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EUROPEAN CAPITAL MARKETS MONTHLY BRIEFING SERIES

ESG IN THE EUROPEAN (UK & CONTINENTAL EUROPE) EQUITY CAPITAL MARKETS: INCHING FORWARD?

ESG disclosure in ECM

- Companies in the IPO process are increasingly making ESG disclosures in prospectuses despite the lack of a robust regulatory framework
- Growing contrast between the strict, more uniform, ESG disclosure standards imposed on listed companies and the limited disclosure obligations of companies seeking to IPO
- Potential for more harmonisation of disclosure standards in light of the impending adoption of the IFRS Sustainability Disclosure Standards

Third-party ESG data and ratings

- Challenging to compare ESG data and ratings between numerous providers due to varying assessment standards and methodologies, entails confusion and risk of litigation / exposure to claims of greenwashing
- Establishment of designations such as the LSE Green Mark and Voluntary Carbon Market to recognise ESG compliance and create greater uniformity in standards
- 'Sustainable Public Offerings' may be a possible solution for companies to demonstrate ESG credentials despite limited uptake to date

Introduction

ESG – environmental, social and governance – considerations are increasingly important for the equity capital markets (ECM), not only for companies whose core business is ESG-driven or those companies motivated by the reputational or financial benefits of ESG performance, but also for investors who may be incentivised to fulfil their growing ESG mandates.

In this briefing, we will look at ESG disclosure requirements in particular in the context of initial public offerings (IPOs), as well as some of the challenges presented by the contrasting requirements applicable to listed companies and the issues surrounding the use of third-party ESG data and ratings. We will also explain that significant progress needs to be made before ESG considerations are thoroughly and efficiently embedded in the processes of European equity capