward to discussing these with you.

Jeroen Ouwehand
Senior Partner

CONTENTS

SECTION 1
THE EU SUSTAINABLE FINANCE ACTION PLAN

1. **STATUS TABLE**
   PROGRESS AND NEXT STEPS 7
2. **SUSTAINABILITY TAXONOMY**
   USAGE, ISSUES AND CHALLENGES 12

SNAPSHOT
GUIDELINES FOR CLIMATE REPORTING
ACTION POINT 9 74

LOW CARBON BENCHMARKS REGULATION
ACTION POINT 5 76

SECTION 2
SPOTLIGHT ON

3. **CLIMATE CHANGE LITIGATION**
   TACKLING CLIMATE CHANGE THROUGH THE COURTS 27
4. **ESG ISSUES FOR CORPORATES**
   RISKS AND OPPORTUNITIES 35
5. **SUSTAINABLE FINANCE**
   THE IMPACT FOR BANKS AND INVESTMENT FIRMS 54
6. **CLARIFYING DUTIES**
   WHAT ASSET MANAGERS NEED TO KNOW.................................... 59
7. **ESMA CONSULTATION ON SHORT-TERMISM IN FINANCIAL MARKETS**
   WHAT ARE THE ISSUES FOR ASSET MANAGERS? 66
8. **CREDIT RATING AGENCIES**
   NEW GUIDANCE ON DISCLOSURE FROM ESMA.. 71

Use the icons to navigate the document sections

SECTION 3
PRODUCTS

9. **THE NEW EU GREEN BOND STANDARD**
TIGHTENING THE GUIDELINES TO WIDEN THE MARKET 79

10. **FROM JUNK BONDS TO JUST BONDS**
THE INCREASING IMPORTANCE OF ESG FINANCING IN EUROPEAN HIGH-YIELD MARKETS............................ 82

11. **THE RISE OF SUSTAINABILITY-LINKED LOANS**
MARKET DEVELOPMENTS AND OPPORTUNITIES 89

12. **BLUE BONDS**
EXPANDING TO THE OCEANS 92

13. **CLEAN, GREEN ENERGY**
THE EVOLUTION IN THE RENEWABLES INDUSTRY 94

14. **CLIMATE CHANGE AND THE PRESSURE ON COAL**
LATEST DEVELOPMENTS 99

SECTION 4
GLOBAL PERSPECTIVES

15. **US**
GREEN BONDS: BRIDGING THE GAP 105

16. **ASEAN**
GREEN BOND STANDARDS AND SOCIAL SUSTAINABILITY BONDS 107

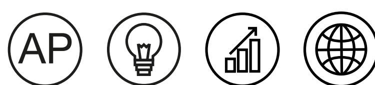
17. **GREATER CHINA REGION**
THE DEVELOPMENT OF THE GREEN BOND MARKET 112

18. **JAPAN**
GROWTH OF GREEN FINANCING 118

19. **FRANCE**
INCREASED DISCLOSURE IN THE GREEN BOND MARKET 119

20. **LUXEMBOURG**
A EUROPEAN SUSTAINABLE FINANCE HUB 126

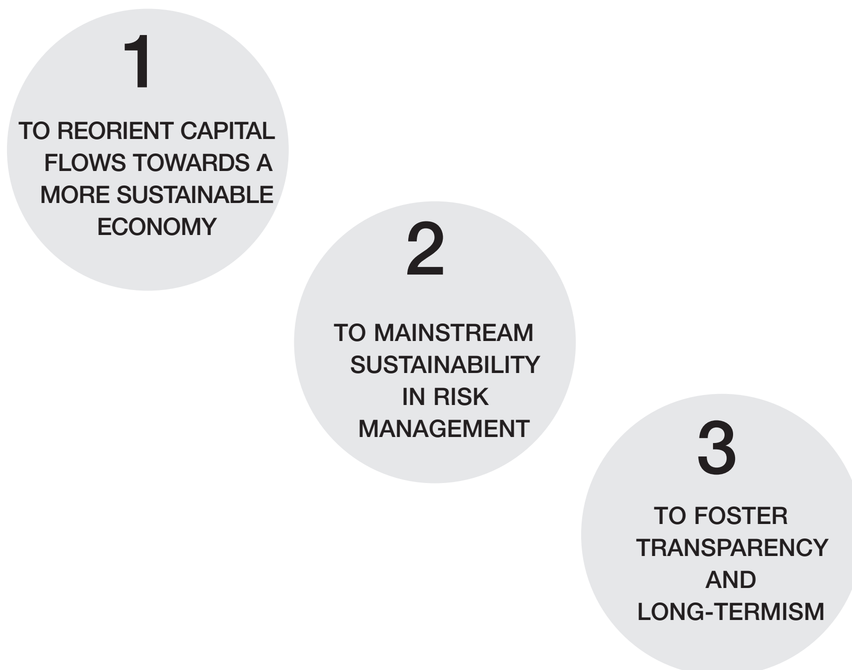
21. **MIDDLE EAST**
THE EVOLUTION OF SUSTAINABLE CAPITAL MARKETS 129


AP

THE EU
SUSTAINABLE
FINANCE
ACTION PLAN

1. STATUS TABLE
PROGRESS AND NEXT STEPS

The European Commission launched its Action Plan on Financing Sustainable Growth (the **Action Plan**) in March 2018. This plan is comprehensive and ambitious, with three broad aims:



These aims are scoped in further detail in 10 separate action points. Some of the action points have been more fully realised than others, but the progress made since the publication of the Action Plan is impressive and reflects the EU's commitment to the sustainability and low carbon transition agenda. This continuing commitment is reflected in the European Council's *New Strategic Agenda 2019 – 2024*, which lists "building a climate-neutral, green, fair and social Europe" as one of its four main priorities.

Status table

The breadth of the Action Plan and the pace of development can make tracking progress on specific points challenging. The status table aims to draw together the different strands of the Action Plan and reflects progress made to date on each of the 10 action points; however, given the scale of the Action Plan, it is not a fully comprehensive overview of all the work undertaken by the EU in this area.

The status table signposts where particular topics are discussed in greater depth in individual articles in this publication.

ACTIONS AIMED AT REORIENTING CAPITAL FLOWS TOWARDS A MORE SUSTAINABLE ECONOMY

1. Establishing an EU classification system for sustainable activities

See also page 12

Status	Next steps
The Commission published its proposal in May 2018. The Parliament published its proposal on 28 March 2019. The Council has not yet published its position.	Q3/4 2019: the Council to publish its position followed by triologue discussions between the Parliament and the Council.
The Commission requested the Technical Expert Group on sustainable finance (**TEG**) to assist in developing its legislative proposals on the taxonomy. The TEG published its initial proposals in December 2018 and its detailed Taxonomy Technical Report on climate change mitigation and adaptation activities on 18 June 2019.	The TEG launched a further call for feedback on its Taxonomy Technical Report on 4 July 2019, which will be open until 13 September 2019. It will submit a further report to the Commission in December 2019. The TEG reports will form the basis of the delegated acts needed to implement the taxonomy. The Commission's draft regulation indicated that the delegated act on climate change mitigation and adaptation will be effective in Q2 2020.

2. Creating standards and labels for green financial products

See also page 79

Status	Next steps
The Commission requested the TEG to assist in developing an EU Green Bond Standard. The TEG published its Interim Report in March 2019 and its Final Report on 18 June 2019.	No further feedback is expected on the Final Report. The TEG will continue to work on its proposal for accreditation of external verifiers.
The EU Joint Research Centre published a technical report in relation to the development of the EU Ecolabel criteria for Retail Financial Products in March 2019. A first Ad-hoc Working Group meeting was held in April 2019, and subsequent sub-group meetings have been held to discuss the technical report.	Q3 2019: next Ad-hoc Working Group meeting.

3. Fostering investments in sustainable projects

Status	Next steps
The European Fund for Sustainable Development 2018 Operational Report was published in June 2019. This states that the EU has allocated EUR3.7 billion in grants and guarantees for sustainable development.	No detailed further information publicly available

4. Incorporating sustainability when providing financial advice

Status	Next steps
The Commission published draft delegated regulations for investment firms and insurance distributors in January 2019 amending MiFID II and the Insurance Distribution Directive to ensure that investment firms and insurance distributors take sustainability issues into account when advising clients. Although adoption of these delegated regulations depends on the publication of the Disclosure Regulation (see Action Point 7), the intention is that investment firms and insurance distributors prepare to take ESG factors into account in the suitability assessments they undertake now.	Official publication of the delegated regulations depends on the timing of the Disclosure Regulation (see Action Point 7).
ESMA Guidelines on certain aspects of MiFID II suitability requirements published in May 2018 specify that it is good practice for firms providing the services of investment advice or portfolio management to collect information on the client's preferences on ESG factors.	ESMA Guidelines are applicable.

5. Developing sustainability benchmarks

See also page 76

Status	Next steps
The Commission published its proposals in May 2018. Political agreement was reached in February 2019. The Parliament passed its legislative resolution on 26 March 2019 and on 5 April 2019 the Council adopted the Parliament position.	Q3/4 2019: expected date of publication in Official Journal.
The Commission requested the TEG to assist in developing methodology on low carbon benchmarks. The TEG published its Interim Report on Climate Benchmarks and Benchmarks' ESG Disclosures on 18 June 2019.	A call for feedback opened on 4 July 2019 and will close on 2 August 2019. The TEG will prepare a final report by end September 2019. The report will form the basis of the delegated acts needed to implement the regulation.

ACTIONS AIMED AT MAINSTREAMING SUSTAINABILITY INTO RISK MANAGEMENT

6. Better integrating sustainability in ratings and market research

See also page 71

Status	Next steps
EMSA conducted a review of credit rating agency ESG practices and consulted on disclosure guidelines. It published its Technical Advice and Final Guidelines on 18 July 2019.	March 2020: Guidelines effective.

7. Clarifying institutional investors' and asset managers' duties (the Disclosure Regulation)

See also page 59

Status	Next steps
The Commission published its proposals in May 2018. The Parliament and the Council reached political agreement on 7 March 2019 and the regulation is proceeding through the EU legislative process.	Q3/4 2019: expected date of publication in Official Journal.
Separately, the Commission requested technical advice from ESMA and EIOPA in July 2018 on how asset managers, insurance companies and investment or insurance advisers should integrate sustainability risks into their businesses.	
ESMA and EIOPA consulted and delivered their technical advice to the Commission on 30 April 2019: (i) ESMA Technical Advice Final Report on UCITS Directive; (ii) ESMA Technical Advice Final Report on MiFID II and (iii) EIOPA Technical Advice and Impact Assessment on Solvency II.	The Commission to determine next steps to act on the recommendations in the ESMA and EIOPA Final Reports.

8. Incorporating sustainability in prudential requirements

Status	Next steps
CRD5 directs the EBA to assess whether ESG risk should be included in the supervisory review and evaluation process (**SREP**) by competent authorities.	Q2/3 2021: EBA to publish report.
CRR2 requires large institutions with securities admitted to trading on an EU regulated market to disclose information on ESG related risks, including physical and transition risk.	Q2/3 2022: CRR2 requirement to apply.
Current draft of the Investment Firms Directive (**IFD**) requires the Commission to report whether ESG risks should be included in the SREP for investment firms subject to IFD. Investment Firms Regulation (**IFR**) requires public disclosure of ESG risks for investment firms subject to IFD.	Q2/3 2019: expected date of publication in Official Journal. Q4 2023: the ESG requirements to apply three years after date of application of IFD and IFR (being 18 months from entry into force).
The Commission requested EIOPA to provide an opinion on sustainability within Solvency II in August 2018. EIOPA requested evidence from market participants on the integration of sustainability risks and factors in (re)insurers' investment and underwriting and, based on evidence received, published, and is consulting on, a draft opinion on sustainability within Solvency II on 3 June 2019. The consultation closed on 26 July 2019.	Q3 2019: EIOPA to deliver its final opinion to the EU Commission.

ACTIONS AIMED AT FOSTERING TRANSPARENCY AND LONG-TERMISM

9. Strengthening sustainability disclosures and accounting rule-making

See also page 74

Status	Next steps
The Commission ran a consultation from March to July 2018 on a number of pieces of legislation as part of its "fitness check" on EU legislation relating to public corporate reporting, including the Non-Financial Reporting Directive (**NFRD**) and the IAS Regulation. It published a summary report on the consultation in October 2018.	Q2/3 2019: Commission to report on the overall fitness check in a Commission Staff Working Document.
In January 2019, the TEG published its report on climate-related disclosures (including on NFRD) followed by a Commission consultation on its proposed revisions to the non-binding guidelines to the NFRD. The Commission published its final non-binding guidelines on non-financial reporting: Supplement on reporting climate-related information on 18 June 2019.	Commission Guidelines in effect.
The European Reporting Lab@ EFRAG was established in September 2018 to encourage innovation in corporate reporting and sharing of best practice. It launched its first project on climate-related reporting in February 2019.	No date specified for completion of the project.
The Commission requested advice from EFRAG on the impact of IFRS 9 and alternative measurement approaches on long-term investing and EFRAG launched a consultation in June 2019. Consultation now closed.	Q3/4 2019: EFRAG to report to Commission.

10. Fostering sustainable corporate governance and attenuating short-termism in the capital markets

See also page 66

Status	Next steps
In February 2019, the Commission requested advice from ESMA, EBA and EIOPA on undue short-term pressure from the financial sector on corporations.	Q4 2019: final advice expected.
ESMA published a Consultation on short-termism in financial markets on 24 June 2019. The consultation is open until 29 July 2019.	Q4 2019: ESMA to deliver its report to the Commission.
In January 2019, the Commission ran a conference on sustainable corporate governance to discuss policy developments and share best practice.	No details on next steps available.
The revised Shareholder Rights Directive (EU) 2017/828) aims to promote effective stewardship and long-term investment decision-making.	10 June 2019: applies in all Member States.

EU SUSTAINABLE FINANCE ACTION PLAN KEY CONTACTS

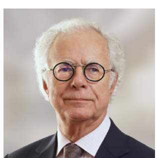
Clare Burgess
Partner
T: +44 20 7006 1727
E: clare.burgess@cliffordchance.com

Michael Coxall
Knowledge Director
T: +44 20 7006 4315
E: michael.coxall@cliffordchance.com

Nigel Howorth
Partner
T: +44 20 7006 4076
E: nigel.howorth@cliffordchance.com

Gail Orton
Head of EU Public Policy
T: +33 1 4405 2429
E: gail.orton@cliffordchance.com

Peter Pears
Senior Associate
T: +44 20 7006 8968
E: peter.pears@cliffordchance.com

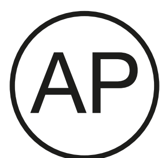


Michel Petite
Avocat of Counsel
T: +33 1 4405 5244
E: michel.petite@cliffordchance.com

Dr. Thomas Voland
Partner
T: +49 211 4355 5642
E: thomas.voland@cliffordchance.com

Jessica Walker
Knowledge Director
T: +44 20 7006 2880
E: jessica.walker@cliffordchance.com

José Luis Zamarro
Partner
T: +34 91 590 7547
E: joseluis.zamarro@cliffordchance.com



2. SUSTAINABILITY TAXONOMY
USAGE, ISSUES AND CHALLENGES

Development of a taxonomy for environmentally sustainable activities is a cornerstone of the EU Sustainable Finance Action Plan. In March 2018, the Commission published its draft taxonomy regulation (the **Regulation**) and, to date, the Parliament has put forward its suggested amendments but the Council has yet to publish its proposal. The Regulation will continue to proceed through the EU political process during the remainder of the year.

This article looks at:

- how the taxonomy will operate
- who will use the taxonomy
- when the taxonomy will be used
- issues and challenges with the taxonomy

This article looks at how the proposed taxonomy is intended to operate, who will use it and for what purposes. We also look at some of the issues raised by the approach taken to the taxonomy and the challenges involved.

Overview of the taxonomy

The basic premise of the taxonomy is to describe when an activity (not a company or an asset) can be classified as environmentally sustainable. It is designed to apply to any EU or national regulator that sets out requirements relating to financial products or corporate bonds that are marketed as environmentally sustainable, and also to financial market participants that offer financial products as environmentally sustainable investments.

An environmentally sustainable activity must satisfy four tests under the proposed Regulation:

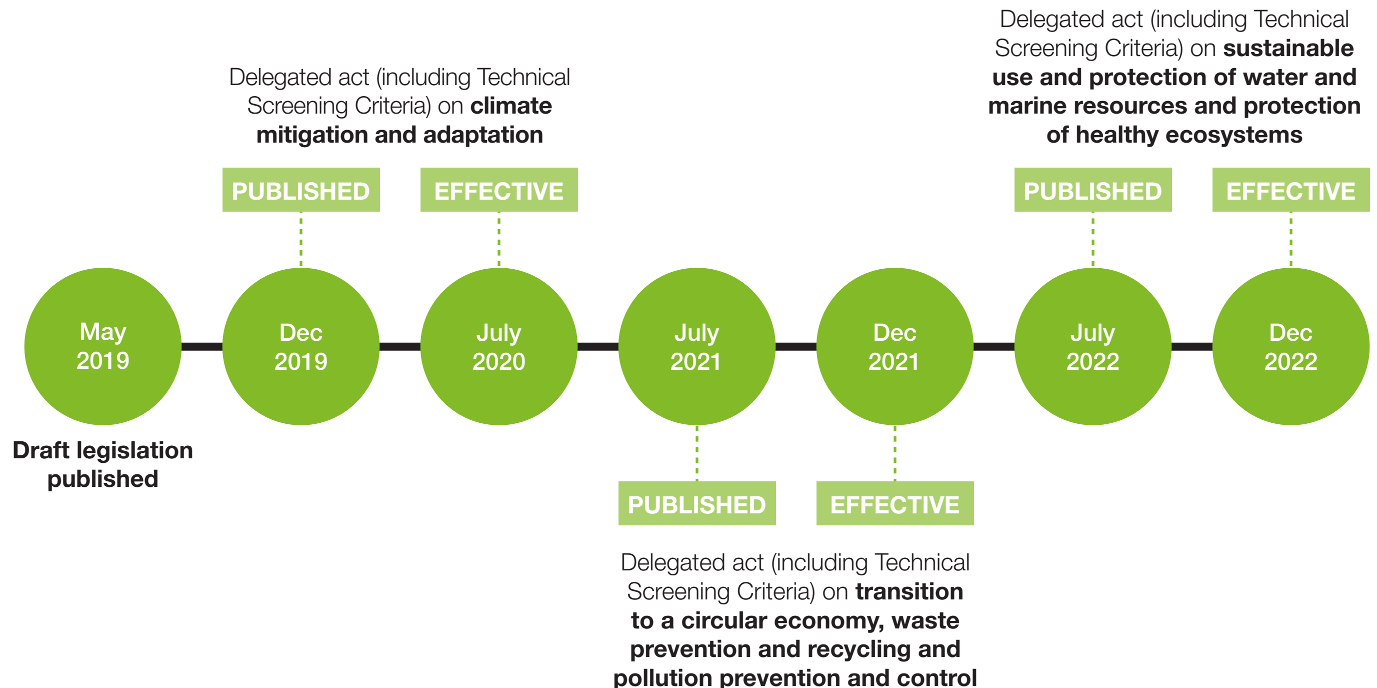
1. it makes “substantial contribution” to one or more of the environmental objectives;
2. it does not significantly harm any of the environmental objectives (Do No Significant Harm or **DNSH**);
3. it must be carried out in compliance with minimum social safeguards, essentially the eight fundamental conventions identified in the International Labour Organisation’s declaration on Fundamental Rights and Principles at Work, such as non-discrimination, equal pay and the right to organise; and
4. it must comply with any specified Technical Screening Criteria (**TSC**) – the TSC will set out in more detail what “Substantial Contribution” and “DNSH” are for each activity in all relevant sectors.

EU Taxonomy

What is an 'environmentally sustainable' activity?

Environmental Objectives

The proposed Regulation leaves future delegated regulations to establish the TSC to determine whether any particular activity is sustainable. The Commission requested the Technical Expert Group on Sustainable Finance (the **TEG**) to advise it on the TSC for each of the individual environmental criteria. Unsurprisingly, creation of the TSC is a significant undertaking and they will be developed gradually over a period up to July 2022 (see below), although this timeframe was set out in the proposed Regulation and may prove, in practice, to be ambitious.



The Technical Expert Group and the development of the screening criteria

The TEG's work, to date, has been on the creation of TSC for the climate change mitigation and adaptation objectives. Following initial stakeholder consultation, the TEG published its first Technical Report in June 2019 setting out suggested detailed TSC for these objectives.

The development of TSC for the other environmental objectives will be addressed in a staggered manner reflecting the timing set out above.

The TEG sought to identify and assess those sectors and activities that bring (or could bring) the most significant contribution to the climate change mitigation and adaptation objectives. In doing so, it adopted the existing NACE[1] industrial classification of economic activities to classify activities into macro-sectors viewed as priority sectors. The report then established detailed TSC for each priority activity. It is worth repeating that the Regulation and the TSC focus on environmentally sustainable *activities*, as opposed to *investible entities*. This allows for the taxonomy to be used by businesses that pursue both activities that can be classed as sustainable and others that cannot.

As required by the proposed Regulation, the TEG assessed activities based on all relevant information, including scientific data and analysis, existing taxonomy frameworks or through its consultation exercises. Quantitative criteria were used wherever possible, including thresholds for considering an activity sustainable. The TEG also applied its own principles, which included ensuring that the criteria were flexible, easy to use and supportive of transition activities.

Defining the "Substantial Contribution" to the objectives

Climate change mitigation

Article 6 of the proposed Regulation establishes when an activity should be considered to make a substantial contribution to climate change mitigation.

The TEG prioritised the following sectors based on emission levels and mitigation opportunities:

- Agriculture, forestry and fishing
- Manufacturing
- Electricity, gas, steam and air conditioning supply
- Water, sewerage, waste and remediation
- Transportation and storage
- Information and communication technologies
- Buildings (construction and real estate activities, with application to other sectors where appropriate).

1 Nomenclature des Activités Économiques dans la Communauté Européenne (NACE), a European industry standard classification system.

Climate change mitigation

Substantial Contribution: activity that contributes substantially to stabilisation of greenhouse gas concentrations by reducing emissions or enhancing removals, through:

- generating, storing or using renewable energy or climate-neutral energy
- improving energy efficiency
- increasing clean or climate-neutral mobility
- switching to use of renewable materials
- increasing carbon capture and storage use
- phasing out anthropogenic emission of greenhouse gases
- establishing energy infrastructure to enable decarbonisation of energy systems
- producing clean and efficient fuels from renewable or carbon-neutral sources

TSC have then been created for priority activities in each of these sectors (the full list of 67 activities is set out in the Annex). TEG classified each of these activities into three types of activity and applied criteria accordingly.

	Types of activity		
	"Green" activities	"Greening of" activities	"Greening by" activities
Features of the activity	Very low and zero emission activities and carbon sequestration	Activities in transition to a net-zero economy	Activities that enable climate change mitigation to take place
Examples	• Renewable power generation • Energy storage • Zero carbon transport • Carbon capture and storage	• Efficient iron and steel manufacturing • Efficient electricity production through gas combustion	• Wind turbine manufacture • Installing on-site renewable generation plant in a building
What "Substantial Contribution" criteria are applied?	Long-term stable criteria tied to GHG emission-based thresholds	Criteria tied to GHG emission-based thresholds subject to regular revision down towards zero emissions	Criteria follow the activities being enabled (i.e. in the boxes to the left)

The thresholds chosen for climate change mitigation activities are generally maximum levels of CO_2 equivalent emissions (per unit product/power generated/distance travelled, etc.).

The importance of transition
The preliminary draft of the TSC provided for feedback in January 2019 and was focused on activities considered as traditionally "green". For example, in the electricity generation sector, only renewable power generation activities were covered. However, the TEG has now taken on board the reality that the "greening" of industrial activities in the transition to a low carbon economy is also important to climate change goals and the taxonomy should also include them where appropriate. Efficient gas combustion and iron and steel manufacturing have therefore been included in the taxonomy on this basis. Strict emissions thresholds are set for these transition activities, and these thresholds reduce over time. Across the electricity sector, a 100g CO_2e/kWh emissions limit declining to zero by 2050 has been applied. In the manufacturing sector, the EU Emissions Trading System benchmark[2] has generally been chosen as the threshold as this represents the top 10% of performance in the relevant sector – the benchmark will reduce over time. Steel and iron manufacturing are included if these benchmark thresholds can be met.

Setting the thresholds was always going to be a challenge: are they initially too tight – is the trajectory for tightening them over time realistic, and how many assets will be left "stranded" as a result? How will investors in assets with significantly tightening limits over time react to their being labelled as "sustainable"? The answers to these, and many more, questions will likely begin to emerge during the feedback period launched on 4 July 2019 which will run until 12 September 2019.

2 EU ETS benchmarks are used to calculate the allocation of free allowances under the EU Emissions Trading System for each applicable sector and are set at the average emission level of the 10% most efficient installations in the relevant sector.

Climate change adaptation

Article 7 of the proposed Regulation establishes when an activity should be considered to make a substantial contribution to climate change adaptation.

Adaptation activities were selected from the following list of macro-sectors (there is considerable overlap with the mitigation categories) as being those most susceptible to climate change impacts:

- agriculture, forestry and fishing;
- electricity, gas, steam and air conditioning supply;
- information and communications technology;
- water supply, sewerage, waste management and remediation activities;
- financial services and insurance; and
- professional, scientific and technical activities.

The TEG stressed that whether adaptation activities can be viewed as sustainable is largely dependent on the location and context of those activities. For example, whereas a reduction in GHG emissions will be beneficial no matter where this occurs in the world, the benefits of carrying out a certain type of flood defence will depend on many factors, including the location of the flood risk problem, the size of the affected area (city/small village) and local capacities to deal with climate risk. For this reason, unlike its approach to mitigation activities, the TEG has produced only a qualitative set of criteria for adaptation activities, giving examples of types of adaptation measures that might qualify for protection against specific types of identified climate change hazard.

Similarly to the mitigation objective, the TEG classified the adaptation activities into different types:

	Types of activity	
	"Adaptation of" activities	**"Adaptation by" activities**
Features of the activity	The economic activity itself is made more resilient to climate change	The economic activity supports the adaptation of other economic activities
Examples	Improving the resilience of: • transmission lines to climate impacts • electricity generation from hydropower	• Promoting new weather-prediction technologies or products • Research on adaptation activities
What "Substantial Contribution" criteria are applied?	• The activity reduces material physical climate risks on "best effort" basis • It does not affect adaptation efforts of others (e.g. does not hamper adaptation efforts elsewhere) • Reduction in physical climate risks can be measured against defined metrics	• Activity contributes to adaptation of other activities/addresses systemic barriers to adaptation • For infrastructure-based activities, the criteria for the economic activity being made more resilient must also be complied with (i.e. in the box to the left).

Climate change adaptation

Substantial Contribution: activity that contributes substantially to reduction of the negative effects of current and expected future climate change; preventing an increase, or shifting of negative effects of climate change, through:

- preventing or reducing the location and context-specific negative effects of climate change
- preventing or reducing the negative effects that climate change may pose to the natural and built environment within which the economic activity takes place

The TEG picked nine selected activities to test this approach, considering these activities to be the most vulnerable to the negative effects of climate change in Europe and which represent a large share of gross value added (GVA) and employment in Europe (see full list in Annex). For these activities, the TSC contain generic options for assessing performance.

An example of an adaptation measure in the power sector is improvement of the resilience of transmission lines to the effects of changing temperature, by increasing the height of poles to avoid sagging. Performance could be measured by reduction of efficiency losses from the transmission line during the relevant period of high temperature.

Do No Significant Harm (DNSH) criteria

No activity will be regarded as sustainable under the taxonomy if it causes significant harm to any of the environmental objectives (set out in the box on page 13). The proposed Regulation establishes principles for assessing significant harm for each of the objectives.

For each climate change mitigation activity, the TSC flesh out DNSH criteria establishing what would be considered to cause significant harm to the other relevant environmental objectives (although gaps still remain in some of these criteria). The TEG has sought to incorporate quantitative thresholds for these where possible. The baseline for DNSH is compliance with relevant EU legislation and standards, and additional qualitative criteria are applied as appropriate. For example, for a mitigation project involving "infrastructure for low carbon transport", not only does the project have to avoid harm to ecosystems by ensuring suitable environmental impact assessment in compliance with relevant Directives, but must also, more generally, avoid pollution by "minimising noise dust and emissions pollution during construction/ maintenance works".

Specific DNSH criteria have not yet been set for the nine adaptation activities included in the TSC. The TSC only provide a more generic requirement not to be consistent with, and not adversely to affect, other adaptation efforts. The TEG will continue to work on specific DNSH criteria for adaptation activities.

Omission of activities from the taxonomy

Certain activities were automatically excluded from the TSC where DNSH issues made the activities unsuitable for inclusion. An example of these is infrastructure for fossil fuel activities because of the likely lock-in of fossil fuel use for the future. The TEG also considered whether to include nuclear power within the TSC. Despite stressing its positive impact, it felt unable to conclude, at this stage, that nuclear could avoid harm to other environmental objectives, in particular due to concerns over long-term waste disposal.

What is Significant Harm? (Article 12 of proposed Regulation)

Climate change mitigation: any activity leading to significant greenhouse gas emissions

Climate change adaptation: any activity leading to increased negative effect on current and expected climate for, and beyond, the natural and built environment within which that activity takes place

Protection of water and marine resources: activity that is detrimental to a significant extent to the good status of EU waters

Circular economy, waste prevention and recycling: activity that leads to significant inefficiencies in the use of materials in one or more stages of the life-cycle of products or activity that leads to a significant increase in the generation, incineration or disposal of waste

Pollution prevention and control: activity that leads to a significant increase in emissions of pollutants to air, water and land

Protection of healthy ecosystems: any activity detrimental to a significant extent to the good condition of ecosystems

In its report, the TEG emphasises that the omission of an activity from the TSC should not be regarded as meaning the activity is unsustainable. The activity would simply be regarded as not classified (but it could, of course, be classified in the future, e.g. for nuclear). It is difficult to predict whether this will have any impact on investments in such unclassified activities. No doubt there will be considerable pressure on the Sustainable Finance Platform (see 'Next steps' below) to assess areas that have not yet been assessed or re-assess those that have been included in the TSC.

Use of the taxonomy

The TEG makes it clear that the taxonomy is a comparative tool, and it is not intended that investors should only invest in taxonomy-compliant activities. However, the taxonomy should help investors identify investments that will contribute to the low-carbon transition and, in particular, to meeting Paris Agreement goals. This will be beneficial, both for directing investment into sustainable businesses as well as helping investors minimise reputational risk and improve discussions with corporates.

Who will be required to use it?
Once finalised, use of the taxonomy will be mandatory in some circumstances:

- If Member States decide to establish rules for market actors setting requirements for products marketed as environmentally sustainable, those rules must follow the taxonomy; and
- Bonds seeking accreditation under the proposed Green Bond Standard (**GBS**) will need to be taxonomy-compliant (see the article on page 79).

Institutional investors and asset managers supplying relevant investment products will have various disclosure obligations under the proposed Regulation (and the proposed Disclosure Regulation – see the article on page 59) in relation to certain investments marketed as "environmentally sustainable" (see table for list of investment types subject to obligations and potential voluntary uses identified by the TEG). In particular, they will need to disclose whether, and how, they have used criteria set out in the taxonomy. They will not be required to adopt the taxonomy (although it remains to be seen whether this could become mandatory in the future). This obligation will be on the provider of the financial product. This requirement to specifically reference the taxonomy is likely to provide a significant incentive to actors wanting to be seen as mainstream players to adopt it.

The TEG also suggests that the taxonomy could also be used on a voluntary basis for green loans and project finance.

Relevant types of investment that could be assessed using the taxonomy

	Disclosure obligations	Optional additional uses
Asset Management	• UCITS funds: – equity funds; – exchange-traded funds (ETFs); – bond funds • Alternative Investment Funds (AIFs): – fund of funds; – real estate funds; – private equity or SME loan funds; – venture capital funds; – infrastructure funds; • Portfolio management	
Insurance	• Insurance-based investment products (IBIP)	• Insurance
Corporate & Investment Banking	• Securitisation funds* • Venture capital and private equity funds • Indices funds • Portfolio management	• Securitisation • Venture capital and private equity • Indices • Project finance and corporate financing
Retail Banking		• Mortgages • Commercial building loans • Car loans • Home equity loans

Users and uses of the taxonomy – extracted from the Taxonomy Technical Report (page 60).

* Securitisations, indices, venture capital or private equity conducted by investment banks do not fall under the scope of the Regulation. The investment banks would not have to report on how they relate to the taxonomy. However, the funds that replicate the indices, aggregate or package the green securitisations or private equity investments which are sold as AIFs, UCITS, EUVECA funds or EU SEF would be subject to the Regulation.

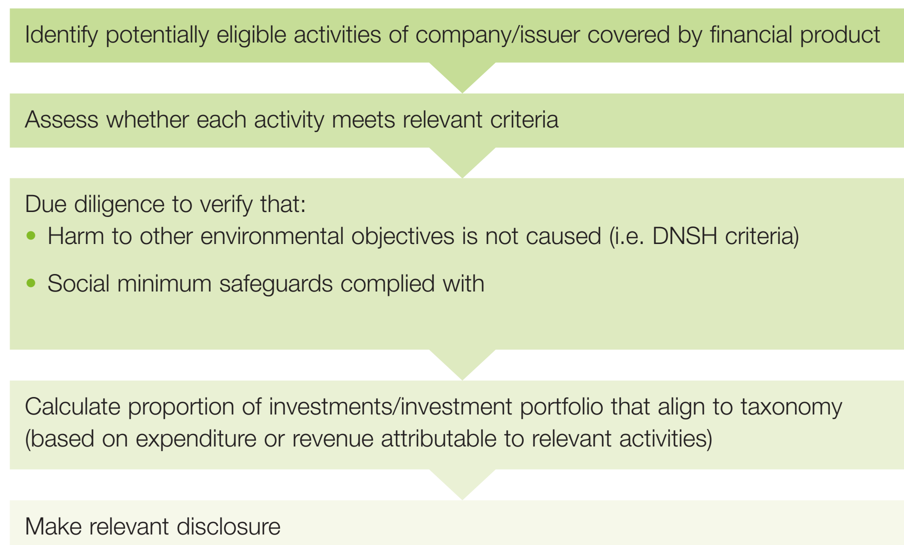
How will institutional investors and asset managers use the taxonomy?
The TEG envisages that institutional investors and asset managers will assess the percentage level of compliance of relevant investments with the taxonomy (for example labelling a real estate fund as 67% taxonomy-compliant). How an investment product would be assessed would differ depending on the type of product. For example:

- Equity portfolio: assess the percentage of revenues or turnover deriving from taxonomy-eligible activities within each company.
- Green Bond fund: assess the percentage of expenditure for eligible (taxonomy-compliant) projects. This would need to be 100% for the GBS.

It is important to note that, aside from the GBS, the taxonomy does not create any threshold of compliance for a portfolio or fund to be considered sustainable. The user would simply need to disclose the percentage of the investment that was taxonomy-compliant. It would then be for the asset manager or investor to establish its own thresholds of compliance.

The process suggested by the TEG for assessing investments against the taxonomy is as follows:

TEG-suggested process for institutional investors/asset managers to use the taxonomy



The need for information and analysis

From the perspective of asset managers and investors, it is clear that substantial due diligence will be required in applying the taxonomy even for clean energy projects. Taking offshore wind as an example, there is a sizeable list of requirements that investors would need to check in terms of the specific impacts on ecosystem elements (e.g. bird populations). They would then, in many cases, need to make judgements, based on qualitative criteria, that certain impacts are being minimised (e.g. in relation to

bird strike, sub-sea noise). The taxonomy will certainly help direct a more consistent approach to these sorts of questions, but significant resource and expertise are likely to be needed either within financial institutions or from third parties. The need to monitor the continuing sustainability of investments over time will add to this burden.

Beyond this activity-level analysis, the TEG notes the importance of considering activities as part of a 'system'. For example, an energy storage project might form part of a wider district's low carbon energy transition. The TEG recommends that taxonomy users go beyond simply assessing the isolated activity within an investment product, and look to see which activities are most coherent in terms of the overall system. It is questionable whether this type of analysis will realistically be possible for many users.

Turning to the corporates conducting the sustainable activities, the TEG makes the point that significant information will need to be provided to taxonomy users to allow them to carry out this due diligence exercise. This information needs to be at a level, and in a form, that will allow checking against the TSC. Currently, data provision by companies is inconsistent and variable. The TEG therefore recommends that companies apply the revised guidelines on non-financial reporting published by the European Commission alongside the TEG reports[3]; this would involve, amongst other things, the inclusion of breakdowns of revenues and turnover into taxonomy-related activity categories. Improving the level and quality of reporting sufficiently to allow easy incorporation of data into TSC assessments is likely to take some time and will involve a major culture shift in reporting. The TEG also calls upon data providers to build or tailor their products in a way that will enable data to be assembled and applied against the taxonomy. Again, this will likely involve significant time and cost, but data providers will probably be more nimble in this regard than corporates.

Using the taxonomy outside the EU

While the focus of the taxonomy is activities conducted in the EU, the TEG suggests that users could apply the taxonomy to activities outside the EU, using analogous local laws and standards where applicable. This might be fairly straightforward for assessment of "significant contribution" of overseas activities to mitigation activities. However, the application of DNSH criteria for mitigation activities largely relies on EU legislative standards. Applying these standards strictly across the globe may be seen as unfairly limiting what would otherwise be considered sustainable investments in these jurisdictions. It is also likely to be a significant due diligence burden for taxonomy users.

It is also notable that, while investments have to comply with minimum social standards, the taxonomy does not require any consideration of the broader social impacts of activities; for example, the impact on developing nations of food-crop land being given over to biofuel production. This is likely to be a more significant issue for investments involving overseas activities as opposed to those taking place within the EU.

3 In June 2019, the TEG also published a report on the proposed EU Green Bond Standard, and an interim report on Climate Benchmarks and Benchmarks' ESG Disclosures. See the articles on pages 79 and 76.

Next steps

The TEG will continue to work on the TSC up to the end of 2019 (for example in filling some of the gaps in the Substantial Contribution and DNSH criteria). It will also continue to seek feedback on the TSC before publishing further recommendations in September 2019, and develop further guidance on implementation and use of the taxonomy. The TEG has, however, confirmed that it will not expand the scope of climate change mitigation activities covered under the taxonomy.

We expect the Commission to publish the formal legislation establishing the taxonomy for climate mitigation and adaptation around the end of 2019. Around this time, the Commission will also establish a Platform on Sustainable Finance made up of representatives of the European Environment Agency, banking supervisory authorities and other expert groups. The Platform will formally advise the Commission on an ongoing basis as to the development of the taxonomy, including the assessment of additional activities.

Although the taxonomy is still in development, asset managers and investors may wish to begin to consider how their investments line up with the taxonomy and what sort of due diligence processes they may need to put in place while the taxonomy continues to be developed. Corporates may also wish to look at the taxonomy to see how their operations are likely to be viewed by asset managers and investors going forward.

CONTACTS*

Michael Coxall
Knowledge Director
T: +44 20 7006 4315
E: michael.coxall@cliffordchance.com

Nigel Howorth
Partner
T: +44 20 7006 4076
E: nigel.howorth@cliffordchance.com

* See also EU Sustainable Finance Action Plan Key Contacts on page 11

Annex list of activities with technical screening criteria

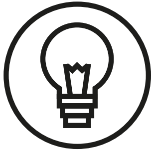
Climate Change Mitigation

NACE Macro-sector	Activities
Agriculture, forestry and fishing	Growing of perennial crops Growing of non-perennial crops Livestock production Afforestation Rehabilitation Restoration Reforestation Existing forest management
Manufacturing	Manufacture of low carbon technologies Manufacture of cement Manufacture of aluminium Manufacture of iron and steel Manufacture of hydrogen Manufacture of other inorganic basic chemicals Manufacture of other organic basic chemicals Manufacture of fertilisers and nitrogen compounds Manufacture of plastics in primary form

NACE Macro-sector	Activities
Electricity, gas, steam and air conditioning supply	Production of electricity from solar PV Production of electricity from concentrated solar power Production of electricity from wind power Production of electricity from ocean energy Production of electricity from hydropower Production of electricity from geothermal Production of electricity from gas combustion Production of electricity from bioenergy Transmission and distribution of electricity Storage of energy
	Manufacture of biomass, biogas or biofuels Retrofit of gas transmission and distribution networks District heating/cooling distribution Installation and operation of electric heat pumps Cogeneration of heat/cool and power from concentrated solar power Cogeneration of heat/cool and power from geothermal energy Cogeneration of heat/cool and power from gas combustion Cogeneration of heat/cool and power from bioenergy Production of heat/cool from concentrated solar power Production of heat/cool from geothermal Production of heat/cool from gas combustion Production of heat/cool from bioenergy Production of heat/cool using waste heat
Water, sewerage, waste and remediation	Water collection, treatment and supply Centralised wastewater treatment systems Anaerobic digestion of sewage sludge Separate collection and transport of non-hazardous waste in source-segregated fractions Anaerobic digestion of biowaste Composting of biowaste Material recovery from waste Landfill gas capture and energetic utilisation Direct air capture of CO_2 Capture of anthropogenic emissions Transport of CO_2 Permanent sequestration of captured CO_2

NACE Macro-sector	Activities
Transportation and storage	Passenger rail transport (inter-urban) Freight rail transport Public transport Infrastructure for low carbon transport Passenger cars and commercial vehicles Freight transport services by road Inter-urban scheduled road transport Inland passenger water transport Inland freight water transport Construction of water projects
ICT	Data processing, hosting and related activities Data-driven solutions for GHG emissions reductions
Construction and real estate activities	Construction of new buildings Renovation of existing buildings Individual renovation measures, installation of renewables on-site and professional, scientific and technical activities Acquisition of buildings
Agriculture, forestry and fishing	Growing of non-perennial crops Silviculture and other forestry activities
Electricity, gas, steam and air conditioning supply	Production of electricity from hydropower Transmission lines
Water, sewerage, waste and remediation	Sewage
ICT	Provision of specialised telecommunications applications for weather monitoring and forecasting
Finance and insurance	Non-life insurance
Professional, scientific and technical activities	Research and development (natural sciences and engineering) Engineering activities and related technical consultancy

SPOTLIGHT
ON ...



3. CLIMATE CHANGE LITIGATION TACKLING CLIMATE CHANGE THROUGH THE COURTS

Litigation is becoming an important element of efforts to combat climate change, prompted by the growing public awareness of, and concern about, the risks that climate change poses and frustration about the slow pace of government action.

The number of climate change-related actions now stands at about 1,500 worldwide. Cases have recently proliferated due to the increasing number of national laws and regulations relating to climate change. The Paris Agreement—by highlighting the urgency of the issue and the extent of the necessary greenhouse gas (**GHG**) emissions cuts—has also played a critical role by providing a benchmark against which citizens can measure the adequacy of government action on climate change.

1,200 of the 1,500 recorded climate change actions have been filed in the United States.

Encouraged by these developments and the perceived increasing urgency of the issue, litigants have pursued climate change-related claims against corporations and businesses. These claims have been brought by a wide variety of litigants—governments, organisations, shareholders, and individuals—and have made a wide range of allegations. For example, some governments have made regulatory allegations related to corporate climate change disclosures, while some individuals have brought claims alleging damages related to global warming and the costs of adapting to climate disruption.

Litigation is also on the rise against governments with the goals of forcing cuts in GHG emissions or the adoption of far-reaching mitigation and adaptation strategies. Actions have also been pursued to hold governments accountable for alleged constitutional, human rights and statutory violations stemming from climate inaction.

What is climate change litigation?

Climate change litigation includes a broad range of proceedings that relate in some way to global warming. These actions have been brought not only before courts, but also before regulatory bodies and international bodies such as the InterAmerican Commission on Human Rights and the UN Human Rights Committee.

By far the greatest number of these cases—1,200—has been filed in the United States. A further 300 cases have been brought around the world, with the bulk of these claims being pursued in Europe and Asia-Pacific, including Australia (98 cases) and the United Kingdom (47 cases). Few cases have been pursued to date in Africa (five cases), although an increased interest in climate change litigation is anticipated in Africa and more generally in the Global South.

Climate change cases can be catalogued in many ways, for example, by the basis for the claim, the remedy sought or the jurisdiction in which the claim is pursued. A simple distinction that we draw here is between claims against corporations and those against governments and government entities.

Climate change actions against corporations

Climate change-related claims against corporations are on the rise. Litigation against corporations has been brought on a broad range of bases, including corporate, securities, tort, consumer protection and environmental law. Actions have predominantly involved either: (1) claims against energy and natural resources corporations alleging that the corporations contributed to climate change through their GHG emissions; or (2) claims alleging inadequate disclosure regarding climate change impacts and risk exposure.

Claims asserting corporate responsibility for climate change-related harm
Claims have been pursued in several jurisdictions against energy and fossil fuel companies alleged to be responsible for climate change. Plaintiffs have sought damages to compensate for the impacts of climate change and costs of protecting against future climate change, as well as, in some cases, injunctive relief ordering the corporation to reduce its GHG emissions.

There has been a raft of such claims in the United States, where plaintiffs—including states, cities and towns—have pursued securities claims, statutory claims, and common law claims against corporations. In *City of New York v. BP plc, et al.*, New York City filed a federal lawsuit against the five largest investor-owned fossil fuel producers seeking costs that the City had incurred and would continue to incur to protect itself and its residents from the impacts of climate change. The court dismissed the case in July 2018, holding that federal common law governed the City's claims and that the Clean Air Act displaced any federal common law claims. A federal district court in California reached the same conclusion in a similar case by the Cities of Oakland and San Francisco (*City of Oakland v. BP plc*). In *Rhode Island v. Chevron Corp.*, the State of Rhode Island filed a lawsuit seeking to hold 21 fossil fuel companies liable for the climate change harm that the State has suffered, or may suffer, in the future. The state seeks, amongst other things, compensatory damages, disgorgement of profits and equitable relief.

In the Netherlands, several environmental groups and individuals filed a case in April 2019 in the District Court of The Hague alleging that the climate change impacts of Shell's activities violate its duty of care under Dutch law, and that they also involve breaches of obligations under the ECHR that the plaintiffs assert are owed by Shell by virtue of its responsibility to respect human rights. In *Milieudefensie et al. v. Royal Dutch Shell plc*., the plaintiffs request a ruling from the court that the company must reduce its emissions by net 45% by 2010 and net 72% by 2040 measured against 2010 levels, and to net zero by 2050.

In Germany, an appeals court has confirmed that a corporation could potentially be responsible for climate change impacts resulting from its GHG emissions. In *Lliuya v. RWE AG*, a Peruvian farmer brought an action against the German electricity producer, RWE AG, seeking declaratory judgment and damages. Lliuya asserted that RWE AG knowingly contributed to climate change through its GHG emissions and that it was partially responsible for the melting of mountain glaciers near his town of Huaraz in Peru. Lliuya claimed that RWE AG was liable for 0.47% of the total cost of mitigating the effects of installing flood protections, reflecting Lliuya's estimate of RWE AG's

contribution to global GHG emissions. The case is currently in an evidentiary phase analysing the factual basis of the plaintiff's claims.

Notably, while most of the claims that have been ruled on to date have not succeeded, the volume of climate change-related claims against corporations continues to increase and the jurisdictions in which they are pursued expanded.

Claims regarding disclosure of information about climate change impacts and risk exposure

Regulatory risks relating to corporate climate change disclosures

Investigations regarding climate change disclosures to investors are becoming increasingly common. Indeed, proposals to require reporting of certain climate change risks across several jurisdictions are likely to trigger even more actions in the future.

In the United States, State Attorneys General have been actively pursuing climate change claims against issuers. The most active regulator in this area has been the NY State Office of the Attorney General (**NYAG**), which has brought claims against, or investigated, at least seven corporations for climate change disclosures. Pursuant to New York's Martin Act, the NYAG has authority to investigate and remediate "fraudulent practices" in the securities markets.

In October 2018, the NYAG filed a high-profile complaint against Exxon Mobil alleging that Exxon misled investors about the risks that climate change regulations posed to its business. Specifically, the NYAG alleged that Exxon claimed to account for the likelihood of regulation of GHG emissions by including a "proxy cost" of carbon but did not apply the "proxy cost" as represented. According to the NYAG, Exxon did not apply the "proxy cost" because doing so would result in "massive" costs and "substantial write downs" of Exxon's assets. Instead, Exxon allegedly used an "alternative methodology" which allowed the company to report lower costs, avoid write downs, and continue to carry its hydrocarbon assets at valuations that were substantially inflated from the values Exxon would have reported if the higher "proxy cost" measure had been used. The Massachusetts Attorney General is also pursuing similar claims against Exxon.

The NYAG has also settled claims with other energy companies regarding allegations that the issuer failed to inform investors about risks. For example, in 2015, Peabody Energy settled with the NYAG and admitted that it had made market projections about the impact of potential climate change regulatory actions, even though Peabody stated in annual and periodic SEC filings that it could not predict the impact of these laws. Peabody's internal projections suggested that climate change regulation could have a significant impact on the company. As part of the settlement, Peabody filed revised shareholder disclosures with the U.S. Securities and Exchange Commission (**SEC**) that restated certain climate change risks.

The SEC has also been active in this area. In February 2010, the SEC published an Interpretive Release addressing disclosure obligations related to the economic impact of climate change. The SEC followed up this guidance with investigations of corporate

disclosures. For example, the SEC investigated Exxon's climate change disclosures and accounting practices. Its probe focused on how Exxon calculates the impact of climate change regulations, including what figures the company uses to account for the future costs of complying with regulations to curb greenhouse gases.

The SEC has also received petitions to investigate climate change disclosures by other companies. For example, on 14 March 2016, more than 30 investor groups promoting sustainable investments asked the SEC to investigate whether Enviva Partners LP—a wood pellet manufacturer—complied with the SEC's guidance on climate change disclosures. The letter also asked the SEC to monitor more closely companies' climate benefit claims; establish and enforce guidelines for those claiming climate benefits; and require companies to disclose the assumptions that underlie those claims. The SEC has received other similar petitions identifying purported material misstatements and omissions in regulatory filings by other companies and requesting guidance about claims of emissions levels and climate benefits.

Shareholder actions concerning corporate climate change disclosures
In the United States, claims against issuers have generally alleged that the issuer's disclosures are false and misleading. These claims have often been based on allegations derived from enforcement actions. For example, after the NYAG alleged in a June 2017 court filing that it had uncovered "significant evidence of potential materially false and misleading statements" regarding climate change, Exxon was sued by shareholders alleging that the corporation misled investors by failing to disclose risks posed to its business by climate change. Specifically, based on the NYAG allegations, shareholders alleged that "Exxon has long understood the negative effects of climate change and global warming and their relation to the worldwide use of hydrocarbons", and that "Exxon understood and appreciated that it was highly likely that it would not be able to extract all of its hydrocarbon reserves and that certain of those assets were 'stranded'. Yet Exxon publicly represented that none of its assets were 'stranded' because the impacts of climate change, if any, were uncertain and far off in the future." In August 2018, a United States District Court in Texas denied Exxon's motion to dismiss the claim, which argued that the plaintiffs were attempting to "manufacture" a claim out of allegations made by the NYAG. The case is now in discovery.

Shareholders have also brought claims alleging that corporations have failed to adequately disclose climate change risks and that corporations are responsible for achieving climate change objectives.

In Australia, shareholders of the Commonwealth Bank of Australia sued the bank, alleging that it violated the Corporations Act of 2001 via the issuance of its 2016 annual report, which failed to disclose climate change-related business risks—specifically including possible investment in the controversial Adani Carmichael coal mine. The bank had made no indication that it would report on these risks or disclose its plans for managing them in 2017. In *Abrahams v. Commonwealth Bank of Australia*, the shareholders asked the Federal Court of Australia for a declaration that the bank has violated the 2001 Act and for an injunction either "restraining the bank from continuing to fail to report" on climate change-related risks or requiring the bank to report on them.

Other potential claims against corporations
As acceptance of the idea that climate disruption impacts the enjoyment of human rights grows, corporations may face claims that their failure to cut emissions or otherwise pursue adequate adaptation and mitigation strategies represents a failure to respect human rights in accordance with the UN Guiding Principles on Business and Human Rights. Corporations may also face claims that they are accountable for human rights violations linked to climate change.

Activists are also using alternative dispute resolution mechanisms to bring claims against corporations. For example, NGOs, other entities and individuals may initiate complaint proceedings before National Contact Points under the OECD Guidelines for Multinational Enterprises, which contain chapters on human rights and on the environment. An example of a climate change-related case is the complaint brought by Oxfam, Greenpeace, Friends of the Earth NL *et al*. against ING Bank before the Dutch National Contact Point alleging that ING violated the MNE Guidelines through its failure to: (i) report levels of GHG emissions caused by its lending activities; and (ii) set itself a target of reducing GHG emissions in its lending. In an interim decision, the Dutch National Contact Point confirmed that the complaint merited further consideration and offered its "good offices" to facilitate a dialogue between the parties. That offer was accepted, and lead to extensive dialogue, which resulted in a Final Statement published in April 2019.

Directors may also face claims alleging that they breached their fiduciary duties by failing to consider climate change. For example, claims could be pursued against directors for failing to pursue adequate emissions-reduction strategies or failing to enforce company policies regarding climate change or human rights. However, in at least some jurisdictions, these claims are unlikely to succeed because of the business judgement rule, which provides substantial protection for decisions made by directors.

Finally, corporations also face reputational risk related to climate change. In an environment of developing awareness about the dangers of climate disruption, corporations should be mindful of the potential consequences of being viewed as insufficiently responsive to the risks posed.

Climate change claims against governments

Actions against governments and public authorities are also increasing. These cases have been brought on several bases and include claims seeking to enforce climate change mitigation and adaptation commitments, to force more ambitious government action to curtail GHG emissions and to raise awareness of climate change issues.

Claims seeking state action, including on grounds of constitutional and human rights
One of the first claims to compel state action in relation to climate change was the 1999 rule-making petition filed by several environmental groups and individuals

Claims have been based largely on constitutional and human rights law, and administrative and planning law.

requesting the Environmental Protection Agency (**EPA**) to regulate GHG emissions under the Clean Air Act. The EPA had declined to regulate GHG emissions, which caused 12 states to join the petitioners to seek review in the United States Court of Appeals for the District of Columbia. That appeal led to the Supreme Court's landmark 2007 decision in *Massachusetts et al. v. Environmental Protection Agency*, which held that the Clean Air Act's "sweeping definition of air pollutant" included carbon and other GHG emissions. Consequently, the Clean Air Act authorised the EPA to regulate GHG emissions. Following the decision, the EPA introduced standards aimed at limiting emissions from power plants, motor vehicles and industrial facilities.

The links between climate change and adverse human rights impacts have been confirmed in various contexts. State obligations to mitigate and prevent adverse human rights impacts of climate change, as well as the responsibility of businesses to respect human rights, have been recognised by both international bodies and domestic courts.

For example, in *Urgenda Foundation v. Kingdom of the Netherlands*, a Dutch environmental group and hundreds of Dutch citizens succeeded in establishing that the government of the Netherlands has a duty under the Dutch constitution and the European Convention on Human Rights to take climate change mitigation measures given the "severity of the consequences of climate change and the risk of climate change occurring". The District Court of The Hague ruled that the government must reduce its GHG emissions by at least 25% compared to 1990 by 2020. The District Court's ruling was upheld by the Court of Appeal and a further appeal is underway in the Supreme Court.

In a highly publicised proceeding in the United States, *Juliana v. the United States*, 21 youth plaintiffs are pursuing a claim in federal court against the US government alleging violations of their constitutional rights to life, liberty and property through the government's failure to curb emissions. This case involves other claims, including a novel application of the public trust doctrine, and is ongoing in the courts.

It has also recently been reported that a group of Torres Strait Islanders submitted a petition to the United Nations Human Rights Committee alleging that the Australian government is violating their human rights through its failure to act on climate change. The complaint asserts that Australia's violations result from its failure to impose adequate targets for mitigating GHG emissions and its failure to provide sufficient funding for coastal defence and resilience measures on the islands. This petition represents the first claim filed against a State by residents of low-lying islands for failure to address climate change.

Claims based on constitutional, human and fundamental rights have also been pursued in multiple other jurisdictions, including Belgium, Canada, Colombia, France, Germany, Ireland, Norway, Pakistan and the United Kingdom.

Alongside other obligations, some plaintiffs have also invoked a State's international commitments to reduce its emissions as a basis for their claims. For example, in *Greenpeace Nordic Association and Nature and Youth v. Norway Ministry of Petroleum and Energy*, two NGOs sought a declaration that the Ministry's grant of licences for deep-water hydrocarbons extraction in the Barents Sea violated the Norwegian

constitution and was inconsistent with the Paris Agreement objective to limit global warming to 1.5° or 2° above pre-industrial levels. Similar arguments were raised about the UK government's decision to permit the expansion of Heathrow Airport in *Plan B Earth and Ors. v. Secretary of State for Transport*. Although the courts in both cases rejected the claims, it is likely that other plaintiffs will attempt to prompt climate action using analogous arguments.

Challenges to planning and permitting decisions
Several planning and permitting decisions have also been challenged based on climate change arguments. For example, in the Australian case of *Walker v Minister for Planning*, a local resident challenged the Minister for Planning's decision to approve a large property and aged care facility development on coastal land. The court ruled that the Minister's decision was invalid because he had failed to consider climate change flood risks and, in particular, whether changing weather patterns could lead to an increased flood risk in connection with the proposed development in circumstances where flooding was identified as a major constraint on development of the site.

In *In re Vienna-Schwechat Airport Expansion*, an NGO and individual petitioners opposed the local government's approval of the construction of a third runway at Vienna's main airport on grounds that it would result in higher GHG emissions. Although successful in the first instance, the decision of the Austrian Federal Administrative Court in favour of the petitioners was ultimately overturned by the Austrian Constitutional Court.

In *Friends of the Irish Environment CLG v. Fingal County Council*, an NGO challenged the local council's decision to issue a five-year extension of the Dublin Airport Authority's planning permission to construct a new runway. The Irish High Court dismissed the plaintiffs' claim for lack of standing, but, in a landmark decision, recognised that:

> *A right to an environment that is consistent with the human dignity and well-being of citizens at large is an essential condition for the fulfilment of all human rights. It is an indispensable existential right that is enjoyed universally, yet which is vested personally as a right that presents and can be seen always to have presented, and to enjoy protection, under Art. 40.3.1 of the Constitution.*

Implications for corporations and businesses of actions against States
Actions against States can have significant consequences for corporations and businesses. Successful litigation and potentially the adverse publicity around litigation may result in governments:

- Enhancing their climate-related goals and imposing higher emissions standards on businesses;
- Passing legislation and regulations that prohibit certain activities (e.g. the phase-out of lignite and coal in Germany); and
- Incorporating climate change issues and human rights as considerations in permit or planning procedures.

Challenges to pursuing climate change litigation

Climate change litigation raises novel issues regarding, for example, the global and transboundary nature of climate change and the difficulty of proving that certain GHG emissions have caused, or will cause, harm to a specific group of people or geographic area. Issues of proof are made more difficult by gaps in the science relating to climate change and its impacts. There are questions of competence and justiciability relating to the perceived use of courts to define government climate change policy. Questions also arise regarding the suitability or availability of certain legal principles and doctrines—for example, the public trust doctrine—as a basis for claims. For plaintiffs, demonstrating standing—i.e., an adequate interest in the outcome of the action at issue—can be an obstacle to pursuing a claim. These issues cut across almost all climate change cases.

It is likely that we will see these issues play out in future climate change litigation and some clarity developed—at least on a domestic or potentially a regional basis—about how they should be addressed. Climate science will also become more adept at establishing a causal link between GHG emitters and the harm caused by emissions. What is clear is that corporations and businesses—especially those that operate across borders—will need to track these legal developments and assess the impact on their operations and their exposure to risk of court rulings and related legislative and regulatory changes. They will also need to be ready to deal with questions about how to manage their exposure, including the insurability of climate change litigation risk.

Looking ahead

Climate change litigation is here to stay. Improvements in climate science and a growing body of case-law should serve to clarify the viability of different claims. Growing climate awareness and activism and, in some jurisdictions, the perceived slow pace of legislative and regulatory action will encourage the pursuit of claims against both governments and businesses. However, absent a global consensus about how to address the relevant issues, these developments will happen at different speeds and have different impacts across different jurisdictions.

For corporations, financial institutions and other businesses, the key will be to keep abreast of legal developments and cases testing liability for the effects of climate change around the world in order fully to understand the relevant risks to their own operations and those of their clients.

CONTACTS

Roger Leese
Partner
T: +44 20 7006 8710
E: roger.leese@cliffordchance.com

Rae Lindsay
Partner
T: +44 20 7006 8622
E: rae.lindsay@cliffordchance.com

Steve Nickelsburg
Partner
T: +1 20 2912 5108
E: steve.nickelsburg@cliffordchance.com

Thomas Voland
Partner
T: +49 211 4355 5642
E: thomas.voland@cliffordchance.com

Janet Whittaker
Senior Counsel
E: janet.whittaker@cliffordchance.com

4. ESG ISSUES FOR CORPORATES
RISKS AND OPPORTUNITIES

Sustainability and environmental, social, and governance (**ESG**) factors have fast risen towards the top of the board agenda — corporates are increasingly aware that a failure to address these matters can be detrimental to their businesses, both financially and reputationally. In the current business climate, a company's purpose, culture and values have never been so under the microscope. Investors and wider society are increasingly of the view that the generation of profits cannot of itself be the ultimate purpose of a company, but rather to run a successful business with a clearly defined purpose and set of values which guide decision-making and with a long-term strategy which recognises the role that the company plays in wider society.

Legal and best practice requirements on institutional investors and asset managers to take into account ESG factors when making investment decisions have a direct consequence for investment in corporates. Institutional investors and asset managers require clear disclosures by the companies in which they invest of their respective policies and actions on ESG issues in order to enable them to report back to their stakeholders that they are investing in line with their own stated policies on sustainability and ESG matters.

Failing to take sustainability issues into account when making key decisions and not having sustainability as a key driver of any long-term business strategy will adversely impact corporates. ESG preparation and planning must be a key focus of boards if corporates wish to remain attractive as investment opportunities.

Over the last decade, there has been increasing appetite amongst international and supranational organisations, governments, regulators, investors and consumers to transition to a more sustainable, ethical, resource-efficient, low carbon, "green" economy, with ESG factors at the heart of that economy. There have also been calls for greater social equity which, in the UK, has led to developments such as gender pay gap reporting amongst larger companies[1] and the requirement on corporates to prepare an annual statement illustrating the steps taken to ensure that modern slavery is not taking place in their businesses or supply chains[2]. From a governance perspective, amongst other initiatives, there has also been a push to encourage diversity (both in terms of gender and ethnicity) on the boards of FTSE 350 companies[3] and to give shareholders a greater say over executive remuneration. This article focuses mainly on the 'E' in ESG.

1 The Equality Act 2010 (Gender Pay Gap Information) Regulations 2017 require employers with 250 employees or more to publish annually information on their gender pay gaps. Note the Government also consulted on ethnicity pay reporting in 2018 (the consultation closed in January 2019), which means we may see further pay gap reporting requirements being introduced in the future.

2 This is required under the Modern Slavery Act 2015.

3 Following, amongst other things, the 2016 Hampton-Alexander Review: FTSE women leaders – improving gender balance in FTSE leadership and the Parker Review on ethnic diversity of boards. The UK Corporate Governance Code 2018, which applies to premium listed companies for accounting periods beginning on or after 1 January 2019, amongst other things, provides that board appointments should promote "diversity of gender, social and ethnic backgrounds".

Background: why has ESG become such an important issue?

The Paris Climate Agreement[4] raised the profile of climate change at every level and has led to an increased discourse about sustainability and sustainability efforts globally. The EU and national governments have taken steps to help achieve the goals of the Paris Climate Agreement by introducing new legislation, regulations and guidelines on sustainability.

While many of these new laws and regulatory requirements apply, or will apply, to those operating in the finance industry or financial services sector[5], they will have a knock-on effect on corporates. See further "Overview of legal and regulatory developments" below.

Macro-economic pressures, including concerns about climate change, the emergence of the enlightened consumer (who wishes to consume only 'ethically produced[6]' goods and services) and a greater sense of responsibility amongst shareholders to invest in sustainable businesses are acting as a catalyst for change.

Governments, organisations and investors are willing to draw attention to perceived deficiencies in, or non-compliance with, environmental reporting requirements and call corporates to account: there has been an explosion[7] of climate change-related litigation brought by governments, organisations, shareholders and individuals against corporates and other businesses in recent years due to (in part) the increasing number of climate change-related laws and regulations. See Climate Change Litigation: Tackling Climate Change Through The Courts on page 27 for a discussion of recent climate change litigation.

Ethical and sustainable business practices are championed by consumers, investors and finance providers alike. ESG products and funds have, in recent years, become increasingly popular with investors, resulting in an increased demand for such products and funds – the trend is likely to continue its upwards trajectory, particularly from support by millennial investors who are more likely to favour sustainable investments.

Millennials, who are very much focused on ESG issues, are increasingly becoming an important consideration for institutional investors and asset managers. Automatic pension enrolment in the UK has brought millennials into the investment chain and, as a result, their influence has grown. A recent report[8] into the attitudes of millennials towards sustainable and responsible investments identifies a number of key trends,

4 The Paris Climate Agreement sets out a global action plan to put the world on track to avoid climate change by limiting global warming to well below 2°C above pre-industrial levels and pursuing efforts to limit it to 1.5°C (as this would significantly reduce the risks and impacts of climate change).

5 e.g from 1 October 2019, new requirements on trustees of defined benefit (**DB**) and defined contribution (**DC**) pension schemes with more than 100 members come into effect which require trustees to ensure that their statement of investment principles includes the trustees' policies on: (i) how financially material factors, including those arising from ESG considerations (including climate change) are taken into account over the time horizon of the scheme in the selection, retention and realisation of investments; (ii) the extent (if at all) that non-financial matters are taken into account; and (iii) engagement and voting activities regarding investments (i.e. stewardship).

6 i.e. which have a minimal negative impact on the environment (if any), do not have a negative impact on the local community and are not produced by child labourers or workers who are not treated with dignity or remunerated adequately.

7 The total number of actions commenced worldwide stands at around 1,500.

8 See further "Millennials and responsible investment", which represents the output of the joint research project conducted by First State Investments and KeplerCheuvreux.

including that an overwhelming majority of millennials are interested in responsible investment and that environmental concerns were considered by over a third of participants to be the area of most focus.

ESG investments may also avoid risk to portfolios – investors can use ESG screening criteria to avoid companies whose practices could present a risk factor (e.g. the widely-reported Volkswagen emissions scandal in 2015 had a negative impact on the car manufacturer, not only financially but also reputationally). High-risk, short-term gains by corporates at the expense of sustainability do not sit well in today's social and political climate.

Environmental activist shareholders of companies in the oil and gas sector have undoubtedly acted as a catalyst to their companies taking climate change seriously (including ensuring that their business strategies are consistent with the goals of international environmental agreements, such as the Paris Climate Agreement). They have demanded that resolutions be added to the agenda at annual general meetings and even managed to strong-arm corporates to link executive remuneration with greenhouse gas emissions[10].

Demand for sustainable investments is being driven, in part, by millennials who prefer to invest in alignment with personal values.[9]

Shareholders, particularly long-term (institutional) investors, are increasingly no longer 'passive investors': they are more willing to challenge decisions by boards and question the direction in which their companies are heading. They are willing to challenge directors on what they perceive to be excessive remuneration packages. See further "Shareholder activism" below.

Corporates must adapt and respond to this evolving ESG climate.

Overview of legal and regulatory developments

We have seen a proliferation of political discourse, consultations, laws, regulations and guidelines (at both the international and domestic levels) in the ESG field, some of which are still being developed/are yet to be finalised.

International/EU developments that corporates should be aware of include:

- The UN Principles for Responsible Investment
- Recommendations of the Task Force on Climate-related Financial Disclosures
- The EU Sustainable Finance Action Plan
- The EU taxonomy of sustainable activities
- Legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations
- The Non-Financial Reporting Directive and Guidelines on Climate-related Information
- The EU Shareholder Rights Directive II

9 EY report: Sustainable investing: the millennial investor.
10 As agreed by the board of Royal Dutch Shell at its 2019 AGM.

Corporates should also be aware of ongoing developments and guidance at the national level, including, in the UK:

- The Financial Conduct Authority's (FCA's) discussion paper on Climate Change and Green Finance
- The Government's Green Finance Strategy: Transforming Finance for a Greener Future and responses by certain UK regulators
- The Financial Reporting Council's (FRC's) Stewardship Code
- The London Stock Exchange's Guidance for issuers on the integration of ESG into investor reporting and communication

Note that there are other ESG developments that will be relevant to corporates, but we have highlighted those we consider most relevant in this article.

International and EU developments

Some of the developments discussed in this section will affect corporates *directly* because they apply to, or impose requirements on, corporates themselves (such as requirements to make certain disclosures), while others will affect corporates *indirectly* via the investment chain — the developments may apply to/impose requirements on institutional investors and asset managers who may, in turn, request information, disclosure or certain action from corporates so that they may satisfy their own obligations.

The UN Principles for Responsible Investment (UN PRI)

The UN PRI apply to corporates indirectly.

The UN PRI are a voluntary set of investment principles that were developed *by* investors *for* investors. They offer a range of possible actions for incorporating ESG issues into investment practice. Institutional investors and asset managers that are signatories to the UN PRI commit to the six principles, including that they will seek appropriate disclosure on ESG issues by the entities in which they invest[11]. Possible actions for achieving this include that the signatories:

- request standardised reporting on ESG issues (using tools such as the Global Reporting Initiative);
- request that ESG issues be integrated within annual financial reports;
- request information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact); and
- support shareholder initiatives and resolutions promoting ESG disclosure.

11 Asset owner and investment manager signatories must report annually on their responsible investment activities through the PRI Reporting Framework.
The UN PRI website has published some guidance/reports on its Listed equity tools page that may be relevant to listed issuers.

Corporates should be prepared for such requests and actions from institutional investors and asset managers who are signatories and should note that the number of signatories is increasing rapidly – even if a corporate's investors are not currently signatories, they may become signatories. For further details on the UNPRI see text box below.

What are the UN Principles for Responsible Investment?

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.**
- Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- Principle 6: We will each report on our activities and progress towards implementing the Principles.

The UN PRI set out lists of possible actions in relation to each of the six principles.

Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)

The TCFD recommendations apply to corporates directly.

The TCFD was commissioned by the Financial Stability Board to develop voluntary, industry-led recommendations aimed at companies (both financial and non-financial) with public debt or equity to include forward-looking climate impacts in their financial filings.

The TCFD final report and recommendations on climate-related financial disclosures focus on four key areas representing core elements of how organisations operate: governance, strategy, risk management and metrics and targets. The four overarching recommendations are supported by 11 key climate-related financial disclosures (see text box at the end of this subsection for details on the four key areas and the 11 recommended disclosures). See also Snapshot: Guidelines for Climate Reporting - Action Plan: Action Point 9 on page 74 for a snapshot of the TCFD recommendations.

The UK Government endorsed[12] the TCFD recommendations and has recently expressed an expectation (in its Green Finance Strategy paper[13]) that all listed companies and large asset owners should disclose in line with the TCFD recommendations by 2022.

The primary aim of the TCFD recommendations is to ensure that investors, lenders and insurance underwriters have sufficient information about how climate change could affect their actual and proposed investments.

12 The Government announced in September 2017 that it has officially endorsed the recommendations.

13 As announced by the Government in its paper: Green Finance Strategy: Transforming Finance for a Greener Future, published in July 2019. The Government also announced that it would (i) develop TCFD guidance for pension schemes; and (ii) set up a joint taskforce with UK regulators to examine the most effective method of approaching disclosure, including whether mandatory reporting might be a feasible option.

How voluntary compliance by corporates has fared so far

A significant number of companies have committed to support the TCFD voluntarily; however, although climate-related disclosure has increased, it is still insufficient for investors and remains inconsistent because companies are failing to:

- provide clarity on the potential financial impact of climate-related issues on them;
- report consistently on the financial impact of climate-related issues; or
- demonstrate how these issues impact the resilience of their strategy using scenario analysis[14].

Corporates need to improve their climate change-related disclosures.

The TCFD recommendations are accompanied by guidance to organisations on implementing the TCFD recommendations. The guidance is divided into three parts:

- guidance for entities operating in all sectors;
- supplemental guidance for entities operating in the financial sector (aimed at banks, insurance companies, asset owners, and asset managers); and
- supplemental guidance for non-financial groups (aimed at groups operating in the following sectors: energy, transportation, materials and buildings and agriculture, food and forest products).

The TCFD has also developed a set of principles for effective disclosure (see text box at the end of this subsection for a list of the principles). The principles are designed to assist organisations in making clear the linkages and connections between climate-related issues and their governance, strategy, risk management, and metrics and targets. The principles also assist with determining the parameters and expected content or nature of disclosures (see Appendix 3 to the TCFD Recommendations or Part F of the guidance for further details).

The TCFD recommendations now form part of the European Commission's Guidelines on reporting on Climate-related Information (which are discussed in The Non-Financial Reporting Directive (NFRD) and Guidelines on Climate-related Information (Action point 9 under the Action Plan below).

14 As reported by the TCFD in its Status Report, published in June 2019.

Listed companies should familiarise themselves with the TCFD recommendations, principles of effective disclosure and guidance to assess whether adequate thought has been given to the impact of climate change on the business and be prepared to make TCFD-compliant disclosures. In particular, companies should ask themselves key questions, such as:

- has the board been sufficiently involved in overseeing climate-related risks and opportunities?
- has the company scoped out the actual and potential impacts of climate-related risks on the business, strategy and financial planning based on appropriate forward-looking climate scenarios?
- are there adequate processes in place to identify, assess and manage climate-related risks and are these integrated into the company's overall risk management?
- where the company has been making climate change-related disclosures, have they provided clarity on, and reported consistently on, the potential financial impact of climate-related issues on them?

If the answer to any of these questions is 'no', companies should start to think about these issues and consider what steps they can take to ensure they are prepared if and when compliance with the TCFD recommendation becomes mandatory.

Where listed companies are already making disclosures in accordance with the TCFD recommendations, they should assess whether these have met investor expectations or whether there is room for improvement (see "How voluntary compliance by corporates has fared so far" above for a high-level overview of failings identified by the TCFD in its most recent status report on the adoption of its recommendations).

What are the four key areas of the TCFD recommendations and accompanying recommended disclosures?

1. **Governance**: disclose the organisation's governance around climate-related risks and opportunities:
   - describe the board's oversight of climate-related risks and opportunities; and
   - describe management's role in assessing and managing climate-related risks and opportunities.

2. **Strategy**: disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material:
   - describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term;
   - describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning; and
   - describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

3. **Risk Management**: disclose how the organisation identifies, assesses and manages climate-related risks:
   - describe the organisation's processes for identifying and assessing climate-related risks;
   - describe the organisation's processes for managing climate-related risks; and
   - describe how processes for identifying, assessing and managing climate-related risks are integrated into the organisation's overall risk management.

4. **Metrics and Targets**: disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material:
   - disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process;
   - disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks; and
   - describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

What are the TCFD's principles for effective disclosure?

- Principle 1: Disclosures should present relevant information
- Principle 2: Disclosures should be specific and complete
- Principle 3: Disclosures should be clear, balanced and understandable
- Principle 4: Disclosures should be consistent over time
- Principle 5: Disclosures should be comparable amongst organisations within a sector, industry or portfolio
- Principle 6: Disclosures should be reliable, verifiable and objective
- Principle 7: Disclosures should be provided on a timely basis

The EU Sustainable Finance Action Plan (Action Plan)
The Action Plan aims to reorient capital flows towards a more sustainable economy[15], mainstream sustainability in risk management, and foster transparency and long-termism. To achieve these aims, the European Commission has adopted 10 separate action points and has tasked the Technical Expert Group on sustainable finance (**TEG**) to assist in developing legislative proposals in relation to some of the workstreams coming out of the action points. Note that there may be multiple workstreams arising under an action point.

Several action points are of relevance to corporates (either directly or indirectly), and some of the ensuing proposals, regulations and guidance arising under those action points are discussed below.

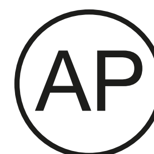
See the text box on the right-hand side for the list of action points and, for a status update on the action points (including progress of any legislative proposals under them), see The EU Sustainable Finance Action Plan: Status Table on page 7.

The EU taxonomy of sustainable activities (Action point 1 under the Action Plan)
The EU taxonomy is an example of an EU development that (once adopted) will be relevant to corporates indirectly, as it will help investors identify investments that will contribute towards the low-carbon transition.

In May 2018, the European Commission published a proposal for a regulation on the establishment for a framework to facilitate sustainable investment. The European Parliament published its proposal in March 2019. It is expected the European Council will publish its position in Q3 or Q4 2019.

The basic premise of the taxonomy is to describe when an *activity* can be classified as environmentally sustainable – which may be relevant when investors are deciding whether to invest in a corporate or to invest elsewhere. See text box on the right-hand side for details on determining whether an activity is sustainable and impact on corporates.

15 Mirroring the aim of the Paris Climate Agreement to align financial flows with a pathway towards low-carbon and climate-resilient development.



What are the 10 Action Points under The EU Sustainable Finance Action Plan?

Some of the ensuing proposals, regulations and guidance referred to under the Action Points listed below in bold are considered in this article.

- **Action 1: Establishing an EU classification system for sustainable activities**
- Action 2: Creating standards and labels for green financial products
- Action 3: Fostering investment in sustainable projects
- Action 4: Incorporating sustainability when providing financial advice
- Action 5: Developing sustainability benchmarks
- Action 6: Better integrating sustainability in ratings and market research
- **Action 7: Clarifying institutional investors' and asset managers' duties**
- Action 8: Incorporating sustainability in prudential requirements
- **Action 9: Strengthening sustainability disclosure and accounting rule-making**
- **Action 10: Fostering sustainable corporate governance and attenuating short-termism in capital markets**

The TEG has clarified that the taxonomy is a comparative tool and the intention is not that investors should invest in taxonomy-compliant/sustainable activities only, but it will assist investors in identifying investments that will contribute to the low-carbon transition and therefore work towards satisfying the Paris Agreement objectives.

Corporates may like to review the proposed taxonomy regulation and technical report by the TEG setting out proposed detailed technical screening criteria now (even though they are still a work in progress and have not been adopted) for an idea of how their activities are likely to be classified under the system and accordingly, how their operations may be viewed by asset managers and institutional investors in the future.

For details on the proposed operation of the EU taxonomy and how it will be used, see Sustainable Taxonomy: usage, issues and challenges on page 12.

Legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations (the Disclosure Regulation) (Action point 7 under the Action Plan)
The Disclosure Regulation is an example of an EU development that will affect corporates indirectly. Although it will apply to the investor community directly (once adopted), it will have a knock-on effect for corporates.

The Disclosure Regulation is expected to be adopted in Q3 or Q4 2019. As drafted, it requires institutional investors and asset managers to integrate sustainability considerations into their investment decision-making process. It also aims to increase transparency to end-investors on how they integrate sustainability factors in their investment decisions, in particular, their exposure to sustainability risks (being environmental, social or governance events or conditions that, if they occur; could cause an actual or potential material negative impact on the value of the investment arising from an adverse sustainability impact).

Asset managers will be required to make certain website and pre-contractual disclosures, including disclosure on the manner in which sustainability risks are integrated into their investment decisions. For further details on the Disclosure Regulation, including an overview of the different requirements on asset managers, see Clarifying Duties: What Asset Managers Need to Know on page 59.

EU taxonomy: what are the requirements for classifying an activity as sustainable?

To be environmentally sustainable, an activity must:

- make a 'substantial contribution' to one or more of the environmental objectives;
- not significantly harm any of the environmental objectives (**DNSH**);
- be carried out in compliance with minimum social safeguards; and
- comply with any specified Technical Screening Criteria (**TSC**) – the TSC will detail what a 'substantial contribution' and DNSH is for each activity in certain sectors

Corporates should familiarise themselves with:

- the requirements of the Disclosure Regulation – even though the requirements apply to 'financial market participants' and 'financial advisers' (asset managers); and
- the specific ESG policies and requirements of any asset managers who invest in them – doing so will give corporates the opportunity to align their policies and requirements (to the extent possible), and enable them to anticipate information requests that will be made and provide the asset managers with the information requested/necessary disclosures in the format that they require.

Consistency and transparency will be key factors. To the extent that any best practice guidelines develop, corporates should take the time to consider these.

The Non-Financial Reporting Directive (NFRD) and Guidelines on Climate-related Information (Action point 9 under the Action Plan)

The NFRD and new Guidelines on Climate-related Information are examples of EU developments that apply to corporates directly.

Directive 2014/95/EU requires large undertakings that are public interest entities (**PIEs**) with over 500 employees to report on **environment** matters, social and employee affairs, human rights and anti-corruption and bribery issues. In addition, the Commission adopted in 2017 Guidelines on Non-Financial Reporting (**2017 Guidelines**) regarding methodology for reporting non-financial information, including non-financial KPIs, general and sectoral, aimed at helping companies disclose non-financial information in a relevant, useful, consistent and more comparable manner.

The NFRD was implemented[16] in the UK in December 2016 by amendments to the Companies Act 2006 provisions regarding the content requirements for strategic reports of PIEs. In addition, amendments were made to the then Disclosure and Transparency Rules of the FCA, requiring disclosure by listed companies of diversity information in their corporate governance statements.

The NFRD was reviewed[17] by the European Commission in 2018 as part of its review of corporate reporting legislation and whether it was still "fit for purpose", including in relation to sustainability reporting requirements.

Following its review, the European Commission published its non-binding Guidelines on Climate-related Information in June 2019 (**2019 Guidelines**), which supplement its 2017 Guidelines.

The disclosures proposed in the 2019 Guidelines correspond to the requirements of the NFRD and integrate the recommended disclosures of the TCFD. They recognise that climate-related disclosures will vary from company to company according to

16 By The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016

17 The European Commission sought views in its consultation paper, Fitness check on the EU framework for public reporting by companies, published in March 2018.

factors such as the geographical location and sector in which the company operates and encourage integrating climate-related information with other financial and non-financial information as appropriate. For a snapshot of the 2019 Guidelines, see Snapshot: Guidelines for climate-reporting: Action Point 9 on page 74.

The 2019 Guidelines highlight that better disclosure of climate-related information can be beneficial for the reporting entity as (amongst other things) it may increase awareness and understanding of climate-related risks and opportunities which may result in:

- better risk management;
- more informed decision-making;
- improved strategic planning;
- a better corporate reputation;
- a diverse investor base; and
- a potentially lower cost of capital (e.g. resulting from improved credit ratings for bond issuance and better creditworthiness assessments by banks for loans).

Further, corporates that improve their disclosures may benefit from inclusion in actively managed portfolios and in sustainability-focused indices.

A "one size fits all" approach does not work for climate-related disclosures. To the extent that companies are not already making climate-related disclosures, they should review the 2019 Guidance and start thinking about how they can integrate climate-related information as part of their non-financial disclosures in annual reports.

Integration of climate-related disclosures in other non-financial disclosures will be key

The EU Shareholder Rights Directive II (SRD II) (Action point 10 under the Action Plan)
The amendments made by SRD II to the SRD discussed below affect corporates indirectly.

Corporates should be aware of the new requirements that apply to their shareholders in the investor community (including obligations to justify investment decisions).

SRD II aims to enhance long-term shareholder engagement, issuer-investor dialogue and transparency in the voting process for listed companies. SRD II amends the Shareholder Rights Directive (the **SRD**) and aims to address certain failings of the SRD. SRD II came into force on 9 June 2017 with an implementation deadline in member states of 10 June 2019.

Key changes (from an ESG perspective) made to the SRD by SRD II[18] include new requirements on *institutional investors and asset managers* (in view of the important role they play in the corporate governance and stewardship of listed companies) to:

- develop and publicly disclose a policy on shareholder engagement;
- disclose annually how they have implemented the policy;
- disclose how they have voted in general meetings of companies in which they hold shares; or
- explain why they have not complied with any of the above requirements.

The shareholder engagement policy must include detail of how institutional investors and asset managers:

- integrate shareholder engagement in their investment strategy;
- **monitor companies in which they have invested;**
- **conduct dialogues with companies in which they have invested;**
- exercise voting (and other) rights;
- cooperate with shareholders;
- **communicate with stakeholders of companies in which they have invested; and**
- manage conflicts of interest (actual and potential)

A description of voting behaviour, an explanation of the most significant votes and the use of proxy adviser services must be included in the annual disclosure of the policy's implementation.

The shareholder policy and annual disclosure on information must be freely available on the websites of the institutional investors and asset managers.

Companies will already know how institutional investors vote, but they should be prepared for greater scrutiny by, and dialogue with, institutional investors and asset managers. They should also be prepared for greater engagement by institutional investors and asset managers with companies' key stakeholders.

SRD II has also introduced new requirements in relation to institutional investors' investment strategy and arrangements with asset managers:

- institutional investors must publicly disclose how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and how they contribute to the medium to long-term performance of their assets;

18 SRD II has also introduced additional requirements, e.g. in relation to shareholder rights to vote on directors' remuneration policies and reports, provisions to assist companies identifying their shareholders and related party transactions, but broadly, these rights already exist in the UK (albeit SRD II may slightly amend the existing UK provisions or broaden the scope of application to a broader range of companies). These and other requirements under SRD II are not discussed in this article.

- where an asset manager invests on behalf of an institutional investor the institutional investor must publicly disclose certain prescribed information regarding its arrangement with the asset manager (information includes how the arrangement incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institutional investor, particularly in relation to long-term liabilities) – if the arrangement with the asset manager does not include any of the arrangements reflected by the prescribed information, it must clearly explain why that is the case; and
- all such information is to be made freely available on the institutional investor's website and updated annually (unless there is no material change).

SRD II has also introduced new requirements aimed at aiding transparency of asset managers: asset managers must disclose annually to the institutional investors for whom they invest how their investment strategy and its implementation: (i) complies with the arrangement with the institutional investor; and (ii) contributes to the medium to long-term performance of assets of the institutional investor or fund. Such disclosure must include certain prescribed information, including:

- on key material medium to long-term risks associated with the investments; and
- on whether and, if so, how, the asset managers make investment decisions based on evaluation of the medium to long-term performance of the company in which they have invested, including non-financial performance.

In the UK, these new requirements on institutional investors and asset managers have been incorporated into the FCA Handbook and the FRC is revising its UK Stewardship Code to incorporate the relevant requirements of SRD II (see "The FRC's Stewardship Code (the Code)" for further details).

Although of direct relevance to institutional investors and asset managers, companies should be aware of the new disclosure requirements on institutional investors and asset managers as they are likely to be shareholders. Asset managers who invest on behalf of institutional investors will have to be able to justify their investment decisions and show that they have assessed a company's long-term performance both financially and non-financially (i.e. taking into account ESG factors).

National developments

Some of the ongoing national developments discussed below will apply to corporates directly, whereas others will apply indirectly (as they will apply primarily to the investor community but will have an impact on corporates).

Corporates with cross-border operations should note that different developments or requirements may apply or be relevant in each of the countries in which they operate. Accordingly, there may be divergence in reporting requirements and practices which may pose practical challenges. This article reviews key national ESG developments in the UK only.

The FCA's Discussion Paper on Climate Change and Green Finance (DP18/8)
The outcomes of DP18/8 will impact corporates directly in terms of reporting requirements, in particular, in relation to climate-related disclosures (the aim being to improve reporting by listed issuers).

The FCA consulted (in the form of DP18/8 published in October 2018) on changes to the way in which the disclosure of climate change risk by listed issuers is regulated. The consultation closed on 31 January 2019. In relation to climate-related disclosures by listed issuers, the FCA:

- noted that there has not been a consistent approach to climate-related disclosures by issuers and it was not clear whether climate-related disclosures were actually helping investors to make informed decisions, or if they were instead causing confusion or even distorting markets;
- sought views on whether greater regulatory encouragement was needed to ensure greater consistency of disclosures to enable investors to compare the standards of climate change-related disclosures across different issuers more effectively and have greater confidence that they are meeting the requirements of any specific mandates or duties; and
- highlighted that inconsistent approaches by listed issuers to climate-related disclosures raised the question of whether the existing regime was adequate in prescribing disclosures, and that one method of encouraging greater consistency would be to require listed issuers to provide a statement explaining whether or not they have followed the TCFD recommendations in preparing their disclosures and, if not, an explanation as to why not (note that since publication of DP18/8, the Government has announced that it will expect listed issuers to disclose in line with the TCFD recommendations by 2022, as referred to in "Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)" above).

Green Finance Strategy: Transforming Finance for a Greener Future, July 2019
While the Green Finance Strategy is primarily of direct relevance to the investor community, some of the requirements coming out of it will be of interest and relevance to corporates, as will the response to the paper by the FRC.

The Green Finance Strategy's two objectives are to: (i) align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by government action; and (ii) strengthen the competitiveness of the UK financial services sector.

The Government intends to meet these objectives by:

- ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision-making, and that markets for green financial products are robust in nature ("greening of finance");
- accelerating finance to support the delivery of the UK's carbon targets and clean growth, resilience and environmental ambitions, as well as international objectives ("financing green"); and
- ensuring UK financial services capture the domestic and international commercial opportunities arising from the "greening of finance", such as climate-related data and analytics, and from "financing green", such as new green financial products and services.

The paper highlights:

- an expectation that all listed companies and large asset owners will disclose in line with TCFD recommendations by 2022;
- the establishment of a joint taskforce with UK regulators to examine the most effective way to approach disclosure, including whether it would be appropriate to introduce mandatory reporting; and
- that the Government will publish an interim report examining progress on the implementation of the TCFD recommendations by the end of 2020.

FRC press release
The FRC published a press release in response to the paper. Of relevance to corporates, the press release states that the boards of UK companies have a responsibility to consider their impact on the environment and the likely consequences of any business decisions in the long-term and that they should address, and report on, the effects of climate change. Reporting should set out how the company has taken into account the resilience of the company's business model and its risks, uncertainties and viability in both the intermediate and long-term in light of climate change. Companies should also reflect the current or future impacts of climate change on their financial position.

The FRC highlights (amongst other things) that:

- the updated UK Corporate Governance Code requires boards to discuss how the matters (including environmental matters) set out in section 172 of the Companies Act 2006 have been considered by the company and report on how opportunities and risk to the future success of the business have been considered and addressed;
- the strategic report requires companies to report on their principal risks and environmental matters when material and that the FRC's Guidance on the Strategic Report has been updated to encourage (amongst other things) better non-financial reporting;
- it will monitor how companies and their advisers are fulfilling their responsibilities by (i) reviewing whether companies are complying with the statutory disclosure requirements of the strategic report (which includes reporting on principal risks and uncertainties) as well as any financial statement implications of climate change; and (ii) in relation to audit monitoring, considering the adequacy of the auditors' work on principal risk disclosures, including climate risk and the financial statement implications of climate change;
- its Financial Reporting Lab will provide practical guidance later in 2019 on how companies can best consider and report on climate-related risk and opportunities; and
- its project on the Future of Corporate Reporting will also consider the need for improved non-financial/sustainability information from companies.

Corporates should take note of the ongoing developments highlighted in the FRC press release.

The FRC's Stewardship Code (the Code)
Although the proposed amendments to the Code apply principally to institutional investors, they will have a secondary impact on corporates as, amongst other things, investor signatories will be required to take into account ESG factors when fulfilling their stewardship responsibilities, including making investment decisions.

The Code sets out good practice for institutional investors when engaging with UK listed companies and it applies on a comply or explain basis.

In January 2019, the FRC published a consultation on proposed amendments to the Code, including a draft revised Code. A final version of the Code is expected to be published in mid-October 2019.

Signatories will need to develop their organisational purpose and disclose their stewardship objectives and governance – this should help to align the Code with the UK Corporate Governance Code and to embed behaviour conducive to effective stewardship and better governance.

In addition, the revised Code makes explicit references to ESG factors and expects signatories to take them into account when fulfilling their stewardship responsibilities.

Principle E provides that signatories integrate stewardship with their investment approach and demonstrate how they take into account material ESG factors, including climate change.

Amongst other things, signatories should disclose the structures and processes they have in place to ensure that information gathered through stewardship activities is factored directly into investment decision-making.

Asset owners should ensure that the investment and stewardship mandates that they issue appropriately reflect the investment time horizon of their beneficiaries and demonstrate how they take ESG issues into account. Asset managers should align their investment and stewardship activities appropriately with the client's investment time horizon and demonstrate how the organisation takes ESG issues into account.

Both asset owners and asset managers should explain how their approach to investment and stewardship is aligned with the investment time horizon of beneficiaries, including how they take material ESG factors into account. The revised Code provides that such reporting should satisfy the relevant requirements of SRD II.

The revised Code also requires that:

- asset owners provide clear and actionable criteria for managers to assess assets against, including prior to investment, to ensure they are appropriate investments to make in accordance with their investment and stewardship strategy; and
- asset managers evaluate assets, including prior to investment, to assess whether they are appropriate investments to make in accordance with their investment and stewardship strategy.

Corporates should take note of the likely disclosure requirements on any of their investors who are signatories to the Code.

The London Stock Exchange's guidance for issuers on the integration of ESG into investor reporting and communication (LSE Guidance)
Listed companies should also be aware of the LSE Guidance, which aims to help issuers and investors "navigate the complex landscape of ESG reporting" and enable "richer data flows and dialogue on ESG" between them.

It highlights that issuers need to have a joined-up approach with investors when it comes to ESG issues. Investors feel that CEOs are not adequately communicating on the business value of sustainability issues. Issuers are failing to understand what information investors need.

The LSE Guidance identifies eight priorities for ESG reporting. See text box on the right-hand side for these priorities.

Shareholder activism

Shareholder activism in the UK (and across the rest of the world) has been on the rise. Traditionally, shareholder activism was largely an issue for US corporates only, or UK corporates with private equity investors looking to extract as much value as possible before exiting and proceeding to the next "venture". In the aftermath of the global financial crisis, a new type of activist emerged: the long-term investor, such as institutional investors who were historically seen as passive. In more recent years, we have seen the emergence of yet another breed of activist: environmental activists (such as Climate Action 100+ and Follow This), spurred on by concerns about sustainability.

Just as the aims of activism are diverse — ranging from governance changes (including demanding changes to the existing board, board representation, changes to directors' remuneration packages, greater board diversity) to increasing the share price of a company so that an activist may sell their interests at a profit (which has been the strategy adopted by many hedge funds and PE houses, particularly where a company is the subject of a takeover) — so are the tools used by activists to raise awareness about a concern, or bring about a desired outcome.

Certain sectors are more prone to activism, including oil and gas (companies such as BP and Royal Dutch Shell who operate in this sector have been the target of environmental activism).

From an ESG perspective, we have seen environmental activist shareholders in the oil and gas sector apply pressure to compel or encourage companies to take on board the magnitude of climate change and to consider adopting different, more sustainable, practices, or to make climate change-related disclosures.

By way of example, at BP's 2019 AGM two special resolutions (resolutions 22 and 23) were requisitioned by shareholder groups coordinated by Climate Action 100+ and Follow This respectively, both in relation to climate change issues. Resolution 22 sought that BP include in its strategic report and/or other corporate reports, as

The LSE Guidance priorities for ESG reporting

- Strategic relevance — What is the relevance of ESG issues to business strategy and business models?
- Investor materiality — What do investors mean by materiality?
- Investment grade data — What are the essential characteristics of ESG data?
- Global frameworks — What are the most important ESG reporting standards?
- Reporting formats — How should ESG data be reported?
- Regulation and investor communications — How can companies navigate regulations and communicate effectively?
- Green revenue reporting — How can issuers get recognition for green products and services?
- Debt finance — What should debt issuers report and what are the emerging standards here?

appropriate, for the years ending 2019 onwards, a description of its strategy which the board considers to be consistent with certain goals of the Paris Agreement as well as certain information relating to capital expenditure, metrics and targets and provide annual progress reports on each of these.

Resolution 23 sought that BP set and publish targets that are aligned with the goal of the Paris Agreement to limit global warming to below 2°C, and that these targets be intermediate to long-term and cover the greenhouse gas emissions of the company's operations and the use of its energy products (including by the end-user).

While BP's board supported the climate change disclosures resolution (resolution 22) proposed by Climate Action 100+ and recommended that shareholders vote in favour of it, the board did not support the resolution on climate change targets (resolution 23) proposed by Follow This, and recommended that the shareholders vote against it.

At the AGM, resolution 22 was passed with the support of over 99% of shareholders. As a result of the passing of the resolution, BP will need to set out a business strategy consistent with the goals of the Paris Agreement on climate change. Resolution 23, on the other hand, was overwhelmingly rejected by BP's shareholders: over 91% of shareholders voted against it.

BP did not support resolution 23 because:

- setting specific long-term reduction targets is inconsistent with the flexibility that is central to BP's strategy;
- it calls for targets regarding end-user emissions that BP does not control; and
- it would risk significant erosion of long-term shareholder value.

It is interesting to note that in the same press release in which it stated it had received a requisition in relation to the Climate Action 100+ resolution which it supported, BP also announced that greenhouse gas emissions reductions had been included as a factor in the reward of 36,000 employees across the BP group globally, including executive directors.

Sometimes, activist shareholders have withdrawn resolutions they requisitioned that were meant to be voted at an AGM, e.g., recently Follow This withdrew a resolution it had requisitioned at the 2019 AGM of Royal Dutch Shell. The resolution called on Shell to change its climate policy. The resolution did not have the support of Shell's board (see 2019 Notice of AGM for the text of the withdrawn resolution and the reasons why the board did not support it). The resolution was withdrawn following the announcement by Follow This on 7 April 2019 that they had received requests for withdrawing the resolution from the shareholders who originally requisitioned the resolution. Shell managed to turn things around by agreeing with shareholders that it would set out plans to introduce industry-leading targets to reduce greenhouse gas emissions and link them to executive pay.

These actions highlight that companies must understand the concerns of their investors, and, where necessary, engage in discussions with activist investors, assessing carefully the merits of any suggestions put forward or concerns raised and consider whether they should be doing more in relation to ESG issues.

Action points for corporates

Boards should examine their company's purpose, culture and values and assess whether they sit well in the current ESG-focused climate, and consider whether it is appropriate to delegate the consideration and oversight of ESG issues to a

separate ESG or risk committee which can dedicate sufficient time and resource to focus on the issues in greater detail, build expertise in the area and report back to the full board regularly. Likewise, boards may wish to seek expert guidance on sustainability issues from specialist ESG consultants if boards believe that the circumstances of their company render this desirable (e.g. because of the nature of business operations, there is a real possibility of negative environmental impact).

Boards should ensure that they have a well-considered long-term ESG strategy in place. They should also ensure that ESG issues are given greater prominence in day-to-day management.

Based on a robust ESG strategy, ESG risks should be identified, and systems and processes should be put in place to ensure greater corporate resilience. Adequate testing of any risk-management systems and processes should be undertaken regularly.

At the other end of the spectrum, ESG opportunities should not be overlooked: is there a way to make the business more robust and attractive to investors from an ESG perspective, by incorporating sustainability factors into its business model, or ensuring that its social and governance practices are exemplary? In addition to attracting and retaining investors, corporates should be showcasing positive ESG issues to attract and retain talented employees and management and build a solid ESG reputation.

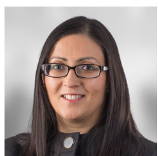
In short, ESG should be high on the board agenda. Boards should be considering, on an ongoing basis, a number of questions, such as:

- is enough thought being given to how their businesses are operating from an ESG perspective, and is the current business model sustainable for the long term?
- has the concept of sustainability been mainstreamed into their risk management strategies and processes?
- have they done all they can to engage with, and align themselves with any reporting requirements of, their institutional investor base?
- are sustainability disclosures that are currently being made in annual reports “fit for purpose” in light of the escalating importance of ESG issues to their investors (including institutional investors) and the gradual evolution of reporting frameworks and expectations, and has their approach to reporting been consistent across the business?
- if they are concerned by the prospect of shareholder activism on ESG issues, have they taken adequate measures to anticipate and address shareholders’ concerns?
- have they been identifying and seizing any ESG opportunities?

“Globally, 47.6% of issuers and 61.4% of investors have an ESG strategy. Amongst issuers, this indifferent view is led by Asia, the Gulf States and the US, with Asia again proving most agnostic amongst investors.

The highest levels of ESG strategy being incorporated into overall company strategy is claimed by Europe, particularly in the UK, which also reports both the highest level of issuers and investors actually disclosing their ESG strategy to the market”.[19]

CONTACTS

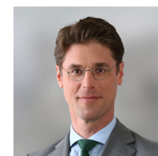


Kavita Bassan
Senior Associate Knowledge Lawyer
T: +44 20 7006 5826
E: kavita.bassan@cliffordchance.com

Melissa Fogarty
Joint Head of Corporate, London
T: +44 20 7006 4699
E: melissa.fogarty@cliffordchance.com

Nigel Howorth
Partner
T: +44 20 7006 4076
E: nigel.howorth@cliffordchance.com

Daud Khan
Partner
T: +44 207006 6069
E: daud.khan@cliffordchance.com



Dr. Thomas Krecek
Partner, Co-Head of Corporate, Germany
T: +49 69 7199 1524
E: thomas.krecek@cliffordchance.com

Kath Roberts
Knowledge Director
T: +44 20 7006 1308
E: kathryn.roberts@cliffordchance.com

19 East & Partners: Sustainable Financing and ESG Investing report, September 2018, page 11. The report also notes that globally, around 52% of issuers and 39% of investors do not have an ESG strategy, but Europe, the UK and Canada buck the trend: the report found that just over 86% of issuers and almost 85% of investors in the UK had an ESG strategy (see page 8 of the report).

5. SUSTAINABLE FINANCE
THE IMPACT FOR BANKS AND INVESTMENT FIRMS

The focus of financial markets regulators and central banks is increasingly falling on climate change and the green economy, and in particular the resilience of the financial system to climate-related risks.

Regulators in both the UK and EU have turned their attention to environmental, social and governance (**ESG**) factors and their impact on banks' business, focusing on three key areas:

- disclosure by issuers, product manufacturers and distributors of information on the ESG credentials of companies and products;
- requiring firms giving advice or making investment decisions to have policies around ESG factors and to disclose additional information to clients; and
- requiring banks and investment firms to assess their exposures to ESG-related financial risks (with the UK Prudential Regulation Authority requiring firms to report on these exposures by 15 October 2019).

The EU proposals in particular are being implemented not just by way of new legislation; but also by way of amendments to or guidance under existing legislation. As a result, banks and investment firms will need a process for monitoring these changes and identifying the provisions that are relevant to their business as well as ensuring that they have allocated responsibility internally for compliance with these obligations.

Many of the EU proposals require additional disclosures to be published or pre-contractual information to be provided to clients. Increased disclosure and enhanced transparency on ESG risks is also a focus of international standard setting bodies, including the FSB's Task Force on Climate-related Financial Disclosures and IOSCO, which recently published a report on sustainable finance in emerging markets recommending reporting and disclosure of material ESG risks.

As these disclosure, reporting and risk management requirements increase and cover multiple jurisdictions, firms will increasingly need a centralised process that brings together different business lines and geographies in order to identify, quantify, monitor and manage ESG risks across their global business as well as a process for drafting and updating disclosures to make sure that their message is consistent and that they record and verify the sources of any published information.

The UK's sustainable finance agenda

In common with central banks and financial services regulators in other jurisdictions, the UK regulators have expressed their concerns about the potential impact of climate change on the financial sector and the role that financial services firms have to play in tackling climate change. The Prudential Regulation Authority (**PRA**) and Financial Conduct Authority (**FCA**) have formed a joint Climate Financial Risk Forum; which brings together senior representatives from across the financial sector to advance financial sector responses to financial risks from climate change, and in July 2019 the PRA, FCA, Financial Reporting Council and The Pensions Regulator published a joint statement on climate change, welcoming the launch of the UK Government's Green Finance Strategy.

The PRA and FCA have both recently published papers setting out in more detail their proposals and expectations both regulated and listed firms in relation to climate change. The requirements of the UK regulators in relation to ESG factors reflect their statutory objectives, with the PRA and Bank of England focusing on prudential risks; while the FCA is focused on services provided to clients and internal governance.

The PRA's expectations for insurers, banks and PRA-regulated investment firms

The PRA published its Policy Statement "'Enhancing banks' and insurers' approaches to managing the financial risks from climate change" in April 2019, with an accompanying supervisory statement (SS3/19) which sets out further detail on the PRA's expectations.

The PRA expects firms to have an initial plan in place to address these expectations by 15 October 2019 and to have submitted an updated Senior Management Function form by that date.

The PRA considers that climate-related financial risks present unique challenges and require a strategic approach to financial risk management. In particular, the PRA describes two key risk factors through which financial risks from climate change are expected to arise:

- Physical risks (i.e., risks relating to specific weather events or longer-term shifts in the climate, which may then impact the value of assets or collateral held by banks); and
- Transition risks (i.e., risks which arise from adjustment to a low-carbon economy, including climate-related developments in policy and regulation, emerging disruptive technology and changing public sentiment and societal preferences, affecting banks' lending portfolios or the value of financial assets in affected sectors).

While a firm's approach to managing financial risks from climate change is likely to evolve over time, the PRA expects the initial response to address at least the following:

- **Governance**: A firm's board should understand and be able to assess the financial risks from climate change that affect the firm, taking a sufficiently long-term view of

"As financial policymakers and prudential supervisors we cannot ignore the obvious physical risks before our eyes. Climate change is a global problem, which requires global solutions, in which the whole financial sector has a central role to play"

– Mark Carney and François Villeroy de Galhau, April 2019

the financial risks that can arise beyond standard business planning horizons. Firms should have clear roles and responsibilities for the board and relevant committees in managing the financial risks from climate change. In particular; the board should identify the Senior Management Functions (**SMF**) with responsibility for identifying and managing financial risks from climate change and ensure that this responsibility is included in the SMF's Statement of Responsibilities.

- **Risk management**: Firms should identify, measure, monitor, manage and report on their exposure to financial risks from climate change, in line with their existing risk management frameworks. In particular, a firm's Internal Capital Adequacy Assessment Process (**ICAAP**) should address material exposures relating to financial risks from climate change.
- **Scenario analysis**: Firms should conduct appropriate scenario analysis to inform their strategic planning and determine the impact of financial risks from climate change on their overall risk profile and business strategy. The PRA expects this analysis to evolve and mature over time, but the initial analysis should cover both a short-term assessment as well as a longer-term assessment looking over a period of decades.
- **Disclosure**: Banks are already required to disclose information on material risks within their Pillar 3 disclosures. They should consider whether further disclosures are necessary to address material risks associated with climate change, and also to indicate how climate-related financial risks are integrated into their governance and risk-management processes. The PRA expects that these disclosures should evolve to be as insightful as possible, and also that firms should prepare for the increasing possibility that disclosures of this sort will be mandated in other jurisdictions.

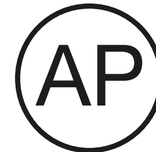
The FCA's expectations for FCA regulated firms and UK issuers
The FCA has also published a discussion paper on climate change and green finance, setting out its proposed approach to address the potential impacts on UK markets. While the FCA is keeping the developing international approach to climate-related financial risks under review, the FCA considers that there are four areas which require regulatory focus in the short term:

- **Pensions**: The long-term nature of pension products means an increased potential impact of climate change-related risks. As a result, the FCA proposes to address the recommendations of the Law Commission's report on Pension Funds and Social Investment, requiring the governance committees for pension schemes to report on their firms' policies on evaluating ESG considerations as well as how they take account of members' ethical and other concerns;
- **Innovation in green products**: The FCA wants to ensure that regulation does not stifle development of positive innovation in green finance and ethical investing, and is considering building on its 2018 proposal to create a global sandbox to support innovative firms in their interactions with regulators as well as using its Global Financial Innovation Network to encourage collaboration between regulators and testing of new ideas.
- **Additional disclosures for listed issuers**: Companies with securities admitted to trading on a regulated market should consider what disclosures they should make (e.g. in prospectuses) to adequately inform investors of the financial implications of climate change on their business, including what adjustments they may need to make to their business to manage risks or explore opportunities.
- **Public reporting for regulated firms**: Regulated firms could be required to report publicly on how they manage climate risks to their customers (e.g. where the

impacts of climate change may affect the appropriateness of certain products or assets) and operations (e.g. where services are outsourced to jurisdictions more severely affected by climate change).

The FCA asked for comments on its discussion paper by the end of January 2019, and is expected to publish further details of its proposals in due course.

The EU Sustainable Finance Action Plan and other recent developments



The EU has adopted, or is in the process of adopting, a number of pieces of financial services legislation which address different aspects of the EU Sustainable Finance Action Plan. These cover a wide range of business areas and product types, and firms will need a process for monitoring these developments and mapping them against their business to ensure that they are compliant. The proposals include:

- **Obligations for benchmark administrators**: The low carbon benchmarks regulation will require all benchmark administrators to include, in their benchmark statements, an explanation of how ESG factors are reflected in each benchmark or family of benchmarks. If the benchmark does not pursue ESG objectives, the benchmark administrator should state this in the benchmark statement.

  The European Commission's Technical Expert Group (**TEG**) has also published detailed recommendations on ESG disclosures in benchmarks which build on the requirements of the low-carbon benchmarks regulation and propose minimum content requirements and templates for both the benchmark methodology and for the benchmark statement.

  For more details, see Snapshot – Low Carbon Benchmarks Regulation on page 76.

- **Requirements for investment firms providing advice or portfolio management services**: The sustainable finance disclosure regulation will require firms which make investment decisions or give investment advice to publish information on their website regarding their policies on integration of sustainability risks in their investment decision-making process. The revised shareholder rights directive imposes further disclosure obligations, including a requirement for institutional investors and asset managers (including investment firms providing investment advice or portfolio management) to make public disclosure of their policies on shareholder engagement and monitoring of investee companies on relevant matters; including social and environmental impact and corporate governance, and for asset managers to give information to institutional investors to enable them to assess whether the asset manager acts in the best long-term interests of the investor.

  Changes to guidelines under MiFID2 will also require firms to take their clients' preferences on ESG risks and factors into account when complying with the MiFID2 suitability requirements; and to include information on ESG risks in pre-contractual information and periodic statements to clients.

- **Product governance requirements for manufacturers and distributors**: Amended MiFID2 delegated acts and guidelines will require investment firms; which manufacture or distribute products; to take sustainability when assessing the target market for products.

- **Prudential and organisational requirements for investment firms and banks**: Amendments to the MiFID2 delegated acts will require investment firms to integrate sustainability risks into their compliance with the general organisational requirements under MiFID2, including in their risk management systems and procedures and when

identifying conflicts of interest. The revised shareholder rights directive also requires the performance of EU company directors to be assessed in relation to both financial and non-financial performance criteria, including ESG factors where appropriate.

- **Other disclosure requirements**: The proposed Regulation establishing a framework to facilitate sustainable investment is expected to require financial market participants to make further disclosure of relevant information, allowing investors to establish whether the products they offer qualify as environmentally sustainable investments.

The European Securities and Markets Authority (**ESMA**) has also published a questionnaire aimed at gathering evidence on short-term pressures on corporations stemming from the financial sector. The European Commission has mandated ESMA and the other ESAs to gather and report on this evidence, as the Commission is concerned that companies focus on near-term performance at the expense of mid- to long-term objectives, including innovation and human capital, and that they may overlook environmental and social objectives.

ESMA's questionnaire focuses in particular on:

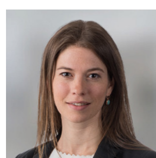
- Investment strategy and investment horizon;
- Disclosure of ESG factors and the contribution of such disclosure to long-term investment strategies;
- The role of fair value in better investment decision-making;
- Institutional investors' engagement;
- Remuneration of fund managers and corporate executives; and
- Use of CDS by investment funds (and in particular whether sell-only or net sell CDS positions may indicate increased short-term risk taking by funds).

Many of these issues are already addressed to some degree in the legislation discussed above, although ESMA's report may result in further changes.

ESMA will report to the Commission by December 2019, presenting its evidence and findings and potentially advising on steps to address any undue short-termism. The Commission will consider ways to follow up on the report's findings. (See the article on page 66)

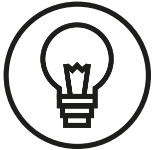
CONTACTS

Caroline Dawson
Partner
T: +44 20 7006 4355
E: caroline.dawson@cliffordchance.com

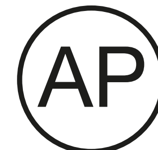


Laura Douglas
Senior Associate
T: +44 20 7006 1113
E: laura.douglas@cliffordchance.com

Stephanie Peacock
Senior Associate
T: +44 20 7006 4387
E: stephanie.peacock@cliffordchance.com



6. CLARIFYING DUTIES
WHAT ASSET MANAGERS NEED TO KNOW



This article focuses on Action Point 7 of the Action Plan; clarifying institutional investors' and asset managers' duties.

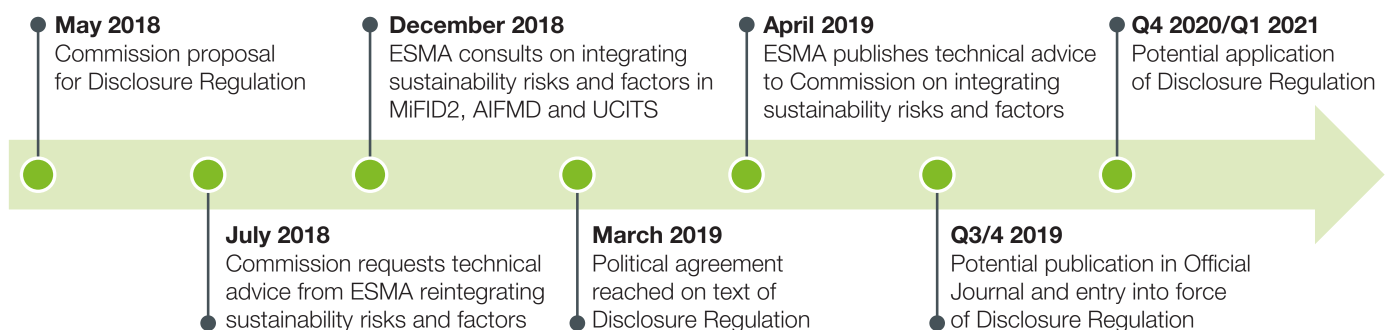
Spotlight on implementation of Action Point 7

- Legislative proposal to clarify institutional investors' and asset managers' duties in relation to sustainability considerations (the **Disclosure Regulation**)
- Consultation on integrating sustainability risks and factors into AIFMD, UCITS, MiFID2, Solvency 2 and IDD

Key concept: what is the aim of the Disclosure Regulation?

- Explicitly require institutional investors and asset managers to integrate sustainability considerations in their investment decision-making process
- Increase transparency towards end-investors on how they integrate such sustainability factors in their investment decisions, particularly their exposure to sustainability risks

Key Dates



Disclosure Regulation

Application
Applies to 'financial market participants', which includes AIFMs, UCITS management companies, and MiFID investment firms (collectively referred to herein as "**asset managers**").

Website disclosure requirements
Asset managers must disclose on their websites:

- information on their policies on the integration of *sustainability risks* in their investment decision-making process;
- where they consider principal adverse impacts of investment decisions on *sustainability factors* or, if they have more than 500 employees, a statement on due diligence policies with respect to these principal adverse impacts;
- where they do not consider adverse impacts of investment decisions on *sustainability factors*, clear reasons for not doing so and, where relevant, information as to whether they intend to consider such adverse impacts;
- information on how their remuneration policies are consistent with the integration of sustainability risks.

Pre-contractual disclosure requirements
Asset managers must disclose, as part of their pre-contractual disclosure obligations:

- the manner in which *sustainability risks* are integrated into their investment decisions;
- the result of the assessment of the likely impacts of *sustainability risks* on the returns of their funds or portfolios;
- where *sustainability risks* are deemed not relevant, a clear and concise explanation of why they are not relevant;
- where they consider principal adverse impacts of investment decisions on *sustainability factors*, or if they have more than 500 employees, by three years after entry into force of the Disclosure Regulation, for each fund or portfolio that they offer, a clear and reasoned explanation of whether and how that fund or portfolio considers principal adverse impacts on *sustainability factors* and a statement that information on principal adverse impacts on *sustainability factors* is available in periodic reports;
- where they do not consider adverse impacts of investment decisions on sustainability factors, a statement (as part of the periodic report) that the asset manager does not consider the adverse impacts of investment decisions on sustainability factors, and a reasoned explanation for not doing so.

Spotlight on extraterritoriality
- Definition of AIFM refers back to Article 4(1) (b) of AIFMD, which includes non-EU AIFMs.
- Presumably non-EU AIFMs must only comply with the requirements in relation to the funds that they market into the EU – awaiting clarification.

Key concepts: sustainability risks, sustainability factors and sustainable investments
- *Sustainability risk*: an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact.

- *Sustainability factors*: environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.
- *Sustainable investments*: mean any of the following or a combination of any of the following:
  - Investments in an economic activity that contribute to an environmental objective
  - Investments in an economic activity that contribute to a social objective,

provided that the investments do not significantly harm any of those objectives and the investee companies follow good governance practices.

Specific requirements for products that promote environmental or social characteristics/sustainable investments
Pre-contractual disclosures must include:

- information on how the environmental and/or social characteristics are met (this assumes that the relevant companies in which the investments are made follow good governance practices);
- if an index has been designated as a reference benchmark:
  - information on whether and how this index is consistent with environmental and/or social characteristics;
  - information on how the designated index is aligned with the sustainable investments objective (including an explanation as to why and how that designated index differs from a broad market index);
- if no index has been designated as a reference benchmark, an explanation as to how the sustainable investments objective is attained;
- where the fund or portfolio has as its objective the reduction in carbon emissions, information on the low-carbon emission exposure objective;
- an indication of where the methodology used for the calculation of the indices and benchmarks referred to above are to be found.

Website disclosures must include:

- a description of the environmental or social characteristics, or the sustainable investment objective;
- information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the relevant fund or portfolio;
- the information to be disclosed in the pre-contractual and periodic disclosures as set out above and below.

Periodic report disclosures must include:

- in relation to funds or portfolios that promote environmental and/or social characteristics, a description of the extent to which environmental and/or social characteristics are attained;
- in relation to funds or portfolios that have as their objective sustainable investments, a description of the overall sustainability-related impact of the fund or portfolio or, where an index has been designated as a reference benchmark, a comparison between the overall impact of the fund or portfolio with the designated index and a broad market index through sustainability indicators.

ESMA's Technical Advice

Background

In July 2018, the European Commission requested ESMA to provide it with technical advice to supplement its initial package of legislative proposals published in May 2018 (of which the Disclosure Regulation was one such proposal), and to assist it with potential amendments to the UCITS Directive, AIFMD and MiFID2 with regard to the integration of sustainability risks and sustainability factors. Following a public consultation, ESMA published its final technical advice on 30 April 2019. The final technical advice covers the following topics: organisational requirements, operating conditions, risk management provisions and, in relation to MiFID2, product governance.

Organisational requirements

- *ESMA's Advice:*
  - UCITS management companies and AIFMs should: (i) take into account sustainability risks; with respect to their internal procedures and organisation; (ii) take into account the necessary resources and expertise for the effective integration of sustainability risks; and (iii) ensure that senior management is responsible for the integration of sustainability risks.
  - Investment firms should, where they are relevant for the provision of investment services to clients, take ESG considerations into account with respect to their internal procedures and organisation.
- ESMA is of the view, in line with many of the responses to the consultations, that:
  - the above 'principles-based' approach is balanced without introducing overly prescriptive requirements; which may risk stifling innovation or creating regulatory inconsistencies; and
  - the explicit designation of a qualified person for the integration of sustainability risks is neither necessary to reach the Commission's objective, nor proportionate.

Operating conditions

- *ESMA's Advice:*
  - When identifying the types of conflicts of interest; where its existence may damage the interests of a UCITS, an AIF or their respective investors, UCITS management companies and AIFMs (as applicable) should include those conflicts that may arise in relation to the integration of sustainability risks (for example, conflicts arising from remuneration as well as any sources of conflicts that could give rise to greenwashing).
  - Such entities should also take into account sustainability risks and, where applicable, the principal adverse impact of investment decisions on sustainability factors when conducting due diligence on investments.
  - Where applicable, such entities should develop engagement strategies with a view to reducing the principal adverse impact of investee companies on sustainability factors.
  - Investment firms, when identifying the types of conflicts of interest whose existence may damage the interests of a client, should include those conflicts that may stem from the distribution of sustainable investments, and should have in place appropriate arrangements to ensure that the inclusion of ESG considerations does not lead to mis-selling practices.

- ESMA explained in each of the final reports that:
  - although it agreed with respondents that due diligence requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio, ESMA is of the view that this is already sufficiently reflected in the existing UCITS and AIFMD frameworks, and so no further legislative clarifications in relation to sustainability risks were required;
  - the provision of any more prescriptive guidance on the application of the due diligence requirements at this stage could raise the risks of regulatory inconsistencies, but ESMA will monitor the situation and may issue further guidance in future;
  - although it acknowledged the operational challenges involved with gaining access to reliable data on sustainability risks and factors, the principle of proportionality is clearly ingrained in the existing due diligence requirements, as well as the additional wording proposed above; and
  - in relation to investment firms, it was important to introduce in the MiFID2 Delegated Regulation a clear reference to the need for firms to identify conflicts; where its existence may damage the interests of a client, and that in doing so such firms should include those that may stem from the distribution of sustainable investments.

Risk management

- *ESMA's Advice:*
  - UCITS management companies' and AIFMs' risk management policies should comprise such procedures as are necessary to enable them to assess, for each fund that they manage, the exposure of that fund to, *inter alia*, sustainability risks.
  - Investment firms should take into account sustainability risk in the establishment, implementation and maintenance of their risk management policies and procedures. In order to do this, investment firms' compliance function, internal audit function, management body and senior management should also consider aspects related to sustainability risk in their respective duties.
- ESMA agreed with respondents to the UCITS/AIFMD consultation paper that:
  - the integration of sustainability risks would be best done by including sustainability in the list of material risks to be managed under the respective UCITS and AIFMD Level 2 framework provisions; and
  - a more granular approach to the integration of sustainability risks in the risk management systems would raise the risks of creating regulatory imbalances and giving sustainability risks precedence over other types of risk.
- ESMA confirmed in its response to the MiFID2 consultation paper that:
  - The methodology used to assess sustainability risks is not prescribed in the text of the technical advice and that, in its view, the text of the technical advice is general enough to allow a flexible approach.

Product governance

- *ESMA's Advice:*
  - investment firms should identify, at a sufficiently granular level, the potential target market for each financial instrument and specify the type(s) of client for whose

needs, characteristics and objectives, and ESG preferences (where relevant), the financial instrument is compatible.

- Investment firms should determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining, *inter alia*, whether the instrument's ESG characteristics (where relevant) are consistent with the target market.
- Investment firms should consider whether the financial instruments they manufacture and offer are compatible, and remain consistent, with the needs, characteristics and objectives, and ESG preferences (where relevant), of the target market.

- ESMA noted in its final report that the above principles-based approach will facilitate the implementation of the requirements and the development of sustainable products, whilst also avoiding giving the impression that the identification of ESG preferences in the target market should be considered more relevant than clients' investment objectives and other characteristics.
- In addition, ESMA explained that the amendments to the MiFID2 delegated acts are just the first step in a more extensive project, and that the requirements for and regulation of sustainability will take more shape as the Commission's initiative evolves.

Next steps
ESMA will cooperate closely with the European Commission in view of transforming the technical advice into formal delegated acts (i.e., as part of the UCITS, AIFMD, and MiFID2 Level 2 frameworks).

Issues for Asset Managers

Obtaining quality data

- There is a general acknowledgement across the industry sector that the quality of sustainability-related data provided by unregulated service providers is both inconsistent and mediocre.
- In its final reports to the Commission, ESMA itself acknowledged this operational challenge, but pointed to the fact that the principle of proportionality existed to mitigate against this difficulty; noting that the question of whether to regulate service providers to ensure sufficient data quality was beyond the scope of its mandate.

Costs

- Experience elsewhere in the financial markets shows that, with the introduction of increased disclosure obligations, it is almost inevitable that increased costs will follow. Stakeholders interviewed as part of the consultation process for the Disclosure Regulation, identified the costs of reviewing and amending pre-contractual and contractual documents to ensure compliance with the increased transparency requirements; as the most significant costs arising from that proposal.
- There are also potential extra costs to be considered as a result of ESMA's technical advice to the Commission on amendments to the UCITS, AIFMD and MiFID2 Level 2 frameworks. For example, whether managers will need to hire extra staff with specific ESG expertise, or purchase new technology, ensuring that sustainability risks and factors are effectively integrated into their systems and processes.

Regulatory issues

- It is not clear how, pursuant to the Disclosure Regulation, the requirement to disclose sustainability-related information on their websites will conform to asset managers' various other regulatory obligations concerning general solicitation to the public.
- Asset managers should also take note that parallel requirements are being implemented with respect to the insurance industry and that, since insurance companies are likely to comprise a not insignificant portion of their investor base, managers could also become subject to increased sustainability-related information requests from such investors as part of their own compliance obligations.

Legal uncertainty and timing for compliance

- As addressed by ESMA in its final reports to the Commission, it is important that there is clarity on the terminology used across the legislative proposals for their correct implementation. Also, the development of any binding definitions needs to consider all legislative initiatives developed in relation to sustainable finance; ensuring a harmonised approach.
- Concerns have been raised that the Disclosure Regulation and the amendments to the UCITS, AIFMD and MiFID2 Level 2 frameworks could come into effect before the implementation of a clear and compulsory taxonomy, which could create confusion and legal uncertainty with respect to the integration and disclosure of sustainability risks and factors.
- Not only that, but there have also been calls (including from ESMA) for the Commission to ensure that application date of the Level 2 amendments is aligned with that of the Disclosure Regulation in order to avoid duplications and reduce compliance costs.
- In addition, concerns have also been raised that managers will not have sufficient time for implementation of the relevant requirements of the Disclosure Regulation and the UCITS, AIFMD and MiFID2 amendments, as applicable.

Proportionality

- The impact of the requirements of the Disclosure Regulation and the Level 2 framework amendments is potentially burdensome.
- Although ESMA has emphasised the application of the proportionality principle in its technical advice to the Commission, and the final text of the Disclosure Regulation states that it is without prejudice to the rules under UCITS, AIFMD and MiFID2 relating to proportionality, it remains to be seen how this will be applied in practice, and whether managers, particularly smaller managers, will ultimately be forced to pass on increased compliance costs to investors.

CONTACTS

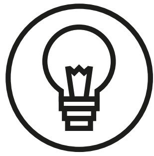
Jacqueline Jones
Knowledge Director
T: +44 20 7006 2457
E: jacqueline.jones@cliffordchance.com

Owen Lysak
Partner
T: +44 20 7006 2904
E: owen.lysak@cliffordchance.com

Lily Marcel
Senior Associate
T: +44 20 7006 4158
E: lily.marcel@cliffordchance.com

Peter Pears
Senior Associate
T: +44 20 7006 8968
E: peter.pears@cliffordchance.com

Amy Watt
Senior Associate
Knowledge Lawyer
T: +44 20 7006 1987
E: amy.watt@cliffordchance.com



7. ESMA CONSULTATION ON SHORT-TERMISM IN FINANCIAL MARKETS
WHAT ARE THE ISSUES FOR ASSET MANAGERS?

Another step has been taken towards fostering sustainable growth in the EU; with the publication by ESMA of a survey on undue short-term pressure on corporations from the financial sector.

This development relates to Action Point 10 of the EU Sustainable Finance Action Plan, which was published in March 2018. Action Point 10 focused on "fostering sustainable corporate governance and attenuating short-termism in capital markets".

In this article, we outline the key areas covered by the survey and some of the issues they may raise for asset managers.

Background

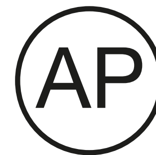
The Commission has previously commented that decisions taken by corporations do not fully reflect the long-term factors that would be required to put the EU economy on a sustainable path and that as a result of short-term market pressures, some companies may under-invest in the drivers of long-term value, such as innovation and human capital and overlook environmental and social objectives that require a long-term time horizon. Consequently, the Commission believes that there are obstacles to sustainability, e.g. where incentives, market pressures and prevailing corporate culture prompt market participants to focus on near-term performance at the expense of mid- to long-term objectives.

The Commission issued a call for advice to the European Supervisory Authorities on this topic in January 2019. The current development is intended to inform ESMA's response to the Commission's Call for Evidence.

Key areas

ESMA has identified six areas which it considers relevant to examine:

- Investment strategy and investment horizons
- Disclosure of Environmental, Social and Governance (**ESG**) factors and the contribution of such disclosure to long-term investment strategies
- The role of fair value in better investment decision-making
- Institutional investors' engagement
- Remuneration of fund managers and corporate executives
- Use of Credit Default Swaps (**CDS**) by investment funds



Short Termism

The focus on short time horizons by both corporate managers and financial markets, prioritising near-term shareholder interests over long-term growth of the firm

Table 1 below summarises what the survey is seeking to ascertain in relation to each of the six areas, and to which sector of the market the questions are directed.

Key issues for asset managers

The survey is relevant to asset managers and many of the questions are directed at, or relate to, that sector. Below, we highlight some of the key issues it may raise for asset managers.

Investment strategy and investment horizon
In section II of the survey, ESMA invites respondents to provide information on the key features and the focus of their investment strategy, as well as on the time horizon(s) they use in their business activities. ESMA's ultimate aim is to gain a broad understanding of how managers prioritise short and long-term values in their investment activities. The range of responses is likely to vary significantly; depending on the asset class and strategy of the relevant fund manager. For example, for funds that pursue a high frequency trading strategy, their investment activities are based on price movements as opposed to value, and so they necessarily have shorter holding periods than, for example, private equity fund managers. It will be interesting to see what sort of approach the Commission adopts towards the more short-termism investment strategies as a result of this consultation.

Disclosure on ESG factors and the contribution of such disclosure to long-term investment strategies
Another section of the survey focuses on ESG disclosure and the contribution of such disclosure to long-term investment strategies. ESMA aims to investigate whether any changes, in addition to the Non-Financial Reporting Directive, are needed at EU level to enable investors to take long-term investment decisions. On the one hand, if the Commission were to take action to require more and/or better quality disclosure of ESG data, this could be beneficial for fund managers, because the difficulty of obtaining quality and consistent ESG data is often cited as a significant challenge for managers and investors alike. For example, fund managers may currently be finding it administratively onerous to comply with their investors' multiple bespoke ESG reporting formats, and investors have cited issues with the inability to accurately benchmark their investments given the lack of harmonisation of data. On the other hand, although the Explanatory Note to the survey acknowledges that the text of the legislation which will clarify the disclosure obligations of asset managers in relation to sustainability considerations (known as the Disclosure Regulation) has reached political agreement, fund managers may well be hoping that any additional rules that the Commission may create as a result of this consultation do not result in duplicative requirements, especially when the proposed changes to AIFMD and UCITS, with respect to integration of ESG factors, are taken into account, as well as the close parallels with the disclosures required by the SRD II regime and the UK FRC Stewardship Code.

Remuneration
ESMA aims to examine whether remuneration policies and practices of fund managers are a driver of short-termism. The obvious potential issue for managers is whether the Commission, either in addition to or as part of the analysis of remuneration rules in connection with the AIFMD Review, will amend the various remuneration codes and/or guidelines applicable to AIFMs and UCITS managers to try and incentivise such managers to integrate ESG considerations into their reward packages in order to prevent short-termism.

Next steps

ESMA will report to the EU Commission, based on its findings, by December 2019, in line with the Commission's request to each of the three European Supervisory Authorities. The report will present evidence and possibly advice on potential undue short-termism. The Commission will consider ways to follow up on the report's findings, which may include policy actions.

Table 1: Survey aims and sector focus

Area of focus	Market sector to which the questions are addressed
Investment strategy and investment horizon The focus of the questions is on the key features and investment strategies, as well as the time horizon(s) used in business activities. Aim: (i) to obtain comprehensive information on the strategic approach taken by various market players in order to get a broad understanding of how they prioritise short- and long-term values in their investment activities. (ii) to provide evidence on how consistent the long-term value drivers of the investment strategy are, considering the investment timeframe and the global approach for investment decision-making, and which specific considerations in investment strategies may induce short-termism.	All respondents. The questions relating to portfolio holdings are addressed to asset owners and asset managers.
Disclosure of Environmental, Social and Governance (ESG) factors and the contribution of such disclosure to long-term investment strategies Experience of market participants with disclosures under the Non-Financial Reporting Directive (**NFRD**). Aim: (i) to ascertain whether, how and to what extent public disclosure on ESG factors can enable investors to integrate into their decision-making process considerations on a company's current and future ability to create long-term sustainable value for its shareholders and for society in general. (ii) whether any changes relating to requirements on non-financial information are needed at European level to enable investors to take long-term investment decisions.	Institutional and retail investors that make use of information in issuers' public reporting in their investment decisions. Issuers that provide such ESG-related information to investors.

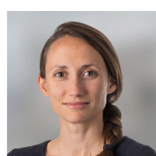
Area of focus	Market sector to which the questions are addressed
The role of fair value in better investment decision-making Aim: (i) to collect further information related to the appropriate accounting treatment for long-term investments (mark-to-market or fair value?) (ii) to ascertain whether and how fair value may impact the capacity of financial reporting to provide relevant and reliable information on equity instruments held for long-term investment purposes. Responses in this area will help ESMA to assess how the measurement and disclosure of fair value may impact the selection of a short- or long-term horizon, as well as assess it whether the transparency benefits arising from the use of fair value for financial instruments, particularly equity instruments, outweigh the intrinsic potential volatility of fair value.	Institutional and retail investors that make use of information in issuers' financial statements in their investment decisions. Issuers that prepare financial statements.
Institutional investors' engagement (The questions in this section indirectly relate to the revised Shareholder Rights Directive that established specific requirements in order to encourage shareholder engagement in EU listed companies.) Aims: (i) to ascertain whether and how institutional investors monitor the long-term value maximisation of their investee companies by further engaging with them and voicing their potential concerns. "Engaging" is defined as any monitoring and interaction by institutional investors with investee companies, including the exercise of voting rights and other activities to influence the investee company. (ii) to collect information on how engagement activities are put in place in the Member States.	Institutional investors.

Area of focus	Market sector to which the questions are addressed
Remuneration of fund managers and corporate executives Aim: to examine whether remuneration policy and practices of fund managers can be a driver of short-termism.	Part A: UCITS management companies, AIFMs, and self-managed UCITS investment companies and AIFs. Part B: Issuers In addition, each section invites all stakeholders to comment on the potential contribution to short-termism from remuneration practices for fund managers or corporate executives.
Use of CDS by investment funds Aim: to collect information on the use of CDS by all investment funds. ESMA will use the information to assess whether the use of such instruments could be one of the potential drivers of short-termism.	UCITS management companies, self-managed UCITS investment companies and AIFMs.

CONTACTS

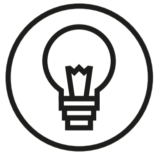
Jacqueline Jones
Knowledge Director
T: +44 20 7006 2457
E: jacqueline.jones@cliffordchance.com

Owen Lysak
Partner
T: +44 20 7006 2904
E: owen.lysak@cliffordchance.com



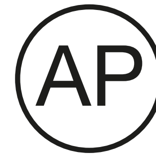
Lily Marcel
Senior Associate
T: +44 20 7006 4158
E: lily.marcel@cliffordchance.com

Amy Watt
Senior Associate Knowledge Lawyer
T: +44 20 7006 1987
E: amy.watt@cliffordchance.com



8. CREDIT RATING AGENCIES
NEW GUIDANCE ON DISCLOSURE FROM ESMA

The Action Plan recognised that although there has been a significant increase in the inclusion of ESG performance and risk management in reports prepared by market research providers and credit rating agencies (**CRAs**), more needs to be done, in particular to address the lack of market standard methodologies and consistent disclosures. The Commission mandated ESMA to assess to what extent ESG factors are incorporated into the current market practices of CRAs and to develop guidelines to improve ESG disclosures. ESMA published a consultation paper in December 2018 and released its technical advice to the Commission and final guidelines in July 2019.



Better integration of sustainability in ratings and market research (Action Point 6) falls within the second broad aim of the Action Plan to mainstream sustainability into risk management.

Technical advice

ESMA found that it is already market practice for rating agencies to consider ESG factors in their credit ratings but that practice varies across rating agencies, the methodology used and asset classes. Existing ratings may therefore give some indication of sustainability but they are not sustainability opinions and should not be confused with sustainability assessments. However, as a credit rating is an opinion on the "creditworthiness" of an entity or financial obligation and not an assessment of any other characteristic, ESMA concluded that no changes should be made to the Credit Rating Agencies Regulation (**CRAR**) to specifically incorporate ESG considerations in credit rating assessments.

However, ESMA does suggest that the CRAR disclosure provisions should be updated to account for ESG factors. The ESMA guidelines discussed below provide an initial platform for developing the disclosure provisions and ESMA will monitor the effect of the guidelines to see if further changes are needed.

ESMA final guidelines

The ESMA final guidelines set out new measures with a view to improving the consistency of disclosures already required by the existing CRAR. The disclosures mandated by the CRAR are designed to enforce standardised levels of transparency and to ensure that CRAs inform investors of the reasons for a given rating, any limits or uncertainties underpinning it and where further background information can be found. These disclosures allow investors to more fully understand the rationale behind the rating and undertake their own due diligence if desired. Typically, CRAs comply with these disclosure obligations by publishing a press release.

The guidelines cover two areas. First, they prescribe a set list of non-ESG information that must be included in a press release or disclosure report that documents a given rating decision. This measure intends to address inconsistent disclosure practice. Second, where consideration of ESG factors is a key underlying element in forming a rating decision, this should be properly disclosed. It is this second limb that goes to supporting Action Point 6 of the Action Plan and is the focus of this article.

Note the guidelines focus on *how* CRAs disclose the consideration of ESG factors only *when* they are a key element behind the issuance of a credit rating. ESMA have been explicit throughout both the consultation process and in its published guidelines that they are not dictating *what* factors a CRA should consider, and indeed, that they do not require a CRA to consider any ESG factors at all if the CRA does not consider them relevant according to the applicable methodology.

The guidelines provide that where ESG factors are a key driver behind a change to a credit rating or outlook, the relevant CRA must confirm as such in the accompanying press release or report. A CRA which makes such a statement must also identify which ESG factors they deem to be material and explain why. Finally, the press release or report should also include a link to either a document or a section of that CRA's website that provides guidance on how ESG factors are considered within its methodologies or associated models.

What the proposals might mean in practice

For Moody's, Fitch and S&P, our understanding is that the guidelines align with established practice, and so it is unlikely that the ESMA proposals will herald any material change in policy.

In January 2019, Fitch introduced ESG "relevance scores" to demonstrate how these factors affected the agency's individual credit rating decisions. This takes the ESMA guidelines a step further. In a press release marking the launch, Fitch commented that it aims to be transparent about the calculation process and the factors considered, with a view to aiding investors in coming to an informed opinion on how ESG factors have been treated at both an entity and sector level, and ultimately, enabling individuals to judge the effect of such on a given credit rating.

Similarly, S&P offer a "green evaluation" which is an asset-level environmental credential. The programme was launched in April 2017 with evaluations for the oil and gas and utilities sectors. It is now being rolled out to all major companies across every sector, and to smaller companies in the sectors most exposed to ESG factors that may be relevant to ratings. S&P subsequently announced at the beginning of this year that it is phasing in incorporation of this analysis of ESG factors in their corporate ratings reports.

Moody's has also taken steps to be clearer about how it incorporates ESG issues into ratings. Notably, in April 2019 it acquired Vigeo Eiris (an ESG research provider).

However, not all CRAs are in agreement with the new guidelines. Some have questioned, the merits of incorporating ESG factors when assessing corporate debt, when the time horizons for typical credit ratings look to the short and medium term, whereas certain impacts of ESG factors may be felt over the long-term.

Next steps
Enhanced ESG disclosure is a feature of much of the Action Plan for a range of market participants. ESMA have stated that they will consider these guidelines for the purposes of its supervision as of March 2020.

CONTACTS

Lydia Morrell
Trainee Solicitor
T: +44 20 7006 5276
E: lydia.morrell@
cliffordchance.com

Peter Pears
Senior Associate
T: +44 20 7006 8968
E: peter.pears@
cliffordchance.com

Jessica Walker
Knowledge Director
T: +44 20 7006 2880
E: jessica.walker@
cliffordchance.com

SNAPSHOT
GUIDELINES FOR CLIMATE REPORTING
EU SUSTAINABLE FINANCE ACTION PLAN

Action Point 9: Strengthening sustainability disclosure and accounting rule-making

- Thorough and consistent disclosure of climate-related information is fundamental to the ambitions outlined in the Action Plan, and the Commission undertook a "fit for purpose" review of EU corporate reporting legislation in 2018, including looking at sustainability reporting requirements.
- The Non-Financial Reporting Directive (**NFRD**) was reviewed as part of this process and the Commission published its Guidelines on Reporting on Climate-related Information (the **Guidelines**) on 18 June 2019. The Guidelines underpin much of the projects and aims outlined in the Action Plan as, unless companies improve their climate disclosures in a transparent and consistent manner based on reliable methodologies and data, the usefulness of the taxonomy and other ESG disclosure requirements will be limited.
- The Guidelines are intended to supplement, not replace, the Commission's existing 2017 guidance in relation to the NFRD. As with the 2017 guidance, the Guidelines are non-binding.
- The six general principles of good non-financial reporting set out in the 2017 guidance still apply, these being that disclosures should be: (1) material; (2) fair; (3) comprehensive but concise; (4) strategic and forward-looking; (5) stakeholder-orientated; and (6) consistent and coherent.
- The Guidelines recognise that disclosures will vary between companies depending on activities, geographies and scale of the climate-related risks, and that methodologies in relation to climate-related disclosures are evolving quickly.
- The Guidelines require companies to consider the materiality of climate-related information from both a financial perspective (i.e. the impact on the company) and an environmental perspective (i.e. the impact on the climate and the environment) and with reference to the company's whole value chain. If a company determines that there are no relevant material climate-related issues, it should disclose this.
- Climate-related disclosures for each of the following five reporting areas listed in the NFRD are suggested, with further guidance provided in relation to each suggest disclosure:
  - business models;
  - policies and due diligence;
  - outcome of policies;
  - principal risks and risk management; and
  - key performance indicators.
- The Guidelines encourage companies to read the recommendations of the Task Force on Climate-related Financial Disclosures (**TCFD**) and incorporate the TCFD recommendations. The Guidelines and the TCFD recommendations are seen as mutually compatible.
- More detailed guidance is also provided for banks and insurance companies.

"Good investment decisions start with good information – that means getting companies to do their climate reporting in a clear and consistent way."

– Valdis Dombrovskis

What is the Task Force on Climate-related Financial Disclosures (TCFD)?
The TCFD was established by the Financial Stability Board in 2015 and published voluntary recommendations in 2017 on climate-related information that companies should disclose to help investors, lenders and others make sound financial decisions.

The TCFD proposed four key recommendations divided into 11 suggested disclosures to help create more consistent, comparable and reliable disclosure.

It recommends disclosures in the following categories:

- *Governance*: disclosure of the role of management in assessing climate change risks and opportunities, and oversight by the board.
- *Strategy*: where material, a description of impacts of actual and potential risks/ opportunities from climate change upon the business's strategy and financial planning over different time horizons, and the resilience of the organisation's strategy based on different climate scenarios.
- *Risk Management*: description of the organisation's process for identifying and managing climate-related risks and how these relate to the organisation's overall risk management framework.
- *Metrics and Targets*: where material, disclosure of the organisation's Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas emissions and related risks, and a description of the metrics used to identify risks and opportunities.

There are currently 785 companies committed to supporting the TCFD on a voluntary basis. However, a TCFD 2019 status report indicated that, although climate-related disclosure has increased, it is still insufficient for investors and remains inconsistent. In particular, companies are not consistently reporting on the financial impact of climate-related issues or demonstrating how these issues impact the resilience of their strategy using scenario analysis.

TCFD recommendations now form part of the Commission's Guidelines on reporting on climate-related Information and the UK Government has recently announced that it expects all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022. Other legislators and regulators may follow suit in making the TCFD recommendations mandatory.

See EU Sustainable Finance Action Plan Key Contacts on page 11

SNAPSHOT
LOW CARBON BENCHMARKS REGULATION
EU SUSTAINABLE FINANCE ACTION PLAN

Action Point 5: Developing sustainability benchmarks

- The Commission published proposals to establish new low-carbon labels for benchmarks in May 2018 and political agreement was reached by the Parliament and the Council in February 2019 on a new regulation. The new types of benchmark introduced by this regulation are intended to assist investors in identifying and pursuing low carbon investment strategies and reducing greenwashing.
- The agreed provisions make amendments to the existing EU Benchmark Regulation to allow for a voluntary low-carbon label to be applied to benchmarks that satisfy the requirements of the new regulation. There are two distinct labels – the "Paris-aligned benchmark" (**PAB**) for use if the indices align with the long-term global warming target of the Paris Climate Agreement and the "Climate transition benchmark" (**CTB**) if the indices comprise companies that follow a decarbonisation trajectory (this is defined in the regulation) by December 2022, but do not satisfy the higher Paris Agreement target.
- The new provisions will also require:
  - all benchmark administrators to include in their benchmark statements details of the extent to which they consider ESG factors or a statement that they do not pursue ESG objectives; and
  - administrators of "significant" equity and bond benchmarks to include detailed disclosure on the extent to which the benchmark aligns with carbon emission reduction or the long-term global warming target of the Paris Agreement.
- The above disclosure requirements are due to come into effect on 30 April 2020.
- These new disclosure requirements are intended to increase transparency, awareness and comparability of ESG factors in benchmarks, lead to better and more-informed benchmark selection by investors and ultimately encourage companies to improve their ESG disclosures in order to achieve benchmark inclusion.
- The regulation provides that further details on the implementation of the CTB and PAB benchmarks will be set out in delegated regulations. The Commission mandated the TEG to provide advice on the minimum disclosure requirements for all benchmarks and minimum standards for CTBs and PABs in order to develop the delegated regulations.
- The TEG delivered its Interim Report on Climate Benchmarks and Benchmarks' ESG Disclosures on 18 June 2019. It is consulting on this report and will deliver its final report in September 2019.

"Benchmarks are indices that play a central role in the price formation of financial instruments and other relevant assets in the financial system. Benchmarks are useful instruments for investors, as they allow them to track and measure performance and allocate assets accordingly."

The Action Plan.

The TEG report requirements for CTBs and PABs

The minimum standards for CTBs and PABs relate to the following areas (included here in abbreviated form):

1. **Input Data:** GHG emissions data should relate to the GHG protocol or ISO standards and should be consistent and transparent;
2. **Carbon intensity:** a specific carbon intensity calculation is recommended and a CTB should have a 30% reduction in carbon intensity compared to investable universe and a PAB should have a 50% reduction;
3. **Inclusion of scope 3[1] emissions data:** this should be considered on a stepped timeline with consideration first being given to the energy and mining sectors (when regulation is effective), to transport, buildings, materials and industrial sectors (within two years) and all sectors (within four years);
4. **Decarbonisation trajectory:** CTB and PAB administrators should use the IPCC decarbonisation trajectory for alignment with the Paris Agreement;
5. **Green share/brown share:** to the extent that this is disclosed, a CTB should have a green share/brown share ratio at least equivalent to the ratio in the investable universe and a PAB should have a green share/brown share ratio four times higher than the investable universe;
6. **Disclosures:** certain annual disclosures are required, including to what extent the IPCC decarbonisation trajectory has been achieved; and
7. **Do No Harm principle:** companies that are involved in controversial weapons and those found in violation of global norms (such as OECD Guidelines) should be excluded from the benchmark and administrators should also consider excluding exposure to companies that significantly harm any of the EU environmental objectives (as specified in the taxonomy regulation).

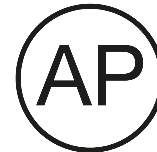
1. Scope 3 emissions are indirect emissions that derive from an entity's broader supply chains.

See EU Sustainable Finance Action Plan Key Contacts on page 11

PRODUCTS

9. THE NEW EU GREEN BOND STANDARD TIGHTENING THE GUIDELINES TO WIDEN THE MARKET

In June 2019, the TEG published its "Proposal for an EU Green Bond Standard". The idea of an EU green bond standard (**GBS**) has been in the works for some time and was proposed in earlier reports from the EU High-Level Expert Group on Sustainable Finance and the Sustainable Finance Action Plan.



The GBS represents part of a wider push by the Commission to create harmonised standards and labels for "green" financial products with the aim of protecting integrity and trust in sustainable financial markets. The stated aim of the GBS is to solve several barriers to the growth of the current green bond market, including reducing uncertainty on what is green by linking it with the Taxonomy, standardising verification and reporting processes, and having an official standard to which incentives could be attached. The Commission is currently considering the TEG's proposal and will determine how the GBS will be taken forward.

Here we look at the basics of the GBS and examine what implications this proposed standard could have for the green bond market.

The basics

To qualify under the GBS, the proceeds of the issue, or an amount equal to such proceeds, must:

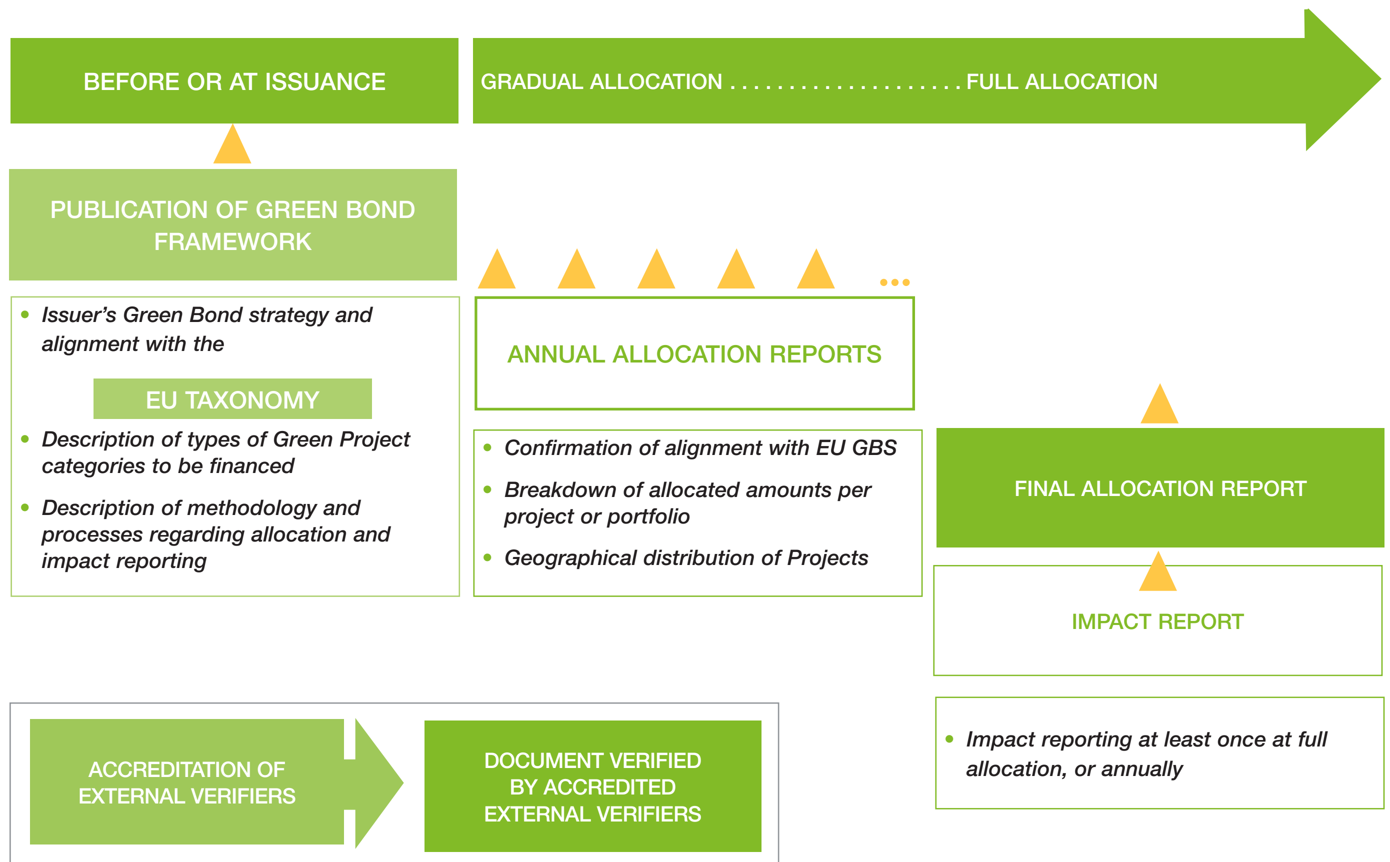
- be allocated only to finance or refinance "green projects" defined as contributing substantially at least one of the EU's "environmental objectives" (as defined in the current draft of the Taxonomy Regulation, namely (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) transition to a circular economy, waste prevention and recycling; (v) pollution prevention and control and (vi) protection of healthy ecosystems)[1];
- not significantly harm any of the other environmental objectives; and
- comply with the minimum social safeguards represented by the principles and rights set out in the eight fundamental conventions identified in the International Labour Organisation's declaration on Fundamental Rights and Principles at Work.

In addition, an issuer of an EU green bond is required to produce a Green Bond Framework (**GBF**) aligned with the GBS including details on all the key aspects of the use of proceeds and on its green bond strategy. On or before issuance, an external verifier must confirm alignment of the GBF with the GBS.

1. As underlying screening criteria developed in relation to the Taxonomy Regulation come into force, green projects will need to be aligned with such additional requirements, subject to limited exceptions due to the complexity, the innovative nature or location of the relevant project.

Issuers are required to report annually until full allocation of proceeds and the final allocation report is required to be externally reviewed. Issuers are also required to produce an impact report at least once during the lifetime of a bond after full allocation of proceeds and thereafter in case of material changes in allocation. Standardised formats for reporting have been proposed by the TEG with the aim of further harmonising disclosures.

EU GBS – in a picture



Source: TEG Report, Proposal for a Green Bond Standard, June 2019

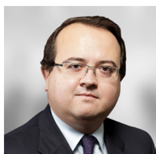
Sounds familiar – what's new?

The EU GBS borrows heavily from existing initiatives such as the ICMA Green Bond Principles (**ICMA GBP**) and most of its features will be familiar.

We think, however, there are a few key points to note:

- use of proceeds must comply with the EU's stated environmental objectives and, when it is in force, the Taxonomy Regulation. This is a significantly more prescriptive standard than the ICMA GBP. The technical guidance accompanying the Taxonomy Regulation includes detailed specific metrics, criteria and guidelines as to what may be funded by an EU green bond. This will need consideration by Issuers and their advisers when drawing up their frameworks;
- external reviewers need to be accredited by an independent body (the TEG suggests that this role could be fulfilled by ESMA). The ICMA GBP has no such accreditation obligations. The accreditation and standardisation of external reviewers may be helpful in mitigating concerns around greenwashing;
- it is hoped that by providing a standardised format under the GBS it will be easier for regulators to (a) monitor with confidence the flow of finance into green assets; and (b) develop incentives to encourage the growth of the green bond market. The TEG report notes that possible incentives could include schemes to offset the additional costs of issuing EU green bonds, preferential purchasing of EU green bonds by central banks, tax incentives and preferential prudential treatment of EU green bonds;
- by aligning the GBS with the Taxonomy the GBS is Intrinsically on "environmental" standard rather than a "social" one. Whilst a "social" element has been built into the GBS through the requirement to be aligned with the International Labour Organisation's declaration on Fundamental Rights and Principles at Work, this is different from the existing ICMA Social Bond Principles where proceeds are used for particular "social" uses. There is currently no "social" Taxonomy in the same way the green Taxonomy is being developed. This may mean that green and social bonds, previously aligned under the ICMA framework, begin to follow different standards in the future; and
- the EU GBS is proposed as a voluntary standard. We see two points of note here. First, the scope of the Taxonomy Regulation is not yet settled and it remains possible that the regulation will require those marketing bonds as environmentally sustainable to disclose alignment with the Taxonomy. This would be a significant push factor towards using the GBS. Second, the TEG has recommended that the Commission conducts a review of the take up and the impact of the GBS after a period of 3 years with a view to introducing legislation in support of the implementation of the GBS.

CONTACTS



Cedric Burford
Partner
T: +33 1 4405 5308
E: cedric.burford@cliffordchance.com

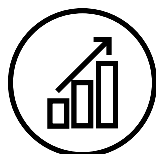
Clare Burgess
Partner
T: +44 20 7006 1727
E: clare.burgess@cliffordchance.com

Antonio Henriquez
Partner
T: +34 91 590 9426
E: antonio.henriquez@cliffordchance.com

Peter Pears
Senior Associate
T: +44 20 7006 8968
E: peter.pears@cliffordchance.com

Kate Vyvyan
Partner
T: +44 20 7006 1940
E: kate.vyvyan@cliffordchance.com

Jessica Walker
Knowledge Director
T: +44 20 7006 2880
E: jessica.walker@cliffordchance.com



10. FROM JUNK BONDS TO JUST BONDS
THE INCREASING IMPORTANCE OF ESG FINANCING IN EUROPEAN HIGH YIELD MARKETS

In this article, we discuss the emerging demand from investors for Environmental, Social and Governance (**ESG**) financing and its potential effects for stakeholders in the leveraged finance market. For an overview of recent precedents with successful ESG integration, please see the attached Annex 1.

Increasingly, investors want to know that their capital is contributing to a more sustainable future, and the capital markets have responded with a wide range of financial products to meet this investor demand. While historically there has been substantial focus on "green" financing products that raise funds for projects with tangible environmental benefits, investors are increasingly looking to issuers' broader ESG credentials as part of their commitment to sustainable investing. Issuers have the ability to design a product that conforms with "green" principles, such as Getlink SE's green bond to provide capital for clean transportation and energy efficient projects, or to focus on improving their overall ESG rating through initiatives like carbon emissions reduction or closing the gender pay gap.

The *Financial Times* has declared 2019 "the year when environmental, social and governance considerations are moving out of a specialised niche into the mainstream."

Investors are formally and informally integrating ESG principles into their management of global asset portfolios. A 2019 UBS survey with Responsible Investor found that 78% of institutional investors surveyed consider ESG factors in making their investment decisions. Although ESG is still emerging in the high yield market, Cerulli Associates estimates that in Europe, 24% of high yield investors currently apply ESG criteria to their investments. In another 2019 survey of asset and fund managers, 90% of managers believed that at least 35-50% of all global assets will be managed under ESG principles in the next five years. Ratings agencies are assisting investors with this integration by including ESG evaluations in their credit ratings analysis. The high yield and leveraged finance market has begun to offer a wider array of products with ESG principles in mind; ESG focused markets are no longer solely dominated by green bonds. The sustainable investment movement has developed "social" bonds, such as a development bank's bond to improve education in a developing country, "sustainability" bonds, such as a bond to build green buildings on a university campus, and "blue" bonds, such as a sovereign bond to improve conservation of an endangered marine area, to capture a larger array of ESG concerns. ESG financing experienced rapid growth in structured finance and sovereign debt, and now the high yield market is following. The first high yield funds managed under ESG principles were established by M&G Investments and Candriam Investors Group in late 2017. Fair Oaks Capital followed the lead of Bardin

Hill and Permira Debt Managers to launch a European ESG focused CLO in May 2019. As a result, issuers are increasingly asked to respond to the concerns of bond investors who prioritise ESG issues. Bondholders, especially the 2,237 signatories of the Principles for Responsible Investment, have begun to ask bond issuers about their ESG credentials during roadshows and meetings.

Paying attention to ESG credentials has the power to provide access to additional pools of capital and opportunities for better rates on debt in the coming years due to increased investor demand. Investors also benefit from ESG deals; there is preliminary research that selective ESG investing generates better returns for investors. A 2018 Barclays study of the US high yield market found that bond portfolios favouring issuers with high ESG ratings had a positive impact of 25-45 basis points over 2012-2018. Likewise, 2018 research from J.P. Morgan also indicates that incorporating ESG criteria in high yield portfolios can lead to increased returns.

Defining ESG

The International Capital Markets Association (**ICMA**) distinguishes between green bonds, which must conform to the Green Bond Principles criteria, and ESG bonds, which "integrate governance criteria which are not featured in the Green Bond Principles … and may refer to an issuer's overall sustainability credentials rather than a specific use of proceeds." Issuers hoping to finance specific projects to improve their environmental impact may be good candidates for green debt issuances.

Issuers looking to raise capital for purposes that may not seem compatible with the ICMA Green Bond Principles for a green financing instrument should not ignore how their ESG credentials can affect the market for their instruments, however. Investment managers are gauging what steps, if any, an issuer is taking to improve its long-term ESG credentials rather than screening investments for specific green projects. "We would rather see companies improve their full corporate wide ESG profile than spending too much time identifying a specific project that meets all the qualifications for it to be a green bond," the head of US stewardship and sustainable investments for Legal & General Investment Management America told the *International Financing Review* in May 2019.

In the context of European high yield markets, which is typically issued to investors across the globe, including in the US, in reliance on Rule 144A and which requires more detailed disclosure, defining ESG may prove to be an additional challenge. In particular, as the disclosure standard for a 144A transaction requires more detailed information to be provided to investors, care will need to be given to describing the nature of ESG elements included in the transactions, and, in the case of issuances designed to fund specific projects, monitoring the use of proceeds to ensure that they are used for the purpose described in the offering memorandum. In instances where, for example, specific performance metrics are targeted, issuers will need to ensure that the information, including third party reports, provided in an offering memorandum or reporting on an ongoing basis, is accurate and verifiable.

Demand for ESG transparency drives credit rating and regulatory movements

Credit rating agencies are responding to investor demand by expanding disclosure of entities' ESG credentials as part of their overall credit rating process. In January 2019, Fitch launched an "ESG relevance scores" programme that will be rolled out across all entities that they rate. The relevance scores are designed to tell investors how ESG issues intersect with the overall credit risk for a particular entity. S&P offers a similar "ESG evaluation" to analyse how an issuer's ESG credentials could impact its financial future, and Moody's has committed to strengthening its analysis of ESG considerations. Third party agencies that rate the sustainability of financial products are also increasing their coverage of the high yield market – by the end of 2017, major sustainability ratings agencies MSCI and Sustainalytics covered about one-third of the US high yield market with ESG ratings.

External ESG disclosure standards from regulators, particularly the European Commission, may drive issuers to consider their ESG credentials even more carefully. The European Commission's Action Plan on Sustainable Finance aims to create a Taxonomy Regulation to reduce confusion in identifying green financial products and a Disclosure Regulation requiring asset managers to identify a sustainable investment target and formulate policies on integrating sustainability risks into their investment decisions. The Disclosure Regulation was agreed in March 2019, and is currently moving through the EU legislative process. Potential issuers should start thinking about how these regulatory constraints on investors will affect the market for their high yield bonds. See also the articles on the Taxonomy Regulation on page 12 and the Disclosure Regulation on page 59.

ESG and green precedents in leveraged finance

Klabin Finance S.A. – $500 million of 4.875% Notes due 2027 (September 2017)
Clifford Chance's New York Capital Markets team advised the Brazilian pulp and paper producer Klabin on its high yield green bond issuance in September 2017. Klabin used the proceeds of its $500 million bond to finance projects in sustainable forest management, restoration and water and waste management. As part of the financing, Klabin Finance created an internal Green Bond Framework and received a second-party opinion from Sustainalytics, which certified the bond's alignment with the ICMA Green Bond Principles. Fitch Ratings affirmed Klabin's ratings at "BB+" in May 2019, one notch higher than Brazil's "BB" country ceiling.

Getlink SE – EUR550 million of 3.625% Senior Secured Notes due 2023 (October 2018)
Clifford Chance's London Capital Markets team represented the initial purchasers on the firm's debut European high yield green bond issuance by French company Getlink SE (formerly Groupe Eurotunnel SE) in October 2018. Getlink develops and manages "safe, modern, and environmentally-friendly mobility infrastructures", including the Channel Tunnel. Getlink issued EUR550 million in notes to finance its G2 Bridge Loan (also certified as a green bond under GBP) and cover capital expenditures for its ElecLink project. As part of the financing, Getlink received a second party opinion from DNV GL Business Assurance Services, which certified that the notes align with the ICMA Green Bond Principles. As of May 2019, Fitch Ratings has affirmed Getlink's bond as 'BB+' with a stable outlook.

MasMovil – EUR100 million RCF and EUR150 million capex line, EUR1.45 billion TLB due 2026 (May 2019)
Term Loan B borrowers are also jumping on the ESG bandwagon and changing the structure of their loan agreements to include ESG features. In May 2019, Spanish telecommunications operator MasMovil launched Europe's first-ever revolving EUR100 million revolving credit facility and EUR150 million capex line with ESG features that sit alongside a EUR1.45 billion seven year TLB. The TLB allows MasMovil to refinance existing debt at a lower cost. The RCF and capex line include terms that will increase interest rates on the loan if MasMovil's ESG rating deteriorates and decrease them by 15 bps if the rating improves.

In all three of the transactions above, issuers and borrowers have chosen to incorporate a focus on ESG in different and flexible ways. Bond issuers in the high yield space have followed the practice of investment-grade green bond issuers in not including specific covenants from the issuer about the sustainable or green nature of the bond, in contrast to some borrowers who sign express covenants linking ESG credentials to interest rates. For example, in June 2019, Nokia signed a EUR1.45 billion RCF which will decrease in margin if Nokia can reduce its greenhouse gas emissions by 41% and its greenhouse gas emissions arising from the use of its products by 71%, as compared to a 2014 baseline. This does not mean that it is impossible to tie bond coupons to sustainability ratings; in June 2019, German manufacturer Dürr AG became the world's first-ever Schuldschein issuer to adjust its bond coupon in line with an ESG rating. Dürr AG has linked the bond coupon to its ESG rating as determined by third-party agency EcoVadis. If the issuer can increase its

sustainability rating to a specific level defined by the third party, the margin of its debt will step down by 2 bps; if its sustainability rating falls proportionally, then 2 bps will be added to the coupon. The bond was several times oversubscribed and allowed the company to borrow at an average rate of 0.84% across various tranches, lower than the firm's previous cost of borrowing. Transactions of this type in investment-grade bonds illuminate ESG's potential to allow cheaper borrowing throughout the leveraged finance world.

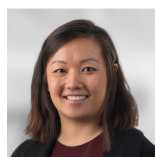
As the demand for sustainable investment accelerates, efforts to conform to high ESG standards do not just protect an issuer's reputation; they have concrete effects for financing. Issuers that work to improve their ESG credentials can raise capital through innovative new financial products and ESG governed funds, cooperate with investors bound by EU regulators and see their ESG credentials reflected in their credit rating. Early movers in the ESG leveraged finance space have succeeded in garnering strong investor buy-in for debt issuance. In 2019, paying attention to ESG is a smart form of strategic management for all players in leveraged finance.

CONTACTS

Michael Dakin
Partner
T: +44 20 7006 2856
E: michael.dakin@cliffordchance.com

Andrew Kelly
Partner
T: +44 20 7006 8552
E: andrew.kelly@cliffordchance.com

Drew Rundus
Senior Associate
T: +44 20 7006 2825
E: drew.rundus@cliffordchance.com



Carolyn Tan
Senior Associate
T: +44 20 7006 3107
E: carolyn.tan@cliffordchance.com

Special thanks to summer law clerk Rachel Sumption for her assistance in the preparation of this article

Annex 1: ESG Precedents in European Leveraged Finance

Issuer	Issuance Type	ESG Integration	Reporting	Size
Klabin Finance S.A. (September 2017)	High yield bond under Rule 144A/Reg S	Use of proceeds for financing and/or refinancing, of investments and/or costs related to eligible Green Projects. Green Project categories include: Sustainable Forest Management; Restoration of Native Forests and Conservation of Biodiversity; Renewable Energy; Clean Transportation; Energy Efficiency; Waste Management; Sustainable Water Management; Eco-Efficient and Circular Economy Adapted Products; Production Technologies and Processes; and Climate Change Adaptation.	Klabin created an internal Green Bond Framework and received an opinion from third-party agency Sustainalytics, which certified the bond's alignment with the 2017 ICMA Green Bond Principles.	USD500 million
Getlink SE (October 2018)	High yield bond under Reg S	Use of proceeds for refinancing a green bridge loan used for construction of the Eurotunnel Fixed Link, financing a new cross-border electrical interconnector ElecLink, and financing several upgrade projects for the Fixed Link.	Getlink created an internal Green Bond Framework and received an opinion from third-party agency DNV GL Business Assurance Services Limited which certified the bond's alignment with the 2018 ICMA Green Bond Principles.	EUR550 million

Issuer	Issuance Type	ESG Integration	Reporting	Size
MasMovil (May 2019)	RCF and capex line alongside Term Loan B	RCF and capex line that sit alongside the TLB include a sustainability pricing mechanism on the reguler loan's interest that either steps up if MasMovil's ESG rating deteriorates or steps down by 15 bps if the rating improves.	BNP Paribas acted as Sustainability Coordinator and Lead Rating Advisor on the loan. Third-party agency MSCI will determine MasMovil's ESG ratings.	EUR100 million RCF and EUR150 million capex line, EUR1.45 billion TLB
Nokia (June 2019)	RCF	RCF includes a sustainability pricing mechanism linking the margin of the RCF to two of Nokia's key sustainability targets: a 41% reduction in greenhouse gas emissions by Nokia's operations and a 75% reduction in greenhouse gas emissions by customer use of Nokia's products. The margin of the RCF will increase or decrease depending on Nokia's progress towards reaching these targets by 2030 compared with a 2014 baseline.	Nokia's sustainability targets are accepted by third-party agency Science Based Targets, ensuring that targets are independently validated to be in line with the 2015 COP 21 Paris Agreement goals.	EUR1.45 billion
Dürr AG (June 2019)	Schuldschein bonded loan	Loan coupon is linked to Dürr's sustainability rating. Dürr's current score is 51/100. If Dürr can score 62 or above on the EcoVadis scale, the debt will step down by 2 bps. If Dürr's sustainability rating falls to 40 or below, 2 bps will be added to the margin.	Third-party agency EcoVadis will determine Dürr's ESG ratings. The rating factors in ecological indicators such as CO_2 emissions and water consumption, while also taking account of such aspects as fair working relations and conditions along the supply chain.	EUR200 million

Source: Klabin S.A., Getlink SE, MasMovil, Nokia, Dürr AG

11. THE RISE OF SUSTAINABILITY-LINKED LOANS
MARKET DEVELOPMENTS AND OPPORTUNITIES

Whilst terminology in the sphere of green and sustainable loans is often used interchangeably, there is a distinction to be drawn between the traditional formulation based on the "use of proceeds" approach where the borrower is required to use the loan proceeds for specific green or sustainable purposes, and the emergence of a new school of "sustainability-linked loans" where pricing is determined based on compliance with certain green or sustainability targets (**SPTs**). The volume of green and sustainability-linked loans has increased significantly to approximately USD111.5 billion (as of June 2019), compared with just USD32 billion 12 months ago. Since our last publication in 2017 when we discussed acting on the "first-of-its-kind" sustainability-linked loan for European commercial property company Unibail-Rodamco, the market for sustainability-linked loans has grown rapidly, from approximately USD5 billion in 2017 to more than USD40 billion in 2018, and 2019 looks on course to surpass that.

The volume of green and sustainability-linked loans has increased significantly to approximately USD111.5 billion (as of June 2019), compared with just USD32 billion 12 months ago.

Sustainability-linked loans versus green loans

A key driver for many companies in entering into a sustainability-linked loan is that this enables them to preserve flexibility and continue to use the loan proceeds for general corporate or other purposes (which may or may not be ESG related) whilst still being able to have a positive ESG impact. This is demonstrated by the breadth of companies entering into these loans across a range of sectors. Recent examples include a EUR1.5 billion financing for Nokia, and credit facilities totalling EUR3.9 billion for the French multinational retailer, Carrefour.

Having published their Green Loan Principles in March 2018 (together with an extended iteration in December 2018), the LMA went on to formally recognise the rise of sustainability-linked loans and publish its Sustainability Linked Loan Principles (**SLPs**) in March 2019.

These focus on the following core components:

(1) **Relationship to the borrower's overall CSR strategy**. The borrower of a sustainability-linked loan should clearly communicate to its lenders its sustainability objectives, as set out in its CSR strategy, and how these align with its proposed sustainability performance targets (SPTs);

(2) **Target setting**. Amongst other things, SPTs should be ambitious and meaningful to the borrower's business and should be tied to a sustainability improvement in relation to a predetermined benchmark of sustainability performance targets;

(3) **Reporting**. Transparency is encouraged and borrowers should, where possible, make and keep readily available up-to-date information relating to their SPTs (such as any external ESG ratings), with such information to be provided to those institutions participating in the loan at least once each year; and

(4) **Review**. External review is encouraged, particularly where information relating to SPTs is not made publicly available or otherwise accompanied by an audit/assurance statement.

Determining sustainability criteria

There are no set sustainability criteria for sustainability-linked loans so each loan can be bespoke depending on a company's sustainability objectives. The most common metrics we see being used by corporates include greenhouse gas emissions and ESG scores, with scores being determined by sustainability ratings agencies such as Sustainalytics and Viego Eiris. The SLPs set out some other indicative categories including energy efficiency, water consumption and affordable housing, amongst others. The pricing adjustments can also be bespoke, although they typically involve a sustainability premium or discount to the margin depending on whether a particular target is met. This has led to an increased opportunity for banks to position themselves as "green agents", "sustainability coordinators" or other similar roles to help borrowers structure the ESG components of the loan.

Recent developments

Despite the recent flurry of activity in sustainability-linked loans, this has brought with it a number of criticisms of the extent to which these loans have any real sustainability impact. Given that the pricing adjustments tend to be small (typically around 2.5 basis points) and ESG related provisions (such as delivery of ESG compliance certificates and/or reports) are usually carved out of events of default, this has led to some criticism of these simply being a PR exercise for both banks and borrowers. Nonetheless, we have seen movement towards making these loans match stricter sustainability standards. For example, some recent financings have required amounts

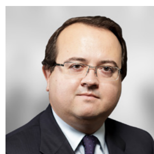
of sustainability premium and discount to be applied by the borrower for ESG purposes, the reasoning behind this being that banks should not be earning additional profit from the borrower's failure to meet its sustainability targets.

Whilst we have yet to see similar coupon adjusting products in the public bond markets, it is interesting to note that Dürr, a German mechanical and plant engineering company, recently issued a EUR200 million sustainability-linked schuldschein highlighting the possibility of using these structures in other forms of financing. (See previous article From Junk Bonds to Just Bonds on page 82 for more details)

We expect to see further innovation in structuring and the terms of these loans as the market for sustainability-linked loans continues to expand.

CONTACTS

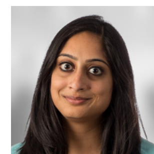
Auriane Bijon
Counsel
T: +33 1 4405 2468
E: auriane.bijon@cliffordchance.com



Cedric Burford
Partner
T: +33 1 4405 5308
E: cedric.burford@cliffordchance.com

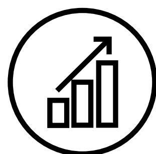
Emma Folds
Partner
T: +44 20 7006 2231
E: emma.folds@cliffordchance.com

Sophie Guilhem-Ducléon
Counsel
T: +33 1 4405 2442
E: sophie.guilhem-ducleon@cliffordchance.com



Puja Patel
Senior Associate
T: +44 20 7006 3351
E: puja.patel@cliffordchance.com

Nicola Wherity
Partner
T: +44 20 7006 2074
E: nicola.wherity@cliffordchance.com



12. BLUE BONDS
EXPANDING TO THE OCEANS

The blue economy is of growing importance and gaining momentum amongst policymakers across the world. The earth's surface is made up of 71 per cent. water, and billions of people rely on the oceans for their livelihoods and socioeconomic well-being. However, the effects of climate change and human activities are destroying the biodiversity of our oceans.

Innovative financial solutions will be required to enhance ocean and coastal resilience. Blue finance, specifically 'blue bonds', have huge potential to help unlock the ocean economy, while also protecting the marine environment.

Blue bonds are a pioneering debt financial instrument issued usually by governments or development banks. Blue bonds follow the same components of the ICMA Green Bond Principles i.e. the use of proceeds must be for projects that address key environmental concerns, a process for project evaluation and selection must be in place, a formal internal process to track the application of, and management of, proceeds must be applied, and annual reporting on the use of proceeds must take place. Where blue bonds slightly differ from green bonds is in the use of proceeds, whereby proceeds from a blue bond issuance are used specifically to finance marine and ocean-based projects or to safeguard the blue economy.

The first blue bond – Seychelles

On 11 October 2018, Clifford Chance advised Standard Chartered Bank as placement agent for the launch of the world's first sovereign blue bond by the Republic of Seychelles to advance the small island state's blue economy. The Seychelles blue bond was partially guaranteed by the World Bank (International Bank for Reconstruction and Development). The ten-year, privately placed bond raised USD15 million from three US international investors. The deal was structured as a private placement to Calvert Impact Capital, Prudential and Nuveen, the Chicago-based asset manager owned by pension fund TIAA-CREF, each investing USD5 million. BNY Mellon acted as trustee for the transaction. The use of proceeds specified, through operating manuals that were shared with investors, that the Government would use the proceeds to finance ocean-based projects, and enhance the protection of marine resources, while further developing the Seychelles' blue economy as it transitioned to a more sustainable fisheries industry.

Other blue bond Issuances

On 24 January 2019, Nordic Investment Bank launched its first Nordic-Baltic Blue Bond. The five-year SEK 2 billion bond was launched under the NIB Environmental Bond Framework and will focus on investments within water resource management and protection for projects such as wastewater treatment, prevention of water pollution and water-related climate change adaptation.

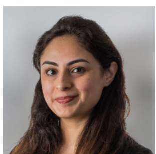
The Nature Conservancy, an international not-for-profit group, recently unveiled plans to mobilise USD1.6 billion of funding for global ocean conservation efforts through blue bonds under a scheme dubbed "blue bonds for conservation", an innovative financial model using philanthropy to save the world's oceans by providing upfront capital.

Blue bond benefits

The inaugural blue bond helped the Republic of Seychelles preserve and restore the biodiversity of the seas around the archipelago. It encouraged international investment and empowered local communities and businesses by developing sustainable fisheries, and encouraging tourism.

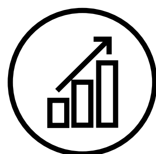
Blue bonds offer an opportunity for private sector capital to be mobilised to support sustainable investment. Capital markets have a key role to play in environmental stewardship and, more specifically, the protection of the oceans.

CONTACTS



Mehreen Malik
Senior Associate
T: +44 20 7006 4626
E: mehreen.malik@
cliffordchance.com

Deborah Zandstra
Partner
T: +44 20 7006 8234
E: deborah.zandstra@
cliffordchance.com



13. CLEAN, GREEN ENERGY
THE EVOLUTION IN THE RENEWABLES INDUSTRY

The renewables industry is rapidly evolving, driven by new technology and innovation, political policy, investor sentiment and public opinion, as efforts to limit climate change demand investment at scale and speed. This chapter draws out some of the emerging trends in the sector.

Technological Developments

Floating offshore wind
Offshore wind has been one of the biggest success stories in the transition to renewable generation, particularly in Europe, providing the greatest utility-scale capacity and one of the steepest cost reductions. Floating offshore wind is the next chapter in that story, whereby turbines are mounted on a semi-submersible platform or spar and tethered to the sea bed much further below by mooring lines. The key advantage of floating offshore wind is its potential to be deployed at depths greater than 50 metres. This opens up a far larger area to offshore wind deployment than its fixed equivalent, in areas with stronger and more consistent sea winds. As much as 80% of the total potential for offshore wind power is thought to be in deep waters. This could lead to offshore wind farms in depth-constrained regions with a narrow continental shelf, including Japan and the United States, as well as larger areas of European sea bed (including Portugal and France) where depth has been a limiting factor. An associated benefit is reduced impact on the sea bed during installation.

Floating offshore wind projects have largely been run as pilots to date, but in 2017 one such pilot, Hywind Scotland, a 30MW wind farm located 25 kilometres off the coast of Aberdeenshire, commenced generation and will power approximately 20,000 households. Two further floating offshore wind projects are currently under construction in Portugal and France. The aim of these projects is to search for cost reductions (as the offshore wind industry has been doing successfully for some time) and demonstrate the commercial viability of floating offshore wind. This could lead to a rapid expansion of the industry.

Battery Storage
One of the greatest challenges in transitioning to renewable energy has been the problem of intermittency of supply and the associated challenges of balancing the grid. Whilst not "renewables" in the strictest sense, battery storage has long been seen as the answer to these problems. However, its deployment at utility scale has been hampered by cost and a lack of tailor-made regulation resulting in energy storage facilities suffering the double punishment of being treated as both generator and offtaker. This said, battery prices have already fallen rapidly and BloombergNEF predicts that the capital cost of a utility-scale lithium-ion battery storage system will reduce by a further 52% between 2018 and 2030. Governments are recognising the important role battery storage has to play in ensuring they are able to meet their

climate change targets and have therefore focussed on addressing the regulatory hurdles. An example of this is the requirement in the EU's "Clean Energy for all Europeans" package, adopted on 22 May 2019, for all Member States to ensure a level playing field for all types of market participants in all organised electricity markets, including ancillary services markets, and to provide incentives to flexible generation and demand. The governments of Australia and Jordan have been pioneers in fostering the development of stand-alone utility scale energy storage systems.

An advantage of battery storage is that it can be integrated with digital grid technology to provide power on demand without human involvement and far more rapidly than the response time of a fossil-fuel fired power station. In a post-subsidy merchant-risk world, the combination of energy storage and renewables will enable the smooth supply of green energy to the grid by renewable generators at times when the sun isn't shining or the wind isn't blowing, when the returns can be maximised.

Carbon Capture, (Usage) and Storage (CC(U)S)
CC(U)S is the process by which carbon dioxide is captured during the combustion of fossil fuels and then either sold for use in industrial processes or stored long-term underground, including in exhausted sub-sea oil and gas fields. When CC(U)S is combined with biomass generation it is feasible that the net carbon output will be negative, resulting in carbon abatement or a net reduction of carbon in the atmosphere.

It is widely acknowledged, notably in the recent report by the UK's Committee on Climate Change (the **CCC**), that renewables alone will not be enough for the UK to achieve net zero carbon emissions by 2050. That report refers to CC(U)S as "a necessity and not an option".

To date, no commercial scale CC(U)S plant has been constructed in the UK and this partly reflects a lack of consistency in government policy and financial support which has undermined investor confidence. However, with the UK Government's recent adoption of the CCC's net zero carbon target by 2050, there is expectation in the industry that this will change. Furthermore, buoyed by the recommendations of the CCC, we are already seeing industry driving forward developments with the signing of a memorandum of understanding between Drax Group, Equinor and National Grid Ventures to explore the possibility of the construction of a large-scale CC(U)S network in the mid-2020s. Drax Power Station, one of the largest power stations in the UK, is already operating a pilot carbon capture project from its biomass fuelled generating units.

Market Participants

The universe of participants in the renewable energy sector and associated industries becomes ever more diverse, with earlier entrants growing to become significant players in the market and existing energy market players adapting their own expertise to take advantage of the opportunities presented by the renewables revolution. A few key trends are worthy of note.

In Europe in particular (less so in the United States), there has been a re-focussing of traditional oil and gas companies towards renewables as these companies seek to position themselves in the energy market of the future, develop corporate strategies

that are compatible with the targets of the Paris Agreement and communicate this change in approach to shareholders and consumers. Examples of this shift include the re-branding of Danish Oil and Natural Gas (DONG) to become Orsted, having entirely divested its fossil fuel interests and emerged to become one of the world's leading offshore wind developers, and of Norway's Statoil to become Equinor which aims to become the world's most carbon-efficient oil and gas producer, whilst expanding its participation in renewables, including in some of the more ground-breaking floating offshore wind and CC(U)S projects. Shell and BP are also becoming significant players in the renewables sphere, bringing to bear their substantial financial capabilities, including through the acquisition of innovative start-ups and technical expertise.

Perhaps more unexpectedly is the increasing presence of big-tech in the renewables space. As discussed further below, companies like Google and Facebook have been pioneers in securing green power to meet their energy needs through corporate power purchase agreements (**PPAs**). However, this is not the extent of their involvement. In May 2019 Facebook announced that it was providing tax-equity financing for a 379-megawatt solar project in Texas with Shell as the offtaker in the shorter-term, the first time the social media giant has directly invested in a wind or solar project. Given their large balance sheets, focus on research and innovation and need to maintain social licence at a global level, it is perhaps unsurprising that large tech companies are applying themselves to the challenge of climate change, and we can expect to see their participation continue.

Japan, Taiwan and the United States are seen as the next key markets in offshore wind as the technology expands outside Europe. China also has a growing offshore wind market although until recently this has been seen as largely closed off to international investors. In preparation for the development of these markets we have seen Japanese and Chinese investors acquiring minority stakes in European offshore wind farms at both the development and operational stages, partly as a means of accessing market knowledge and developing experience of this asset class.

The Rise Of Corporate PPAs

A relatively recent trend, particularly in the USA and Scandinavia, but increasingly across European and other jurisdictions, is the growth of corporate PPAs. Under a corporate PPA, a corporate directly contracts with an energy generator for the purchase of energy to meet the corporate's energy demands, by-passing the supply companies. Large tech companies, including Apple and Google, who have very high energy demands in their data centres, have been pioneers in this area in developed economies, and large corporates in other sectors have been following suit. For a large corporate with relative certainty around its medium to long-term energy needs, contracting for renewable energy in this way meets two distinct business objectives: firstly, with the dramatic reduction in the cost of renewable power, such PPAs can now present an opportunity to drive down power costs (often a large and volatile operational expense) below market price and increase certainty around such costs in the longer term. Secondly, energy efficiency and energy sourcing are increasingly subject to stakeholder (including shareholders but also including contractual counterparties and employees) scrutiny and the commitment to acquire renewable power enables such companies to meet their, often very ambitious, clean energy targets. By way of example, Facebook has committed to attain 100% clean energy by 2020.

Corporate PPAs can generally by categorised as either physical or virtual/synthetic.

Under a physical PPA the corporate offtaker physically receives the power generated by the generator, often through a direct, private wire, with the aim of avoiding use of system charges. The downside for the corporate consumer is that unless effective storage is also deployed, the consumer will be exposed to the intermittency of supply associated with renewable power and will therefore require a back-up supply or grid connection. In many examples, the corporate agrees to buy a fixed block of power, typically leaving the generator to deal with at least some of the intermittency risk. The concern for the generator, particularly if this arrangement is to be bankable, is that it is tied to a single customer for up to fifteen years, and so long-term creditworthiness of the counterparty is key.

By contrast, in the case of a synthetic or virtual PPA, both the generator and the corporate offtaker are connected to the system grid and their primary liability for imbalances of supply and demand is to the grid operator. This type of PPA allows the counterparties more flexibility, both in terms of pricing structures, which can range from fixed-price and discount-to-market to contracts for difference, and in terms of counterparty default, because both the generator and the offtaker have the ability to find alternative buyers or sellers.

The use of corporate PPAs is not restricted to established markets. We are also seeing direct supply PPAs in regions with limited grid infrastructure, particularly between energy-intensive mining operations in Australia, South Africa and Chile with a neighbouring renewable generator. Such long-term renewable PPAs are now often cheaper than the diesel generators that have historically been used in mining.

Developments in Financing

Financing offshore wind

Europe is the home to the largest offshore wind farms in the world, with Orsted's operational Walney Extension Project producing enough power for nearly 600,000 homes, soon to be out-done by the Hornsea One Project which will provide clean energy to one million homes when completed in 2020. The massive size of these projects is resulting in the need to tap multiple sources of debt and is even leading to consolidation amongst developers, as evidenced by the recently announced joint venture between Portuguese EDP and French utility company Engie, in order to bring together the expertise and financial clout required to deliver projects at this scale.

As the projects increase in size, financings need to leverage both banks and institutional investors, typically with some export credit agency support. More recently mezzanine financing has been layered on top of these senior tranches. Nevertheless, the relative maturity and proven track record of this asset class, especially those projects developed by the most experienced sponsors, together with the substantial ticket size and longer tenor of debt available, has proved extremely attractive to financial institutions looking for a "green" home for capital and as a result the debt terms are very much those of a borrower-driven market.

The next challenge for this sector as the size of wind farms, distance from shore and therefore associated financing costs continue to increase, will be ever reducing government subsidies and the transition to merchant power price risk. Whilst we are already seeing some investors being comfortable with a relatively brief subsidy-free tail period, that is certainly not the case for all investors currently participating in offshore wind farm financings, at least in the UK. The signing by Orsted and Northumbrian Water Group in February 2019 of a ten year fixed-price power purchase agreement for

a percentage of the power generated by Race Bank offshore wind farm is the first corporate PPA for an offshore wind farm in the UK, and reflects one way of providing certainty of revenue in a post-subsidy environment. However, with the size of offshore wind farms currently in the planning stages, for the UK, corporate PPAs alone might not be enough to satisfy potential lenders that the future revenue streams will be sufficient to meet debt service obligations.

Nevertheless, in some jurisdictions (e.g. the Netherlands), zero-subsidy bids appear to be becoming the new norm. For example, Vattenfall was awarded the permits for Hollandse Kust (zuid) I and II on a subsidy free basis and it is understood that a number of competitive subsidy free bids have been submitted for the Hollandse Kust (zuid) III and IV auction process. There also appears to be appetite for non-recourse project financing for these transactions due to availability of long-term PPAs and continuing reduction of construction costs and capex.

Portfolio Financing
A number of sponsors are seeking to develop or buy a portfolio of assets in order to benefit from diversification of risk and operational synergies. Many such portfolios of operational assets are now being financed on terms which sit somewhere between project finance and corporate debt. Institutional investors have been attached to such portfolios, both in debt and equity, as offering a scalable opportunity. To date, such portfolios have tended to be of renewables generation assets, but we can envisage further additions in the form of battery storage.

Given the political commitments made and pubic sentiment, we can only expect that the green growth story remains strong.

CONTACTS

Lori-Ann Bean
Partner
T: +1 202 912 5014
E: lori.bean@cliffordchance.com

Matthew Buchanan
Partner
T: +65 6410 2206
E: matthew.buchanan@cliffordchance.com

Clare Burgess
Partner
T: +44 20 7006 1727
E: clare.burgess@cliffordchance.com

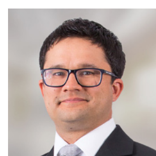
Jose Guardo
Partner
T: +34 91 590 7595
E: jose.guardo@cliffordchance.com

Dr. Christof Häfner
Partner
T: +49 69 7199 3160
E: christof.häfner@cliffordchance.com

Dr. Florian Mahler
Partner
T: +49 211 4355 5232
E: florian.mahler@cliffordchance.com

David Metzger
Partner
T: +44 20 7006 4240
E: david.metzger@cliffordchance.com

James Pay
Partner
T: +44 20 7006 2625
E: james.pay@cliffordchance.com



Philip Sealey
Director, Head of Renewables, Asia Pacific
T: +61 8 9262 5542
E: philip.sealey@cliffordchance.com

Delphine Siino Courtin
Partner
T: +33 1 4405 5236
E: delphine.siinocourtin@cliffordchance.com

Hein Tonnaer
Partner
T: +31 20 711 9528
E: hein.tonnaer@cliffordchance.com

Felicity Ward
Senior Associate
T: +44 20 7006 4504
E: felicity.ward@cliffordchance.com

14. CLIMATE CHANGE AND THE PRESSURE ON COAL
LATEST DEVELOPMENTS

Coal projects are under pressure from governments, courts, businesses and investors as the momentum to reduce the use of coal builds. This briefing explores some of the action being taken by the public and private sectors and its impact on the industry.

Coal powered the industrial revolution and remains a key fuel source powering growth in nations such as China and India. However, continued high demand for coal across Asia – both for power and industrial processes such as steel production – contrasts with rapidly declining coal use across much of the developed world. With the Paris Agreement's objective of limiting the increase in global temperatures to 2°C above pre-industrial levels, calls to reduce coal use have been growing steadily.

Coal use has been on the decline in developed countries over the last two decades as the combination of aged coal plants, increasingly cost-competitive alternatives and environmental imperatives has led an increasing number of countries to favour cleaner, lower-carbon energy generation. The huge global growth of renewable generation, alongside the adoption of policies to phase out all coal generation in countries like Germany and the UK, epitomise this change. Although the International Energy Agency predicts only a 2% decline by 2023 in coal's contribution to the total global energy mix (from 27% to 25%), the change has been, and will be, significantly more dramatic across Europe where the European Electricity Sector Association (Eurelectric) has pledged on behalf of its members (other than Poland and Greece) not to build any further coal plants after 2020.

Intervention by Courts/decision-makers on coal projects

National courts and decision-makers are starting to rely on climate change as a ground for stopping coal extraction projects. Most recently, in February 2019, the Chief Judge of the New South Wales Land and Environment Court dismissed an appeal against a refusal for a mining application given by the NSW Planning Assessment Commission in 2017 for a new open cast coal cast mine in New South Wales, Australia, known as the Rocky Hill Coal Project. This landmark judgment cited traditional zoning, visual and amenity impacts as sufficient grounds for refusal of the appeal, but, critically, the judge also cited the likely contribution of extracted coal to the adverse impacts on the climate system as a further reason for refusal. In a decision which analysed climate issues in depth, the judge decided that he should take into account in his determination not only the direct emissions of extraction (e.g. fugitive methane emissions), but also so-called scope 2 and scope 3 emissions caused by combustion of coal down the supply chain. The judge concluded (with words that may be echoed in future judgements on this issue) that the Rocky Hill Coal Project would be in the "wrong place at the wrong time […] because the GHG emissions of the coal mine and its coal product will increase global total concentrations of GHGs at a time when what is now urgently needed, in order to meet generally agreed climate targets, is a rapid and deep decrease in GHG emissions. These dire consequences should be avoided."

Coal – key issues

- Coal use is declining in developed countries due to lower cost, and cleaner, alternatives and environmental policies.
- Courts and decision-makers are starting to take an interventionist approach in blocking coal projects.
- Political pressure against coal projects is growing with some developed countries putting in place coal bans.
- Private sector action is also increasing, fuelled by investor concern, CSR and ESG commitments and supply chain pressure.
- Coal is still a key fuel in countries with developing economies driven by lower costs and support for national coal industries, but these drivers may change.
- Technological questions still remain over a move to cleaner alternatives, including the role of carbon capture and alternatives to coal in the steel industry.

Given the central role of coal in the mining sector in Australia, it is unsurprising that this judgment has proved highly controversial, with domestic commentators claiming that it will have far-reaching consequences for other fossil fuel projects. The developer has confirmed that it will not pursue further avenues of appeal in the NSW Supreme Court, and will not proceed with the Rocky Hill Coal Project.

This judgment followed a similar case in the UK in 2018 in which the UK Secretary of State for Communities and Local Government rejected planning approval for an opencast mine in England. The decision was based upon UK planning policy which requires that permission for extraction of coal should not normally be given unless the proposal is environmentally acceptable or can be made so; or, failing that, if the benefits of extraction clearly outweigh the adverse impacts. The Secretary of State decided that the significant impact caused by greenhouse gas (**GHG**) emissions and on climate change were factors that needed to be considered, and that the balance ultimately tilted towards rejecting the scheme. The decision was later quashed on procedural grounds and is now subject to an appeal to the UK Court of Appeal – its decision will be watched very closely by industry.

In the United States, reflecting the currently divergent views between many state and federal authorities, there are several pending cases that challenge approvals or denials of specific coal-related projects. At the federal level, several environmental advocacy groups have sued the US Department of the Interior to stop the expansion of the Bull Mountains coal mine in Montana. At state level, the developer of a coal export terminal sued the Washington State Department of Ecology, alleging that it improperly denied approval for the coal export terminal due to concerns with the environmental impact of coal. Both cases remain pending, so we will have to wait to see whether, and how far, the courts will act as a check on the Trump administration's ambitions for the US coal sector.

It remains to be seen whether cases such as these will provide impetus for other countries' courts and decision-makers to take into account climate impact in planning and related approvals relating to, *inter alia,* future coal and coal power projects. Doubtless, domestic energy needs, economics and employment will remain factors that will weigh heavily in such decisions, but the increased willingness of courts to require direct and indirect climate change impacts to be taken into account is potentially very significant.

Political pressure on coal

In November 2017, an alliance of national and sub-national governments, businesses and organisations signed a declaration on ending coal-fired power generation by 2030 in the EU and OECD countries, and by 2050 elsewhere. Signatories to this Powering Past Coal Alliance Declaration proposed the phasing out of traditional coal power generation and a moratorium on all new coal plant without Carbon Capture and Storage (CCS). This Alliance has grown from an initial 20 members to 80 as of December 2018, including 30 national governments (see table below).

Powering Past Coal Alliance members as at December 2018	
National Governments	Austria, Angola, Belgium, Canada, Costa Rica, Denmark, El Salvador, Ethiopia, Fiji, Finland, France, Ireland, Israel, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Marshall Islands, Mexico, Netherlands, New Zealand, Niue, Portugal, Senegal, Sweden, Switzerland, Tuvalu, Vanuatu, United Kingdom
Sub-national Governments	Australian Capital Territory Australian cities: Melbourne, Sydney Canadian Provinces: Alberta, British Columbia, Ontario, Quebec, Vancouver US States: California, Connecticut, Hawaii, Minnesota, New York, Oregon, Washington US Cities: Honolulu, Los Angeles Government of the Balearic Islands, Spain South Chungcheong Province (South Korea) City of Rotterdam, Netherlands Scottish and Welsh Governments
Businesses and Organisations	Alterra Power Corp., ArcTern Ventures, Autodesk, Avant Garde Innovations, BT, CCLA Investment Management Limited, Diageo, Drax, DSM, Econet Group, EcoSmart, Electricité de France (**EDF**), Engie, GeoExchange Coalition, GreenScience, Iberdrola, Kering, Marks and Spencer, Natura Cosmetics, Ørsted, Pacific Islands Development Forum, Salesforce, Scottish Power, SSE, Storebrand, Unilever, Virgin Group, XPND Capital

Commitments under the Paris Agreement are contributing to a number of countries' decisions (mainly in Western Europe) to move away from coal in a transition to a low carbon economy, but in a way that suits the national context. Examples are:

- **Germany:** The German Coal Commission voted in January 2019, subject to Government approval, to prohibit coal-fired power generation by 2038 at the latest (and possibly by 2035). This would be a bold and historic move for Germany which has a large coal industry, and comes despite the pledge to also phase out nuclear power generation following the Fukushima disaster. It remains to be seen whether the Government is prepared to pay the large compensation bill to close these plants down and whether coal-producing regions will further support this move. Despite these concerns, even stricter targets, such as a prohibition by 2030 are, being discussed seriously.
- **The Netherlands:** Legislation which would set a phased close-down of coal-fired plants between 2025 and 2030 is currently being debated, driven by the Netherlands' national target to reduce domestic CO_2 emissions by 49% by 2030 (against 1990 levels). In October 2018, the Dutch Court of Appeal upheld a decision that the state must reduce emissions by at least 25% by 2020. This decision has already led to a Government decision to close a coal-fired power station in Amsterdam (*Hemwegcentrale*) by 31 December 2019.
- **UK:** The world's first coal power plant opened in London in 1882, but today the UK Government is committed to ending coal-fired generation (unless developed with carbon capture, use and storage (CCUS)) by 2025. This is to be achieved by imposing CO_2 emissions limits on power generation units. The UK's support for CCUS was initially strong, with the UK government seeking to promote UK leadership in the technology with a £1 billion subsidy to develop a commercial scale CCUS plant. However, the subsidy was cancelled as part of wider budget cuts, leaving development of CCUS in the UK with little substantive government support.

Elsewhere, coal remains key to many national economies.

Australia's energy policy has been subject to much politicking in recent years. The current federal (coalition) Government has been a vocal supporter of investment in new coal power stations. However, in March 2019, the Prime Minster released a shortlist of 12 baseload projects across Australia that the federal government could underwrite as part of its strategy to increase competition in the generation sector; only one of these involved coal. The others were gas-fired or pumped hydro projects. The opposition Labour party is also threatening to ban the federal government from funding new coal investments if it comes into power. A federal election is set to take place on 18 May 2019, and so Australia's energy policy may remain in a state of flux this year. Following the Liberal party's recent victory in the May 2019 federal election, we expect that stakeholders will continue to push for changes to Australia's energy policy in order to encourage investment in large scale low emissions projects following the end of the federal renewable energy target from 2020. Whether this occurs through a revival of the national energy guarantee (or something like it) at the federal or state level remains to be seen.

In the US, coal-fired power generation has been declining in recent years, but this is largely due to other cheaper sources of energy (natural gas and renewable energy) undercutting coal prices, as well as air-quality issues. While the current US Administration has been strongly supportive of the US coal industry, and stated an intention to pull out of the Paris Agreement, signs of a new green movement may be emerging. Twenty-two US states (and one territory) have committed to upholding the objectives of the 2015 Paris Agreement and have followed these commitments with action. In May 2018, Governor Andrew Cuomo of New York announced regulations that would end coal use in New York state by 2020. In January 2019, he also announced a "Green New Deal," which mandates 100% clean energy in New York state by 2040. The US House of Representatives has also reinstated the Select Committee on the Climate Crisis, which will focus on global warming "from the standpoint of health, security, economics and morality". The debate, generated by Alexandria Ocasio-Cortez's Green New Deal, which proposes a comprehensive plan to address US climate change and stimulate the economy, may push climate change issues to the fore in the 2020 Presidential election.

The importance of coal as a major power generation source for countries with developing economies is unlikely to diminish for the foreseeable future where coal is seen as a cheap energy source powering industrialisation. However, the coming years are likely to see the drivers necessary to reduce the use of coal increasing. These may be directly as a result of climate commitments, but are equally likely to result from increasingly stringent environmental policies to control air pollution (e.g. in China), as well as the improving economics of natural gas and renewable power generation (e.g. in India).

The private sector

In addition to independent action taken by utilities (notably the restructuring of E.ON and Innogy in Germany), and pressures exerted by NGOs and government policy, individual investors and investor groups (such as Climate 100+ and the Institutional Investors Group on Climate Change, IIGCC) have led calls for mining companies to move away from coal extraction and for utilities to make coal-fired power generation a thing of the past. Following the conclusion of the latest Climate Conference in Katowice, Poland, investors with over USD11 trillion under management urged power generators to eliminate coal use by 2030. How coal-reliant organisations will manage future stranded assets resulting from the inevitable (and possibly rapid) exit from coal is of particular concern to these investors.

The UK Church of England (through its Church Commissioners, a Climate 100+ investor) led action urging Australia-based mining and commodities company Glencore to limit its coal production. This led to Glencore pledging in February 2019 to cap its coal production at around 150 million tonnes of coal per year. This follows Rio Tinto's 2018 decision to exit coal completely, selling its remaining coal mine interests.

In February 2019, the Global Investor Coalition on Climate Change (formed of four investor groups including IIGCC) turned its sights to the steel producing industry, announcing its expectations that steel companies set goals and transition plans consistent with Paris Agreement targets. A key aspect of those transition plans is likely to be a move away from use of coking coal in the manufacturing process to the alternatives, e.g. hydrogen, although this technology has not yet been fully commercialised.

Adding to this pressure is the position taken by increasing numbers of banks and insurance companies who are refusing to provide finance or insurance cover for coal extraction or coal-fired power generation. Allianz, for example, decided to stop offering insurance to planned and existing coal-fired generation plants in May 2018. In December 2018, the European Bank for Reconstruction and Development launched its five-year strategy, announcing its decision to end the financing of thermal coal mining or coal-fired power generation; this decision may well have a significant effect on developing regions where coal is still dominant. A combination of corporate social responsibility and environmental and social governance policies, fear of bad publicity and actual divestment threats are driving banks to address the issue directly, with investors and pressure groups asking banks to lend in a manner consistent with the Paris Agreement. A number of commercial banks have already said they will not provide further coal power funding – there will be continuing pressure on others to follow suit.

A growing number of corporates are taking a strong lead on climate issues also. To give just one prominent recent example, in February 2019 Volkswagen announced that it would give performance ratings to its supply chain based on environmental impact and social responsibility, with those ratings counting in its procurement decisions. Its aim is to produce a carbon-neutral vehicle fleet by 2040. Where it is leading, others will surely follow.

What's next?

While coal may still be king in much of the world, where industrialisation is key, it is clear that momentum is building in Western economies for a move towards cleaner fuels. This move is being driven from a number of different directions in the public and private spheres. The pressure for change is likely to grow as the recognition of the need for urgent climate change action intensifies, and as global businesses increasingly seek to distance themselves from activities labelled as 'unsustainable'.

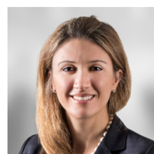
Of course, even in Western economies there are countervailing concerns: a continuing need for cheaper energy often provided by coal; a natural desire to support national coal industries and exports; and fears that low carbon sources will be inadequate to maintain economical and reliable power systems. Questions will also remain over technological development – what role will CCUS play in the continuation of coal use in the power sector and who will fund it? Will alternatives to coking coal prove suitable and economic in the steel sector? However, with the Paris Agreement's 1.5°C and 2°C warming targets in mind, pressure for change is likely to continue from governments, NGOs, the courts, corporates, investors and voters alike.

CONTACTS

Liesbeth Buiter
Counsel
T: +31 20 711 9326
E: liesbeth.buiter@cliffordchance.com

Michael Coxall
Knowledge Director
T: +44 20 7006 4315
E: michael.coxall@cliffordchance.com

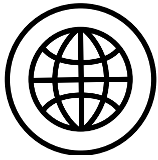
Nigel Howorth
Partner
T: +44 20 7006 4076
E: nigel.howorth@cliffordchance.com



Nadia Kalic
Partner
T: +61 2 8922 8095
E: nadia.kalic@cliffordchance.com

James Pay
Partner
T: +44 20 7006 2625
E: james.pay@cliffordchance.com

GLOBAL PERSPECTIVES



15. US
GREEN BONDS: BRIDGING THE GAP

As demand for green financings continues to grow and issuers begin to see marketing or pricing advantages where they commit to using the proceeds of a financing for green purposes, there is a concern amongst some market participants that bond investors located in the United States are seeing more limited opportunities to invest in green bonds than in Europe and elsewhere.

Part of the reason for a more limited supply of green bonds directed at US investors is likely the more onerous disclosure requirements under the US securities laws, principally liability under Rule 10b-5 for material misstatements or omissions in an offering document. For Rule 144A offerings to qualified institutional investors in the US, which is one of the most common ways in which non-US issuers offer bonds to US investors, offering participants are subject to Rule 10b-5 liability. European and other issuers offering green bonds outside of the US in record numbers have so far shown themselves hesitant to extend their offerings of green bonds into the US through Rule 144A, no doubt in part due to concerns over US securities law liability and associated costs.

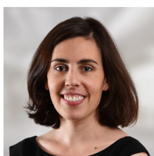
Are their concerns justified? On the one hand, there is no denying that a Rule 144A offering into the US imposes additional costs for offering participants. For any bond offering, opening the offering to US investors under Rule 144A already entails heightened due diligence and more granular disclosure of the issuer's business and financials. In particular, the offering document must be appropriately diligenced and drafted in a verifiable manner in order to provide offering participants with a defence against potential lawsuits under Rule 10b-5.

In the context of green bonds, opening the offering to US investors under Rule 144A would likely also impose additional diligence and drafting requirements on the use of proceeds section (which is one of the disclosure sections where green bonds demonstrate why they deserve to benefit from the "green" label), and may necessitate third party reporting depending on the circumstances and the kind of projects the issuer wants to qualify as "green". Amongst other requirements, offering participants may also need to include specific disclosure on the risks of failing to meet the expected green outcomes and to otherwise generally ensure that the disclosure does not contain any material misstatements or omissions.

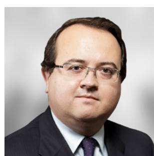
On the other hand, the regulatory trend in Europe and elsewhere is to move towards more disclosure for green bonds, not less; third party reporting regimes are becoming more commonplace; and asset managers and other investors are becoming more vocal in their demand for green bonds with full disclosure. In light of these trends, the gap with what would be required for a Rule 144A green bond is narrowing.

For the time being, green bonds offered to US investors seem to be largely limited to sovereign and quasi-sovereign entities and a handful of trail-blazing private issuers. But as green bond demand slowly leads to an expected price advantage for issuers over the non-green variety, as well as increased investor expectations for green bond disclosure, the incremental costs of offering a green bond into the US under Rule 144A may start to be outweighed in issuer's minds by the benefits of accessing the world's deepest capital markets.

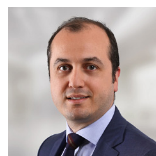
CONTACTS



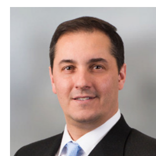
Aurian Bijon
Counsel
T: +33 1 4405 2468
E: aurian.bijon@
cliffordchance.com



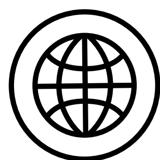
Cedric Burford
Partner
T: +33 1 4405 5308
E: cedric.burford@
cliffordchance.com



Oliver Plessis
US Counsel
T: +33 1 4405 5487
E: oliver.plessis@
cliffordchance.com



Hugo Triaca
Partner
T: +1 212 878 3222
E: hugo.triaca@
cliffordchance.com



16. ASEAN GREEN BOND STANDARDS AND SOCIAL SUSTAINABILITY BONDS

In the last few years the market demand for green financing in the Asia-Pacific region has grown in sync with the financing needs to support the "greening" of Asian economies. The Asia-Pacific region accounted for approximately USD48 billion (more than a quarter of global green bond issuance) in 2018, and it is estimated that ASEAN[1] alone will require USD1.47 billion in green investment annually until 2030. As of June 2019, the Singapore green bond market alone accounted for USD4.5 billion in issuance.[2]

Recognising that the public sector and the bank lending markets do not, by themselves, have the capacity to bear these significant demands for green financing in the region, the ASEAN governments, and, in particular, the Monetary Authority of Singapore (the **MAS**), have continued to demonstrate leadership in adopting innovative policy measures to unlock capital markets solutions for financing green investments. Given the growing depth and liquidity of fixed income markets in ASEAN generally, the MAS recognises that capital markets have a central role to play in meeting this demand.

Two particular policy initiatives have developed over the past 12-18 months, aimed at moving capital markets towards the centre ground of meeting the growing need for green financing in ASEAN.

The ASEAN Green Bond Standards

In November 2017, the ASEAN Capital Markets Forum (the **ACMF**)[3] adopted the ASEAN Green Bond Standards (the **ASEAN GBS**), which aim to serve as a guide to ASEAN countries in implementing their commitments under the Paris Agreement and the UN Sustainable Development Goals. In addition, prior to the adoption of the ASEAN GBS, ASEAN countries either adopted and implemented their own green bond standards or did not follow internationally recognised green bond standards at all.

1 The association of South East Asian Nations, whose member states are Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Singapore, Thailand and Vietnam.

2 Mr Benny Chey, Assistant Managing Director, Monetary Authority of Singapore, opening remarks at *Innovate4Climate* (4 June 2019, Singapore).

3 The ACMF is a forum which comprises capital markets regulators from ASEAN countries, whose primary task is to promote greater integration and connectivity of capital markets in the ASEAN region.

4 ASEAN GBS 2018, Introduction.

Accordingly, the ASEAN GBS has been developed in order to enhance transparency, consistency and uniformity across ASEAN green bond issuances, and aims to contribute to the development of a new asset class, reduce due diligence costs and make informed investment decisions.[4]

Convergence with ICMA Green Bond Principles and the ASEAN Green Bond Label

Importantly, the ASEAN GBS are based on the ICMA Green Bond Principles (**ICMA GBP**), as they are perceived as being "internationally accepted and widely used for the development of national green bond guidelines or standards issued globally."[5] While borrowing from the structure and technology of the ICMA GBP provides a point of convergence between internationally accepted standards and those aimed at addressing ASEAN-specific issues, a key conceptual difference is that, whereas the ICMA GBP provides a broad principles-based guidance framework on green bonds, the ASEAN GBP aims for a more granular approach to its guidance framework. In order for an ICMA GBP-compliant green bond to be labelled as "ASEAN Green Bonds" it must also comply with additional ASEAN specific requirements as set out below.

The ASEAN Green Bond label is aimed at providing certainty to investors that the instruments benefiting from the label have met uniformed standards in the region, while also "providing issuers with guide rails on best practices for green bonds".[6]

Development of the ASEAN Green Bond Principles

The ASEAN Green Bond Principles were originally issued in November 2017 following consultation with ICMA, ASEAN capital markets regulators and capital markets industry participants in the region and endorsement by the ACMF. The ACMF released updated standards in 2018, aimed at reflecting the development and growth of the green bond market in ASEAN, and providing key enhancements to the ASEAN GBS around:

- additional guidance and updated definitions for external reviews;
- references to eligible project categories contributing to five high level environmental objectives, namely: climate change adaptation; natural resource conservation; biodiversity conservation; and pollution prevention and control (compared with four key "areas of control" set out in the original 2017 ASEAN GBS); and
- timely reporting of material developments.

The ICMA GBP and ASEAN GBS Compared

The ASEAN GBS remains aligned with the four key principles of the ICMA GBP in that it requires defining the use of proceeds, provides a process for project evaluation and selection and management of the proceeds, and requires a reporting framework for the use of the proceeds.

However, in addition to adhering to the ICMA GBP principles, the ASEAN GBS includes the following additional features:

5 ASEAN GBS 2018.

6 ASEAN GBS 2018.

Eligible Issuers

For the bonds to qualify as ASEAN Green Bonds, either the issuer or issuer of the instrument must have a geographical or economic connection with the ASEAN region. This translates into a requirement that either the issuer is incorporated in ASEAN, or, in the case of a non-ASEAN issuer, that the eligible projects are located in any of the ASEAN countries. In addition, the ASEAN Green Bond issuance must also have originated in any of the ASEAN member countries.[7]

Ineligible Projects

The ASEAN GBS specifically excludes fossil fuel power generation projects from its remit, with the stated purpose of this specific exclusion to mitigate any "greenwashing" of projects, and so to preserve and protect the integrity of the ASEAN Green Bond label.

Continuous Accessibility to Information

In addition to setting out relevant green bond information in the offering document, issuers are also required to ensure that information relating to the use of proceeds, the process for project evaluation, and selection and management of the proceeds, is also publicly accessible from a website designated by the Issuer throughout the tenor of the series of ASEAN Green Bonds in issuance.

Encourage More Frequent Reporting

In addition to annual reporting, issuers are encouraged to report periodically on a more frequent basis, with the aim of increasing transparency on the allocation of the proceeds from the ASEAN Green Bonds, and, in so doing, enhancing investor confidence in the label. The annual report (annual reporting being the minimum requirement) requires disclosure of a list of the projects to which the proceeds from the ASEAN Green Bonds have been allocated, a brief description of those projects, the amounts allocated, and their expected impact.[8]

External Review

Consistent with the ICMA GBP, the appointment of an external reviewer is voluntary under the ASEAN GBS. However, in taking into account the comparably nascent stage of development of the green bond market in ASEAN, the ASEAN GBS requires external reviewers to have "the relevant expertise and experience" in the areas they are reviewing, with their credentials and the scope of review being conducted being made publicly accessible from a website designated (and presumably maintained) by the issuer through the life of the series of ASEAN Green Bonds issued. The aim of this enhanced requirement is to ensure that this continuing, and more granular, disclosure on the review enhances awareness of the standard and, in turn, promotes investor confidence in the label.

7 ASEAN GBS 2018, Paragraph 3 (Criteria for ASEAN Green Bonds).

8 ASEAN GBS 2018, Paragraph 4.4 (Reporting).

Social and Sustainability Bonds

ASEAN Social Bond Standards

The ACMF has developed ASEAN Social Bond Standards and Sustainability Bond Standards, and these were published in October 2018. These follow the same format as ASEAN GBS in that they align with the ICMA Social Bond Principles and ICMA Sustainability Bond Guidelines, respectively, but also require additional features, similar to those set out in the ASEAN GBS, in order to provide an ASEAN-specific standard and label.

Singapore Sustainability Bond Grant Scheme

Singapore remains a major Asian centre for capital raising, enterprise financing and fixed income, and has, accordingly, taken a number of steps to enhance its capabilities to support growth in the financing of green investments and sustainable practices in the broader Asia-Pacific and, more specifically, ASEAN regions.

Following on from the introduction of the MAS Green Bond Grant Scheme introduced in February 2017[9], in February 2019, the MAS announced the expansion of the Green Bonds Grant Scheme to include social and sustainability bonds, with the scheme now referred to as the Sustainability Bond Grant Scheme (or **SBG Scheme**).

The fusion of policy initiatives aimed at the enhancement of fixed income markets for social and sustainability bonds with green bonds therefore represents an important inflection point in how regulators perceive the financing challenge, viewing this through a broader lens of sustainability, as opposed to the arguably more limited focus of distinct green bond frameworks.

The SBG Scheme will serve the same purposes as the Green Bond Grant Scheme (namely, to assist certain qualifying issuers with the costs of obtaining an external review); however, the eligibility criteria have now been expanded to include bonds verified by an external reviewer as holding green, social or sustainable status based on internationally accepted and recognised frameworks such as the ICMA GBPs, ICMA Social Bond Standards, the Climate Bonds Standards and, tying in to the broader ASEAN green financing initiatives described above, the ASEAN GBS and ASEAN Social Bond Standards.

"Social and sustainability bonds can play a distinct yet complementary role to green bonds. Social bonds are aimed at delivering positive social outcomes such as basic infrastructure, affordable housing and employment for specific segments of the population, including people living below the poverty line and marginalised communities. These financing initiatives dovetail with sustainability bonds which cater to both environmental considerations and social outcomes. Globally, social and sustainability bond issuance volume reached USD32 billion in 2018. Industry estimates point to further growth in issuance volume for 2019, to around USD38-45 billion."

Mr Benny Chey of the MAS

9 See "*Singapore: Innovation to Encourage Green Bonds*" in *Greening the Financial System*, 1st Ed.

While the essential framework of the Green Bond Grant Scheme has been retained, the new SBG Scheme relaxes certain requirements, presumably with the aim of widening the scope of the grant to a greater range of issuers in light of the wider eligibility of the new scheme. These changes are summarised in the table below:

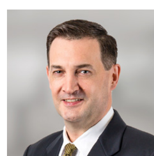
Criterion:	Former Green Bond Grant Scheme:	New Sustainability Bond Grant Scheme:
Minimum non-redeemable tenor	Three years	Under one year
Principal Amount	SGD200 million	SGD200 million However, SGD20 million issuance sizes are permissible if issued off a debt issuance programme with a size of at least SGD200 million.
Maximum Amount of Grant Size	Lower of 100% of actual eligible expenses and SGD100,000	Lower of 100% of actual eligible expenses and SGD100,000 (potential for subsequent issuances to be eligible where issued under a debt issuance programme described above).

The introduction of the SGD20 million minimum drawdown off a programme with a minimum SGD200 million size presents a significant degree of flexibility to issuers seeking to fund eligible projects in the capital markets, but who may have variable financing requirements and require funding (and, therewith, access to the grant) over phases of the sustainability project in question. The smaller minimum size also presents opportunities for issuers seeking to raise smaller amounts of financing for their projects, which represents a recognition by the MAS of the fact that the broader sustainability initiative may require smaller initial financing on a deal-by-deal basis.

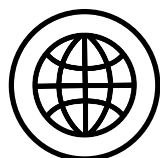
CONTACTS

Ying Chiang Chong
Senior Associate
T: +65 6506 2796
E: yingchiang.chong@cliffordchance.com

Gareth Deiner
Partner
T: +65 6410 2202
E: gareth.deiner@cliffordchance.com



Johannes Juette
Partner
T: +65 6410 2293
E: johannes.juette@cliffordchance.com



17. GREATER CHINA REGION THE DEVELOPMENT OF THE GREEN BOND MARKET

The governments and agencies within the greater China region have continued at their respective pace with the advancement of China's green financing. Over the course of the past five years, regulators in the greater China region, including those of Mainland China and the Special Administrative Regions of Hong Kong and Macau, have announced and implemented a number of policies and guidelines in support of the overall policy direction on green financing.

Mainland China

In 2015, the first clear policy direction concerning the implementation of a green financial system in China was outlined under China's 13th five-year plan. In support of this policy direction, key PRC regulators such as the People's Bank of China (**PBoC**) and the National Development and Reform Commission (**NDRC**) published guidelines relating to the issuance of domestic green bonds by Chinese corporations and financial institutions in the same year as the 13th five-year plan was announced (see below). In August 2016, the PBoC published its Guidelines for Establishing the Green Financial System. The PBoC guidelines were developed with the approval of the Chinese State Council and had the aim to "promote the sustainable development of the economy, establish a sound green financial system, improve the function of the capital markets in allocating resources… and support and promote the development of an ecological civilisation". In June 2017, the Chinese government formally launched five pilot zones within China to promote domestic green finance through the provision of various incentives and funding from PRC financial institutions to climate-friendly businesses operating within these pilot zones. Further, also in 2017, two key financial regulators of China, the National Association of Financial Market Institutional Investors (**NAFMII**) and China Securities Regulatory Commission (**CSRC**), each issued further guidelines concerning domestic green financing carried out by PRC non-financial enterprises and PRC onshore listed companies respectively (see below).

In 2018, each of the Shanghai Stock Exchange (**SSE**) and the CSRC issued clarifications concerning disclosure requirements for PRC onshore-listed companies seeking to raise domestic green financing. Specifically, the SSE issued a "Q&A" targeted at onshore listed companies clarifying queries relating to the regulatory requirements for domestic green corporate bonds and green asset-backed securities, while the CSRC issued a set of Guidelines for Corporate Governance of Listed Company outlining the scope of environmental, social and governance (**ESG**) information-related disclosure that onshore listed companies are expected to publish. Correspondingly, the PBoC also put forward several initiatives towards the improvement of the existing domestic green finance framework as applicable for PRC onshore banks and financial institutions, such as permitting the inclusion of green

bonds or green loans as forming part of the eligible Medium Lending Facilitation (**MLF**) and recognising green bonds and green loans as being part of the "Green Credit Performance evaluation results" to be assessed within the Macro Prudential Assessment (**MPA**) that onshore banks and financial institutions are subject to.

In January 2019, the State Council of China published a Government Work Report which expressly prioritised the need for the country to "strengthen [its] pollution prevention and control, enhance[e] [its] ecological improvement, and [to] make big advances in green development" as one of the ten key tasks that the government should focus on. In support of the objectives expressed in that report, the NDRC released a Green Industry Catalogue (the **NDRC Catalogue**) which defined the types of assets and activities that would constitute "green assets" and "green activities" respectively, and from which local governments and regulators could further formulate applicable policies and measures relating to domestic green finance (see below).

Hong Kong SAR (HKSAR)

In 2016, the HKSAR Government via the Hong Kong Quality Assurance Agency (**HKQAA**) formally launched a Green Finance Certification Scheme, establishing an independent certification framework for entities seeking to raise green financing within the HKSAR region. Under the Green Finance Certification Scheme, the HKQAA is able to reference a number of recognised standards on green finance, including international standards such as the ICMA Green Bond Principles (**ICMA GBP**) and national standards such those established by the PBoC Announcement [2015] No. 39 and the NDRC Catalogue. To further promote the Hong Kong Green Finance Certification Scheme, the HKSAR Government announced its first-ever Hong Kong Green Bond Grant Scheme in 2018 (see below). In 2018, Hong Kong's key securities regulator, the Hong Kong Securities and Futures Commission (**SFC**) also issued the Strategic Framework for Green Finance (see below). In 2019, the HKSAR government formally established its first Government Green Bond Programme and carried out a green bond issuance under the established programme. The HKSAR government also participated in establishing a government-backed non-profit organisation, the Hong Kong Green Finance Association, with the aim of promoting the development of green finance in Hong Kong. Most recently, in May 2019, the Hong Kong Monetary Authority (**HKMA**) introduced three sets of key measures on sustainable banking and green finance (see below).

Macau SAR

Under the impetus of the Guangdong-Hong Kong-Macau Greater Bay Area (**Greater Bay Area**), Macau has recently begun to take steps towards transforming the region into a green financial exchange platform between China and Portuguese-speaking countries and a new green financing leasing platform operating within the region.

In December 2018, the NDRC signed an arrangement with the government of the Macau SAR regarding the participation and reinforcement of infrastructure development under the Belt and Road Initiative (國家發展和改革委員會與澳門特別行政區政府關於支持澳門全面參與和助力"一帶一路"建設的安排, the **Arrangement**). In February 2019, the PRC CPC Central Committee and the State Council of China jointly published the Outline Development Plan for the Guangdong-Hong Kong-Macau

Greater Bay Area (the **Plan**). Under the Arrangement and the Plan, it is expected that the Mainland Chinese government and authorities will support Macau SAR to further study the feasibility of establishing a green finance platform denominated and cleared in Renminbi in the region.

Key green bond policies and guidelines

Mainland China
PBOC Announcement [2015] No. 39 (中国人民银行公告 [2015] 第39号)

In December 2015, the PBoC, China's central bank, established tangible definitions and guidelines on the eligibility of bonds being regarded as "green" domestically.

NDRC Green Bond Guidelines [2015] No. 3504 (国家发展改革委办公厅关于印发《绿色债券发行指引》的通知 [2015] 3504号)

In December 2015, the NDRC, the country's national policy management agency, published its guidelines for green bond issuance in China, which provided tangible guidance on the eligibility of bonds being regarded as "green" domestically.

Both NDRC's Green Bond Guidelines of December 2015 and the PBoC's Announcement were published as complementary sets of guidelines covering different areas of the onshore green bond capital market. PBoC's guidelines are aimed at establishing guidance over green bonds issuances by financial institutions in the Chinese Interbank Bond Market; NDRC's guidelines regulate green enterprise bonds for the non-listed, state-owned enterprise sector.

CSRC Guidance on Green Bond Support and Development [2017] No.6 (中国证监会关于支持绿色债券发展的指导意见（证监会公告 (2017) 6号）)

In March 2017, the China Securities Regulatory Commission (**CSRC**) released a set of guidelines on the issuance of green bonds by PRC stock exchange-listed companies. As the main regulator supervising China's securities market, the CSRC oversees the issuing, trading, custody and settlement of equity shares, bonds and investment funds. The CSRC's guidelines supplemented the guidelines published by the PBoC and the NDRC, and also sought to encourage both the Shanghai and Shenzhen stock exchanges to build up dedicated green bond lists, indices and other instruments to facilitate green investment.

NDRC Green Industry Guiding Catalogue [2019] No.293 (国家发展改革委办公厅关于印发《绿色产业指导目录（2019年版）》的通知 [2019] 293号）)

In February 2019, the NDRC, PBoC and five other regulators jointly issued the NDRC Catalogue, together with detailed definitions on what constitute green assets and green activities in China. The NDRC Catalogue covered six broad categories of industries, including the energy-saving and environmental protection industry, cleaner production industry, clean energy industry, eco-environmental industry, green upgrading of infrastructure industry, and green service industry.

Compared with the 2015 guidelines issued by the PBoC and NDRC, the NDRC Catalogue is more comprehensive in scope, covering the upstream, midstream and downstream segments, of the Chinese green industry, and is more practicable as it

deletes various ambiguous concepts contained in the respective existing PBoC and NDRC guidelines. In particular, the NDRC Catalogue introduced the concept of the green service industry, identifying organisations capable of providing green bond second party opinions, assurances and certification-related services. Given the high policy status of the NDRC Catalogue, it is expected that both the PBoC and NDRC will further update their respective green bond guidelines to harmonise with the NDRC Catalogue and with each other.

Hong Kong

HKQAA Green Finance Certification Scheme and HKSAR Government's Green Bond Grant Scheme (香港品质保证局绿色金融认证计划和香港特区政府绿色债券资助计划)

In 2016, HKQAA developed the Green Finance Certification Scheme (**GFCS**) to provide third-party conformity assessment for Green Finance issuers. The GFCS is developed with reference to a number of widely recognised international and national standards on green financing such as the ICMA's GBP and the NDRC Catalogue, amongst others.

In 2018, the HKSAR Government announced the launch of the GBGS to subsidise eligible green bond issuers in obtaining certification under the GFCS. Under GBGS, the full cost of obtaining certification under the GFCS for eligible green bond issuances may be granted on a per bond issuance basis. The GBGS scheme was launched as an annual scheme, and is anticipated to be renewed alongside the approval of the HKSAR government's governmental budgets tabled each year.

SFC Strategic Framework for Green Finance (香港证监会公布绿色金融策略框架)

In 2018, SFC announced its strategic framework to contribute to the development of Hong Kong's green finance. It plans: to enhance and harmonise the disclosure standards relating to green finance with the Mainland policy direction and other international standards; to facilitate and support the development of green-related investments; and to promote HKSAR as an international green finance centre.

HKMA Key Measures on Sustainable Banking and Green Finance (香港金管局公布可持续银行业及绿色金融的重要举措)

In 2019, the HKMA unveiled three sets of measures to support and promote Hong Kong's green finance development, including Green and Sustainable Banking, Responsible Investment, and a Centre for Green Finance (**CGF**). In particular, HKMA will establish the CGF under its Infrastructure Financing Facilitation Office as a platform for technical support and experience sharing for the green financial industry's development.

Key differences between domestic green standards and international green standards

There are certain key differences between the present domestic green standards and established international green standards. Key differences include: (i) the type of projects that would be recognised as eligible as being "green"; and (ii) the restrictions over the use of bond proceeds. For example, projects involving "clean" coal, refitting of

fossil fuel power stations and the mixed use infrastructure projects (e.g., involving both renewable energy and fossil fuels) would be regarded as being green eligible projects under the domestic green standards, but in most cases will not be recognised under international green standards such as the GBP. Such difference still remains in the newly issued NDRC Green Industry Guiding Catalogue, even if it is largely aligned with international standards. However, as the PBoC is interested in harmonising its guidelines with international best practice, "clean" coal might be removed from its updated green bond catalogue, but such revision, if it were to take place, may nonetheless not apply to the NDRC's Green Bond Guidelines that govern enterprise green bonds. Further, guidelines such as the NDRC Green Bond Guidelines permit state-owned enterprise green bond issuers to use up to 50 per cent. of bond proceeds to repay existing bank loans and invest in general working capital. In contrast, generally speaking, at least 90 to 95 per cent. of the bond proceeds would be required to be linked to green assets or projects before being eligible under the applicable international green standards.

Offshore green bond issuances
For PRC issuers seeking to raise capital via offshore green bond issuances, the focus has been to ensure that the bond issuance and the use of bond proceeds comply with established international market standards, primarily represented by the GBP. At present, there are only a limited number of offshore green bond issuances being undertaken in China. The majority of offshore issuances have come from large Chinese financial institutions, such as the Agricultural Bank of China, Industrial and Commercial Bank of China, Bank of China and Agricultural Development Bank of China, although there is more issuance being carried out from PRC corporates, notably, Xinjiang Goldwind and China Three Gorges Corporation.

Onshore green bonds issuances
The majority of green bond issuances carried out by PRC entities have been made in the onshore PRC capital markets complying, since 2015, with the domestic green standards described above. Unlike offshore green bond issuances which are largely principles-based and self-regulated, onshore green bond issuances are regulated and require specific approval from applicable PRC regulatory authorities.

Given the overall policy support provided by the Chinese Government under the 13th five-year plan, China has rapidly developed into having the world's largest green bond market. According to the China Green Bond Market 2018 Report, jointly published by the Climate Bond Initiative (CBI) and China Central Depository & Clearing Co. Ltd. (CCDC), green bond issuance from China increased from almost zero in 2015 to approximately CNY282 billion (USD42.8 billion) in 2018. According to the report, in 2018 green bond issuance with internationally aligned standards from Chinese issuers reached CNY210.3 billion (USD31.2 billion), and CNY1.4 billion (USD208 million) of green panda bonds were issued by Hong Kong issuers in the Chinese domestic markets. In addition, there were CNY122 million (USD17.7 million) green loans aligned to the Loan Market Association (LMA) / Asia Pacific Loan Market Association (APLMA) Green Loan Principles incurred by Chinese borrowers. The report also indicated the increasing proportion of green bonds issued by Chinese issuers that are in line with international green bond definitions such as the GBP. The report noted that, in 2017, 38% of Chinese issuance did not adopt the international standards. In 2018, that figure fell to 26%.

Offshore green bond issuance adopting both domestic and internationally aligned standards – Agricultural Development Bank of China

In November 2018, the Agricultural Development Bank of China (**ADBC**) carried out an offshore standalone issuance of green and sustainability bonds. This was the first-ever green and sustainability bond issuance carried out by this PRC policy-focused development bank. ADBC issued a single series of offshore green and sustainability bonds with an aggregate principal amount of EUR500 million.

The bonds were issued in accordance with the Green and Sustainability Bond Framework (the **Framework**) established by ADBC, and was assessed by: (i) Centre for International Climate and Environmental Research Oslo (CICERO) and the International Institute for Sustainable Development which provided a Second-Party Opinion; and (ii) China Energy Conservation and Environmental Protection Group (中國節能環保集團有限公司) which provided a Third-party Certification for the bonds. In particular, with respect to the applicable green standards implemented under the Framework, the relevant Second Party Opinion and Third Party Certification confirmed that the Framework was compliant with both the internationally aligned GBP of 2018 and the domestic green standards established under the PBoC Announcement No. 39.

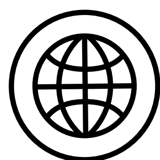
On an ongoing basis, ADBC undertook to ensure that the bond proceeds would be used exclusively to finance eligible green or social projects in support of sustainable water and wastewater management, environmentally sustainable management of living natural resources and land use, renewable energy, affordable housing and affordable basic infrastructure and services. Eligible green and social assets would first be identified and preselected by the frontline credit departments of ADBC's various branches, applying the Framework as the primary selection guideline. The initial eligible assets list would be proposed to the head office of ADBC, which would then select the final list of eligible assets. ADBC has also undertaken to hire a qualified third-party consultant to participate in the process of project evaluation and selection. The relevant ADBC departments would regularly include eligible green and/or social assets submitted by branches into a reserve for any future issuances of green, social and/or sustainability bonds of the bank. For so long as any of the relevant green and sustainability bonds are outstanding, ADBC will make annual disclosures relating to its green and sustainability bond issuance(s), with information on the allocation and the environmental and/or social impacts of the proceeds included.

CONTACTS

Angela Chan
Partner
T: +852 2825 8891
E: angela.chan@cliffordchance.com

Connie Heng
Partner
T: +852 2826 2457
E: connie.heng@cliffordchance.com

David Tsai
Partner
T: +852 2826 2466
E: david.tsai@cliffordchance.com



18. JAPAN
GROWTH OF GREEN FINANCING

Encouraging growth in its green bond market is one of Japan's key environmental priorities. Following on from the establishment by the Ministry of the Environment (*Kankyōshō*) (the MoE) of its Green Bond Guidelines (the Green Bond Guidelines) in March 2017, the Ministry of Economy, Trade and Industry (the METI) formulated the Guidance for Climate-related Financial Disclosure (the TCFD Guidance) in December 2018 with the aim of providing guidance to Japanese companies making disclosures in line with the recommendations (the TCFD Recommendations) of the Task Force on Climate-related Financial Disclosures (TCFD) of the Financial Stability Board (FSB). In March 2019, the Tokyo Metropolitan Government (the TMG) published its revised Green Bonds Issuance Policy and, in the build-up to the 2020 Olympic Games, is working "to grow as a leading environmental city and as an international finance/economic powerhouse".[1]

The MoE's Green Bond Guidelines

Based on ICMA's Green Bond Principles (2017; the then-current version) and adapted for the Japanese bond market, the MoE's Green Bond Guidelines provide a general overview of green bonds, and the requirements and procedures for their issuance. This includes outlining characteristics and features that green bonds are expected to have, to ensure they are internationally accepted as green bonds and to prevent "green-washing" bonds from being issued and invested in.[2] Although legally non-binding, the MoE hopes that the Green Bond Guidelines will help establish the credentials of green bonds and reduce the cost and administrative burden on issuers. In doing so, the MoE believes this will increase green bond issuances and encourage investments into Japan.

The MoE's Support Programmes for Green Bond Issuances

The MoE has established support programmes to promote green bond issuances in Japan. As part of the "Green Bond Model Issuance Creation Project", the MoE selects "model issuances" with the aim of disseminating information relating to examples of green bond issuances which meet the requirements of the Green Bond Guidelines and which have model characteristics that may aid in the promotion of issuances of further green bonds in Japan. Under the "Financial Support Programme for green Bond Issuance", the MoE provides subsidies to green bond issuers to help cover the costs

1 Tokyo Metropolitan Government (2019). *Green Bond Issuance Policy*. [online] Available (in Japanese) at: http://www.zaimu.metro.tokyo.jp/bond/tosai_ir/gb/greenbond310329.pdf

2 https://www.env.go.jp/en/policy/economy/gb/summary2017.pdf

of external review and consultation. At the time of publication, the MoE is looking to launch in late 2018 a second round of calling for proposals for new innovative support programmes.

The METI's TCFD guidance

At the same time as declaring its support for the TCFD Recommendations, the METI released its TCFD Guidance in December 2018. The TCFD Guidance sets out an overview of the TCFD Recommendations as well as detailed commentary and case studies, including sector-specific guidance, with the aim of providing guidance to Japanese companies to promote TCFD-based disclosure.[3] In May 2019, the "TCFD Consortium" was set up by Japanese financial institutions and companies as a platform to discuss and promote effective climate-related financial disclosure based on the TCFD Recommendations, with the METI, the Financial Services Agency and the MoE participating as observers.[4] As of June 2019, 178 Japanese companies and institutions have expressed their support for the TCFD Recommendations. Companies are currently considering matters such as whether to include the TCFD-based disclosure in their Annual Securities Reports (*yūkashōken hōkokusho*) – which would require them to undertake disclosure liabilities under the Financial Instruments and Exchange Act of Japan – or in separate documents (to which no securities law-based disclosure liabilities attach) such as CSR/Environmental reports.

Tokyo 2020: A greener way forward

The TMG's Green Bonds Issuance Policy is part of its plans to transform Tokyo into a sustainable "Smart City", one of several goals outlined in its four-year "Action Plan for 2020".[5] The TMG has publicly identified green bonds as a means for investment both in Japan and internationally and has stated it must "assertively deploy environmental measures and undertake measures to create flow for the expansion and invigoration of the domestic Green Bonds market". Current projects set out in the Green Bond Issuance Policy and funded by green bonds include environmental measures for Olympic venues, the conversion of Tokyo street lights and lighting systems in TMG facilities to environmentally friendly LED lights, and carbon neutral conversions for municipal buildings. In July 2018, the TMG obtained a second party opinion from ISS-oekom research in relation to green bonds issued pursuant to its Green Bonds Issuance Policy.[6] As of October 2018, around 30 Japanese investors, including banks, life insurance companies and asset management companies, have publicly indicated their support for the significance of the issuance of TMG green bonds, and declared their intention to invest in such bonds.

3 https://www.meti.go.jp/english/press/2018/pdf/1225_006b.pdf

4 https://www.meti.go.jp/english/press/2019/pdf/0521_001a.pdf

5 Tokyo Metropolitan Government (2017). *The Action Plan for 2020*. [online] Summary available at: http://www.metro.tokyo.jp/ENGLISH/ABOUT/PLAN/index.htm

6 http://www.zaimu.metro.tokyo.jp/bond/tosai_ir/gb/greenbond290920en_2.pdf

Tokyo Pro-Bond Market's Green and Social Bond Platform

The Tokyo Stock Exchange (**TSE**) launched a dedicated platform for green and social bonds listed on its Tokyo Pro-Bond Market (a bond listing market targeting professional investors only) in January 2018.[7] The platform allows issuers, at their discretion, to post information relating to their green/social bonds from amongst those listed on the Tokyo Pro-Bond Market. Information that can be posted includes use of proceeds, external review, reporting and other related information (such as eligible projects). The TSE does not itself impose any continuing reporting or other obligations in relation to the platform. At the time of publication, there is one issuer (Japan International Cooperation Agency) which has listed its Tokyo Pro-Bond Market listed bonds on this platform.

Recent Trends in Green Financing

Given the public statements and commitments of agencies such as the MoE, and influential governments and governmental entities such as the TMG and Development Bank of Japan Inc. (**DBJ**), Japanese issuers have increasingly explored the option of domestic and international green bond transactions. The volume of green bond issuances, initially driven by governmental entities and financial institutions, has been experiencing a surge in issuances by Japanese corporates and REITs, with issuance volume by Japanese issuers more than doubling in 2018 as compared with 2017[8]. Recent deals by Japanese issuers and/or in Japan have included:

- The TMG's issuances of both Japanese yen-denominated green bonds targeting institutional investors and US dollar and Australian dollar-denominated green bonds targeting retail investors resident in the Tokyo metropolitan area annually since 2017, in each case with the proceeds used for supporting the TMG's green projects in line with the ICMA Green Bond Principles;
- Issue by Sumitomo Forestry of the world's first green convertible bond in September 2018, aligned with the ICMA Green Bond Principles (second opinion provider: Vigeo Eiris) and the proceeds of which are to be used to refinance the acquisition of a plantation forest project in New Zealand;
- Issues by all of the "megabanks" of various series of green bonds, including Sumitomo Mitsui Financial Group's euro-denominated green bonds issued in May 2019 in line with both the ICMA Green Bond Principles and the MoE's Green Bond Guidelines (second opinion provider: Sustainalytics);
- Issue by Mitsubishi Estate of JPY-denominated domestic green bonds in June 2018, aligned with the ICMA Green Bond Principles (second opinion provider: Sustainalytics), with a green bond assessment by Rating & Investment Information, Inc. (**R&I**). The bond issue was selected as a model case by the MoE for its Models of Green Bond Issuance;

Volume of green bond issuances by Japanese issuers more than doubled in 2018 compared to 2017

7 https://www.jpx.co.jp/english/equities/products/tpbm/green-and-social-bonds/index.html

8 Source: MoE (2019) (in Japanese): http://greenbondplatform.env.go.jp/greenbond/current.html

- Issue by Japan Real Estate Investment Corporation of JPY-denominated domestic green bonds in June 2018, aligned with the ICMA Green Bond Principles (second opinion provider: Sustainalytics), with proceeds being used to finance/refinance the refurbishments to, or acquisition of, those of the REIT's assets that meet its green eligibility criteria;
- Issue by Japan Housing Finance Agency of JPY-denominated 20-year domestic green bonds in January 2019, aligned with the MoE's Green Bond Guidelines (and selected as a model case by the MoE for its Models of Green Bond Issuance). The proceeds are used to finance residential loans for the purchase of new, energy-saving housing (the interest rates on mortgage loans for energy-saving housing being lower than normal mortgage loans for a certain period);
- Issue by Electricité de France of JPY-denominated 12-year and 15-year green "samurai" bonds, aligned with the ICMA Green Bond Principles, in January 2017; and
- Issue by Bank of China Tokyo Branch of CNY-denominated two-year green bonds, listed on the Tokyo Pro-Bond-Market.

Green Loans

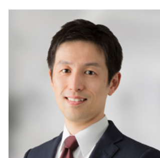
An increasing number of Japanese borrowers have turned to alternative financing formats such as green loans. After the announcement of the Green Loan Principles by the Loan Market Association (**LMA**) and the Asia Pacific Loan Market Association (**APLMA**) in 2018, Japan Credit Rating Agency, Ltd. (**JCR**) started offering new services of evaluating whether a loan is aligned with the Green Loan Principles, and some Japanese banks have started offering loan products which utilise such services by JCR. Recent examples of such green loans include:

- NYK Line's green loan (arranged by MUFG Bank) in March 2019, which is certified by JCR as being aligned with the Green Loan Principles, following the issuance of green bonds in May 2018 (second opinion provider: Vigeo Eiris), the first shipping company to issue green bonds in the world, with proceeds used to finance LNG-fuelled ships and sulphur oxide (SO_2) emission-reducing scrubber system;
- Nissen Kaiun's green loan (arranged by Sumitomo Mitsui Banking Corporation) in June 2019, which is certified by JCR as being aligned with LMA's and APLMA's Green Loan Principles; and
- United Urban Investment Corporation's green loan from Sumitomo Mitsui Trust Bank, which is certified by JCR as being aligned with LMA's Green Loan Principles, as well as the MoE's Green Bond Guidelines (although not a green bond product, JCR considered its alignment thereto as well, due to the similarities between the core components of the Green Loan Principles and those of the Green Bond Guidelines).

Japanese borrowers and investors have expressed interest in other "ESG-type" lending such as social and sustainability bonds and loans. Recent examples of such bonds and loans include:

- Sustainability bonds issued by DBJ, the latest issued in October 2018, in line with the ICMA Green Bond Principles and the Sustainability Bond Guidelines (second opinion provider: Sustainalytics). DBJ was the first Japanese issuer to issue green bonds in 2014;
- Japan Railway Construction, Transport and Technology Agency (JRTT)'s sustainability bonds issued in May 2019 and sustainability loan in March 2019 under a "Sustainability Finance" framework (second opinion provider: DNV GL) which is the first framework by a Japanese issuer that is certified by the Climate Bonds Initiative. JRTT has previously issued two series of green bonds;
- East Nippon Expressway's establishment of a "Social Finance" framework (second opinion provider: R&I) under which it has entered into a "social impact" syndicated loan (arranged by Mizuho) in June 2019;
- Issuance of renewable energy project bonds (with 23-year maturity) issued as trust beneficiary interests by Hitachi Capital Trust (arranged by Mitsubishi UFJ Morgan Stanley) in February 2019, with proceeds used to finance the development of a solar power project in Okayama prefecture;
- Issuance of sustainable development-themed "samurai" bonds by BPCE, the latest issuance being in July 2018; and
- Issuance of international cooperation purpose bonds by Japan International Cooperation Agency (JICA) listed on the Tokyo Pro-Bond Market, the latest issuance being in June 2019.

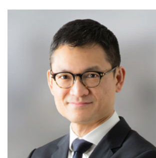
CONTACTS



Yusuke Abe
Partner
T: +81 3 6632 6332
E: yusuke.abe@cliffordchance.com

Chihiro Ashizawa
Counsel
T: +81 3 6632 6414
E: chihiro.ashizawa@cliffordchance.com

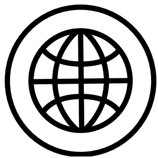
Suguru Kimura
Senior Associate
T: +81 3 6632 6412
E: suguru.kimura@cliffordchance.com



Leng-Fong Lai
Partner
T: +81 3 6632 6625
E: leng-fong.Lai@cliffordchance.com

Yurika Mikuriya
Lawyer
T: +44 20 7006 2797
E: yurika.mikuriya@cliffordchance.com

Reiko Sakimura
Partner
T: +81 3 6632 6616
E: reiko.sakimura@cliffordchance.com



19. FRANCE
INCREASED DISCLOSURE IN THE GREEN BOND MARKET

The Dutch and French financial market supervisory authorities recently published a Position Paper on Green Bonds, advocating increased transparency and openness from issuers of green, social or sustainable bonds in order to enable investors to make more informed decisions. They take the view that the absence of mandatory regulation could hinder the further expansion of the market. While at first glance this may seem like an addition that should be welcomed and one that will allow the green bond market to flourish, is this change really as positive as one might think? For some, the implementation of this position may seem too burdensome, but is it as difficult as it first seems to implement this Position Paper? A French perspective.

The Position Paper[1] sets out that it will be for an issuer to decide whether they would like to qualify their bond issuance as green, social or sustainable. However, if they decide to do so, they will then be required to include additional information in the "use of proceeds" section of their prospectus, in relation to, in particular, the selection process and the eligibility criteria used to select the funded projects or assets and how the proceeds will be managed. Issuers would also be required to include additional information, namely whether they *intend to* (i) comply with green bond standards, (ii) publish ongoing reporting on the use of the green bond proceeds, and (iii) mandate a third-party verification.

"Use of Proceeds" Building Blocks

In an attempt to avoid proposing a regulation that would be too burdensome on issuers, the French supervisory authority, the AMF (*Autorité des marchés financiers*), and the Dutch supervisory authority, the AFM (*Autoriteit Financiële Markten*), recognised that issuers of green bonds should not be required to produce a full prospectus Annex on their green bonds. Instead, this information would be required in the "Use of Proceeds" section through 'building blocks'. While one can recognise the intention of the AMF and the AFM to reduce the burden on issuers, from the perspective of an issuer there is likely to be little difference between producing an Annex on a green bond as opposed to a building block.

Issuers listing their green bond issuances in France (and presumably in The Netherlands) would therefore need to comply with additional rules that are not applicable to other issuers in the EU, and may be frightened off by need for additional disclosure. Indeed, the green, social and sustainable bond market has developed in France based on the voluntary disclosure made by issuers, who have so far been able to define for themselves the level of disclosure that they intend to provide to the market.

1 Currently available at the following link: Press release: Sustainable finance: the AMF and AFM publish a common position on the content of the prospectus for green bonds, or: AMF and AFM Position Paper

This change in regulation could have the effect of acting as a brake on the growth of the nascent green bond market – if costs are too high for the issuance of green bonds in comparison with "classic" bonds (while their pricing remains the same), there could be reduced motivation for an issuer. The AMF and AFM may have considered that the market had sufficiently developed to now require regulation.

A change in regulation could have the effect of acting as a brake in the growth of the nascent green bond market.

Early Notification

In France, issuers who issue green bonds are usually frequent issuers and carry out such green bond issuances under an EMTN programme, rather than as stand-alone issuances. In accordance with the Position Paper, this would mean that issuers would need to satisfy the requirements for their "Use of Proceeds" section in the base prospectus of their EMTN programme, rather than in the final terms as was done previously.

However, this raises the question of what happens if an issuer decides to issue green bonds after they have already published their base prospectus? As issuers often are required to do, it seems that they would have to publish a supplement. From the perspective of an issuer this may bring unwanted attention – publishing a supplement purely for this purpose signals to the market that one intends to issue green bonds. Once again, this could have the effect of slowing the growth of the green bond market if issuers are forced to wait until they update their EMTN programme rather than risk detrimental effects from the publication of such a supplement.

New Issuers

Another question this Position Paper raises is in relation to new issuers. As previously set out, under the standards set by the Position Paper, issuers would be required to disclose a high level of detail, in particular in relation to the ongoing reporting on the use of proceeds. In the context of a new issuer, it is hard to see how one can disclose information on this before ever having undertaken this type of issuance, and it would be a significant effort for a new green issuer to anticipate the level of detail required even before having issued the bonds. These requirements have the effect of forcing new issuers to decide on these issues early and as a result may restrict or discourage them from issuing green bonds.

If the aim is to encourage the growth of the green bond market, surely there should be a degree of tolerance, or less stringent requirements, for first time issuers? It would seem sensible to start applying these regulations to issuers who are more experienced with green bond issuances and can be expected to be able to adequately disclose their plans.

Is this where the green bond market is heading?

Not all issuers share the sentiment of not wanting to give more information on green bonds. In their 100% green EMTN programme, Société du Grand Paris's "Use of Proceeds" section for its 2019 Base Prospectus aims to comply with the requirements of the Position Paper, as it is keen to demonstrate to the market that it applies high standards of disclosure. Its "Use of Proceeds" section states that the use of proceeds will be used to invest in the Grand Paris Express metro with the aim of "provid[ing] Grand Paris with low-carbon and sustainable multimodal transport solutions", and further cross-refers to the website of the issuer where the disclosure can be updated from time to time.

Other issuers have also decided to state that they "intend to" disclose additional information on their website, e.g. in their green framework. This leaves them room to

define the exact method of reporting at a later stage. Therefore, while it is easy to identify various potential problems caused by these new requirements and difficulties at first to implement these, one cannot definitively say that these requirements will come to hinder the green bond market.

In addition, one may acknowledge that this Position Paper has had the merit of forcing some issuers of green, social or sustainable bonds to be more careful about their disclosure and to ensure that such disclosure is effective, complete and up to date.

The Position Paper notes further that there was a gap between the disclosure made outside the prospectus and in the prospectus, while for regulatory purposes the prospectus should contain the information that enables investors to make an informed assessment of the securities offered by the issuer. In this respect, the new prospectus regulation (EU) 2017/1129 ("PD3"), which entered into force on 21 July 2019, provides that a prospectus should now also contain the necessary information which is material to an investor for making an informed assessment of, in particular, the reasons for the issuance and its impact on the issuer.

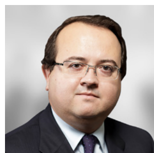
Furthermore, dealers involved in EMTN programmes of green issuers had already started requesting the insertion of risk factors related to green bonds: it seems that the demand for greater disclosure on all things green is here to stay.

Increased scrutiny by the AMF is also here to stay, as shown in the recently published press release announcing that the French banking and insurance supervisory authority (*Autorité de contrôle prudentiel et de résolution* (**ACPR**)) and the AMF will implement a mechanism for monitoring and assessing the climate-related commitments taken by Paris financial institutions.[2] The ACPR and the AMF will, in particular, publish an annual report on their work, set up a "Climate and Sustainable Finance" consultative commission as from the second half of 2019, and establish a joint action protocol to monitor the financial sector's climate-related commitments.

Since the Paris Agreement signed in 2016, the political push and the awareness of French market players have shown that they can transform announcements into real actions and achieve the development of a mature green bond market. The Position Paper seems to suggest that now is the time for more regulation, to ensure a better quality of the disclosure and a better recognition of the efforts that have been made so far.

CONTACTS

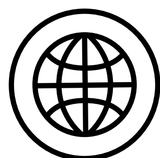
Auriane Bijon
Counsel
T: +33 1 4405 2468
E: auriane.bijon@cliffordchance.com



Cedric Burford
Partner
T: +33 14405 5308
E: cedric.burford@cliffordchance.com

Andrew McCann
Counsel
T: +33 1 4405 5431
E: andrew.mccann@cliffordchance.com

2 Currently available at the following link: Press release: A new mechanism to monitor and independently assess the climate-related commitments taken by Paris financial centre entities



20. LUXEMBOURG
A EUROPEAN SUSTAINABLE FINANCE HUB

Best known as the location of the Luxembourg Stock Exchange, which hosts the world's only platform exclusively dedicated to sustainable securities, and of the European Investment Bank, Luxembourg is also the home of the international non-profit association LuxFLAG, and of various other initiatives to promote sustainable finance, as detailed in the Luxembourg Sustainable Finance Roadmap.[1]

LuxFLAG – The Luxembourg Finance Labelling Agency

In July 2006, an international non-profit association called LuxFLAG (Luxembourg Finance Labelling Agency) was created in Luxembourg to promote the raising of capital for the responsible investment sector by awarding a recognisable label for eligible investment vehicles. LuxFLAG grants various labels, including the Environment Label, which reassures investors that the investment fund has a portfolio of investments in environment-related sectors corresponding to at least 75% of the fund's total assets; the Climate Finance Label which certifies that at least 75% of total assets are invested in investments related, with a clear and direct link, to mitigation and/or adaptation of climate change or cross-cutting activities; the ESG (environmental, social, governance) Label, which requires that the fund screens 100% of its invested portfolio according to one of the ESG strategies and standards recognised by LuxFLAG; and the Green Bond Label, which ensures that the green bond follows internationally recognised standards and uses its proceeds to finance green projects.

In order to show its support for this independent agency, which enhances transparency and investor confidence in the sustainable investment market, the Luxembourg Government has signed a new multi-annual convention with LuxFLAG, committing itself to an annual subsidy for a minimum period of three years, until 31 December, 2021. This financial contribution has led Luxembourg to establish itself as a European pioneer in the labelling domain of sustainable finance.

Luxembourg Green Exchange

The Luxembourg Stock Exchange (**LuxSE**) has been actively involved in the listing of green bonds for over a decade, including the first listing of a green bond in 2007 (the European Investment Bank Climate Awareness Bond), and the first listing of a green bond by a Chinese bank in the European market in 2018. Another significant

1 The roadmap was drafted in partnership with the UN Environment Programme Finance Initiative (UNEP FI) and is accessible here: "*Luxembourg Sustainable Finance Roadmap: A journey towards a sustainable financial system*": https://gouvernement.lu/dam-assets/documents/actualites/2018/10-octobre/04-sustainable-finance/Luxembourg-Sustainable-Finance-Roadmap-WEB.pdf

step was taken in 2016 when the Luxembourg Green Exchange (**LGX**) was launched. This, the world's first platform exclusively dedicated to the listing of green securities, has played a major part in making Luxembourg the primary centre in the world for listing green bonds and the European leader in responsible investment fund assets. The LGX lists almost half of the world's green bonds by volume, and an estimated third of all sustainability and social bonds. All securities displayed on LGX contribute to achieving the United Nations Sustainable Development Goals.

The LGX aims to provide issuers, asset managers and investors with an environment for bonds and funds which are green, social and sustainable. Green bonds include, for example, those which finance renewable energy, pollution prevention and control, and clean transportation, but also environmentally sustainable management of living natural resources and land use, and green buildings which meet regional, national or internationally recognised standards or certifications. This platform gives asset managers and issuers a higher visibility with an enhanced sustainable profile, while investors benefit from easy access to labelled, sustainable financial instruments with an improved comparability of those securities due to a high level of transparency.

Gateway to China

Luxembourg is a frontrunner in forging alliances with China on sustainable finance initiatives. LuxSE welcomed the first domestic green bond from a Chinese policy bank, the Agriculture Development Bank of China, in March 2018. In June 2018, the LuxSE partnered with the Shanghai Stock Exchange (**SSE**) to create a Chinese domestic information channel (**Green Bond Channel**). The Green Bond Channel aims at bridging the language and information gap between Chinese and European or international investors by providing free access to information on Chinese domestic green bonds on LuxSE's official website. In March 2019, an extension of the existing Green Bond Channel was agreed, to allow the display of international bonds on the SSE, and, following the success of the existing partnership, a complementary Green Bond Channel was launched with the Shenzhen Stock Exchange.

Climate Finance Platform and Climate Finance Accelerator

Under the Luxembourg-EIB Climate Finance Platform (LCFP) the Luxembourg government agreed to make EUR30 million of subordinated funding available to support investment vehicles based in Luxembourg with the aim of mobilising private sector co-investments in funds dedicated to climate change mitigation and adaptation both inside and outside the European Union.

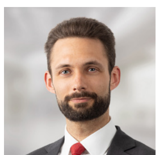
The International Climate Finance Accelerator (ICFA) is a joint initiative by the Luxembourg government and private actors of the Luxembourg financial sector, aimed at offering assistance to innovative investment fund managers that want to invest in projects with a measurable impact in the fight against climate change. Projects focus

on one of the following target areas: climate mitigation finance, REDD+ (reducing emissions from deforestation or forest degradation) or climate adaptation finance. The initiative has received support from the EIB.

Recent legislative developments

In line with its ambitions to impact climate change through finance, Luxembourg enacted, on 26 June 2018, its Renewable Energy Covered Bond Law, introducing a new asset class of renewable energy covered bonds backed by security on movable and immovable renewable energy property.

CONTACTS



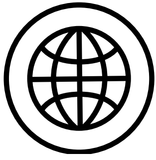
Bart Denys
Counsel
T: +32 2 533 5905
E: bart.denys@cliffordchance.com

Marc Mehlen
Partner
T: +352 48 50 50 305
E: marc.mehlen@cliffordchance.com

Eimear O'Dwyer
Senior Associate
T: +352 48 50 50 259
E: eimear.odwyer@cliffordchance.com

Ioanna Saranti
Foreign Lawyer
T: +352 48 50 50 417
E: ioanna.saranti@cliffordchance.com

Katharina Thiegles
Avocat
T: +352 48 50 50 214
E: katharina.thiegles@cliffordchance.com



21. MIDDLE EAST
THE EVOLUTION OF SUSTAINABLE CAPITAL MARKETS

In keeping with global trends which have seen sustainable finance continue to expand to the level where it now accounts for roughly USD30.7 trillion of managed assets globally (source: Global Sustainable Investment Alliance), the development of sustainable finance, through the use of green bonds, green sukuk and green loans, continues to evolve across a region more readily associated with its conventional energy resources, oil and gas.

Despite a legacy of substantial oil and gas production across the Middle East, governments and corporates in the region continue to show increasing sensitivity to environmental issues and a desire to develop their economies in a sustainable manner, and this push towards sustainable development seems likely to encourage further growth in green capital markets origination going forward, with a clear political and social mandate to do so. In particular, the United Arab Emirates includes developing a "Sustainable Environment and Infrastructure" amongst its Vision 2021 National Agenda goals, with an emphasis on "improving the quality of air, preserving water resources, increasing the contribution of clean energy and implementing green growth plans" (UAE Vision 2021). The Emirate of Dubai has similarly set itself a number of sustainability goals to be advanced by its hosting of Expo 2020 next year. Further, the Dubai Financial Services Authority has also published its own Green Bond Best Practice Guidelines as of August 2018, to offer infrastructure and guidance in relation to green issuances in the capital markets. Sustainability initiatives in the region are not only limited to the United Arab Emirates, however, with the Kingdom of Saudi Arabia, (which remains the world's second largest oil producer,) including sustainability objectives as part of its National Transformation Programme (one of 13 programmes developed with the intention of achieving the Kingdom's Vision 2030).

Green sukuk

Historically, the first Middle East green bond was issued by a financial institution, First Abu Dhabi Bank, in 2015. However, with no new issuance since this debut green bond, the region is poised to see further development in sustainable finance, and this year witnessed the launch of the first green sukuk issuance by a corporate issuer in the Gulf Cooperation Council, a USD600 million issuance by Majid Al Futtaim LLC, one of the largest developers and operators of shopping malls and hypermarkets in the Middle East and North Africa region.

As is the case with a green conventional bond, the defining feature of a green sukuk is that the issuance proceeds must be used for green purposes, the key distinction being that the issuance will assume a sharia-compliant structure, rather than a conventional issuance structure. Depending on the nature of the issuance in question, the use of proceeds may be for a specific project or operation; it is also common for the proceeds to be used for unspecified present or future projects in compliance with certain criteria set out in the offering document. In the case of Majid Al Futtaim, the issuance is to be applied in accordance with the company's Green Finance Framework for any one of four eligible project categories: green buildings; renewable energy; sustainable water management; and energy efficiency.

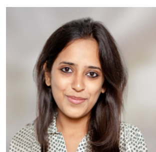
Of course, the issuance by Majid Al Futtaim of the region's first green sukuk cannot be divorced from commercial considerations – namely, diversification of the issuer's investor base, liquidity and cost of funds. A positive development in this regard is portfolio managers' awareness of including sustainable assets as part of a diversified portfolio, and managed funds becoming increasingly decisive in their desire to invest in yielding sustainable assets. From a commercial perspective, particularly where an issuer has an existing credit curve of conventional bonds and/or sukuk, a key consideration in the decision to issue a green bond/sukuk will be pricing in line with the existing credit curve. This is particularly the case when the establishment by the issuer of a green framework is taken into consideration, together with the management infrastructure involved in that process. In the absence of political considerations, that pricing outcome will remain a key determinant of the speed at which issuers across the region embrace sustainable funding in the capital markets.

Opportunities and next step

With international energy markets ever sensitive to extraneous geopolitical events and technological disruption, commercial and political emphasis in the region will likely continue to move towards sustainable forms of development. In addition to the growing global consensus on the need for environmental sustainability, the nature of Government and corporate issuers in the region also leaves the Middle-East well primed to take advantage of increasing opportunities provided by sustainable finance. Many frequent entrants into the capital markets in the region may well determine that their businesses lend themselves to sustainable development strategies: for example, real estate developers may seek to construct more energy and resource-efficient buildings; and transport and logistics corporates may wish to utilise advancements in renewable energy sources and more energy efficient technologies. The Majid Al Futtaim transaction has, accordingly, provided a timely advance in the region's use of sustainable finance.

CONTACTS

Matthew Oliver
Trainee Solicitor
T: +971 4503 2759
E: matthew.oliver@cliffordchance.com



Alekhya Prakash
Senior Associate
T: +971 4503 2688
E: alekhya.prakash@cliffordchance.com

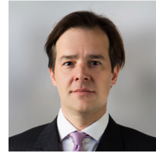
Stuart Ure
Partner
T: +971 4503 2659
E: stuart.ure@cliffordchance.com

CONTACTS

Amsterdam

Liesbeth Buiter
Counsel
T: +31 20 711 9326
E: liesbeth.buiter@
cliffordchance.com

Tineke Kothe
Senior Counsel
T: +31 20 711 9146
E: tineke.kothe@
cliffordchance.com

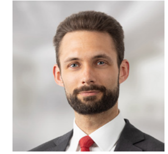


Jurgen van der Meer
Partner
T: +31 20 711 9340
E: jurgen.vandermeer@
cliffordchance.com

Hugo van der Molen
Associate
T: +31 20 711 9520
E: hugo.vandermolen@
cliffordchance.com

Hein Tonnaer
Partner
T: +31 20 711 9528
E: hein.tonnaer@
cliffordchance.com

Brussels



Bart Denys
Counsel
T: +32 2 533 5905
E: bart.denys@
cliffordchance.com

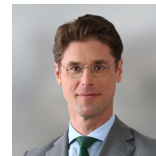
Dusseldorf

Florian Mahler
Partner
T: +49 211 4355 5232
E: florian.mahler@
cliffordchance.com

Thomas Voland
Partner
T: +49 211 4355 5642
E: thomas.voland@
cliffordchance.com

Frankfurt

Dr. Christof Häfner
Partner
T: +49 69 7199 3160
E: christof.häfner@
cliffordchance.com



Dr. Thomas Krecek
Partner, Co-Head of
Corporate, Germany
T: +49 69 7199 1524
E: thomas.krecek@
cliffordchance.com

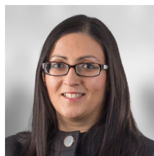
Hong Kong

Angela Chan
Partner
T: +852 2825 8891
E: angela.chan@
cliffordchance.com

Connie Heng
Partner
T: +852 2826 2457
E: connie.heng@
cliffordchance.com

David Tsai
Partner
T: +852 2826 2466
E: david.tsai@
cliffordchance.com

London



Kavita Bassan
Senior Associate
Knowledge Lawyer
T: +44 20 7006 5826
E: kavita.bassan@
cliffordchance.com

Clare Burgess
Partner
T: +44 20 7006 1727
E: clare.burgess@
cliffordchance.com

Michael Coxall
Knowledge Director
T: +44 20 7006 4315
E: michael.coxall@
cliffordchance.com

Michael Dakin
Partner
T: +44 20 7006 2856
E: michael.dakin@
cliffordchance.com

Caroline Dawson
Partner
T: +44 20 7006 4355
E: caroline.dawson@
cliffordchance.com

Laura Douglas
Knowledge Lawyer
T: +44 20 7006 1113
E: laura.douglas@
cliffordchance.com

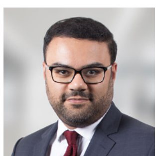
Melissa Fogarty
Joint Head of Corporate,
London
T: +44 20 7006 4699
E: melissa.fogarty@
cliffordchance.com

Emma Folds
Partner
T: +44 20 7006 2231
E: emma.folds@
cliffordchance.com

Nigel Howorth
Partner
T: +44 20 7006 4076
E: nigel.howorth@
cliffordchance.com

Jacqueline Jones
Knowledge Director
T: +44 20 7006 2457
E: jacqueline.jones@
cliffordchance.com

Andrew Kelly
Partner
T: +44 20 7006 8552
E: andrew.kelly@
cliffordchance.com



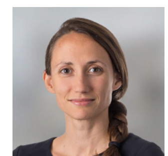
Daud Khan
Partner
T: +44 207006 6069
E: daud.khan@
cliffordchance.com

Roger Leese
Partner
T: +44 20 7006 8710
E: roger.leese@
cliffordchance.com

Rae Lindsay
Partner
T: +44 20 7006 8622
E: rae.lindsay@
cliffordchance.com

Owen Lysak
Partner
T: +44 20 7006 2904
E: owen.lysak@
cliffordchance.com

Mehreen Malik
Senior Associate
T: +44 20 7006 4626
E: mehreen.malik@
cliffordchance.com



Lily Marcel
Senior Associate
T: +44 20 7006 4158
E: lily.marcel@
cliffordchance.com

London

David Metzger
Partner
T: +44 20 7006 4240
E: david.metzger@
cliffordchance.com

Yurika Mikuriya
Lawyer
T: +44 20 7006 2797
E: yurika.mikuriya@
cliffordchance.com

Lydia Morrell
Trainee Solicitor
T: +44 20 7006 5276
E: lydia.morrell@
cliffordchance.com

Puja Patel
Senior Associate
T: +44 20 7006 3351
E: puja.patel@
cliffordchance.com

James Pay
Partner
T: +44 20 7006 2625
E: james.pay@
cliffordchance.com

Stephanie Peacock
Senior Associate
T: +44 20 7006 4387
E: stephanie.peacock@
cliffordchance.com

Peter Pears
Senior Associate
T: +44 20 7006 8968
E: peter.pears@
cliffordchance.com

Kath Roberts
Knowledge Director
T: +44 20 7006 1308
E: kathryn.roberts@
cliffordchance.com

Drew Rundus
Senior Associate
T: +44 20 7006 2825
E: drew.rundus@
cliffordchance.com

James Shepherd
Senior Associate
T: +81 3 6632 6600
E: james.shepherd@
cliffordchance.com

Kirsty Souter
Senior Associate
T: +44 20 7006 4178
E: kirsty.souter@
cliffordchance.com

Carolyn Tan
Senior Associate
T: +44 20 7006 3107
E: carolyn.tan@
cliffordchance.com

Kate Vyvyan
Partner
T: +44 20 7006 1940
E: kate.vyvyan@
cliffordchance.com

Jessica Walker
Knowledge Director
T: +44 20 7006 2880
E: jessica.walker@
cliffordchance.com

Felicity Ward
Senior Associate
T: +44 20 7006 4504
E: felicity.ward@
cliffordchance.com

Amy Watt
Senior Associate
Knowledge Lawyer
T: +44 20 7006 1987
E: amy.watt@
cliffordchance.com

Nicola Wherity
Partner
T: +44 20 7006 2074
E: nicola.wherity@
cliffordchance.com

Deborah Zandstra
Partner
T: +44 20 7006 8234
E: deborah.zandstra@
cliffordchance.com

Luxembourg

Marc Mehlen
Partner
T: +352 48 50 50 305
E: marc.mehlen@
cliffordchance.com

Eimear O'Dwyer
Senior Associate
T: +352 48 50 50 259
E: eimear.odwyer@
cliffordchance.com

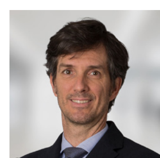
Ioanna Saranti
Foreign Lawyer
T: +352 48 50 50 417
E: ioanna.saranti@
cliffordchance.com

Katharina Thiegles
Avocat
T: +352 48 50 50 214
E: katharina.thiegles@
cliffordchance.com

Madrid

Eduardo Garcia
Partner
T: +34 91 590 9411
E: eduardo.garcia@
cliffordchance.com

Jose Guardo
Partner
T: +34 91 590 7595
E: jose.guardo@
cliffordchance.com

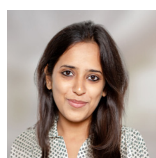


Antonio Henriquez
Partner
T: +34 91 590 9426
E: antonio.henriquez@
cliffordchance.com

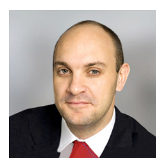
José Luis Zamarro
Partner
T: +34 91 590 7547
E: joseluis.zamarro@
cliffordchance.com

Middle East

Matthew Oliver
Trainee Solicitor
T: +971 4503 2759
E: matthew.oliver@
cliffordchance.com

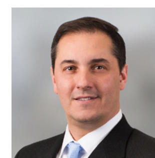


Alekhya Prakash
Senior Associate
T: +971 4503 2688
E: alekhya.prakash@
cliffordchance.com



Stuart Ure
Partner
T: +971 4503 2659
E: stuart.ure@
cliffordchance.com

New York

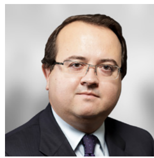


Hugo Triaca
Partner
T: +1 212 878 3222
E: hugo.triaca@
cliffordchance.com

CLIFFORD
CHANCE

Paris

Auriane Bijon
Counsel
T: +33 1 4405 2468
E: auriane.bijon@
cliffordchance.com



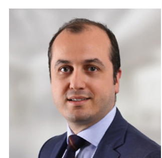
Cedric Burford
Partner
T: +33 1 4405 5308
E: cedric.burford@
cliffordchance.com

Sophie Guilhem-Ducléon
Counsel
T: +33 1 4405 2442
E: sophie.guilhem-ducleon@
cliffordchance.com

Andrew McCann
Counsel
T: +33 1 4405 5431
E: andrew.mccann@
cliffordchance.com

Gail Orton
Head of EU Public Policy
T: +33 1 4405 2429
E: gail.orton@
cliffordchance.com

Michel Petite
Avocat of Counsel
T: +33 1 4405 5244
E: michel.petite@
cliffordchance.com



Oliver Plessis
US Counsel
T: +33 1 4405 5487
E: oliver.plessis@
cliffordchance.com

Delphine Siino Courtin
Partner
T: +33 1 4405 5236
E: delphine.siinocourtin@
cliffordchance.com

Richard Tomlinson
Partner
T: +33 1 4405 5216
E: richard.tomlinson@
cliffordchance.com

Perth

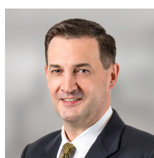
Philip Sealey
Director, Head of Renewables, Asia Pacific
T: +61 8 9262 5542
E: philip.sealey@
cliffordchance.com

Singapore

Matthew Buchanan
Partner
T: +65 6410 2206
E: matthew.buchanan@
cliffordchance.com

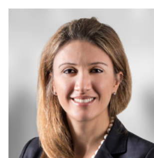
Ying Chiang Chong
Senior Associate
T: +65 6506 2796
E: yingchiang.chong@
cliffordchance.com

Gareth Deiner
Partner
T: +65 6410 2202
E: gareth.deiner@
cliffordchance.com



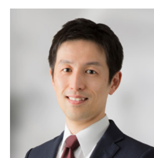
Johannes Juette
Partner
T: +65 6410 2293
E: johannes.juette@
cliffordchance.com

Sydney



Nadia Kalic
Partner
T: +61 2 8922 8095
E: nadia.kalic@
cliffordchance.com

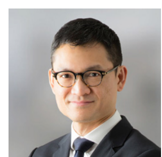
Tokyo



Yusuke Abe
Partner
T: +81 3 6632 6332
E: yusuke.abe@
cliffordchance.com

Chihiro Ashizawa
Counsel
T: +81 3 6632 6414
E: chihiro.ashizawa@
cliffordchance.com

Suguru Kimura
Senior Associate
T: +81 3 6632 6412
E: suguru.kimura@
cliffordchance.com



Leng-Fong Lai
Partner
T: +81 3 6632 6625
E: leng-fong.Lai@
cliffordchance.com

Reiko Sakimura
Partner
T: +81 3 6632 6616
E: reiko.sakimura@
cliffordchance.com

Washington DC

Lori-Ann Bean
Partner
T: +1 202 912 5014
E: lori.bean@
cliffordchance.com

Steve Nickelsburg
Partner
T: +1 20 2912 5108
E: steve.nickelsburg@
cliffordchance.com

Janet Whittaker
Senior Counsel
E: janet.whittaker@
cliffordchance.com

C L I F F O R D

C H A N C E

This publication does not necessarily deal with every important topic nor cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2019

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571
Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or contact our database administrator by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.

Abu Dhabi • Amsterdam • Barcelona
Beijing • Brussels • Bucharest
Casablanca • Dubai • Düsseldorf
Frankfurt • Hong Kong • Istanbul
London • Luxembourg • Madrid
Milan • Moscow • Munich • Newcastle
New York • Paris • Perth • Prague
Rome • São Paulo • Seoul • Shanghai
Singapore • Sydney • Tokyo • Warsaw
Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

J20190407191730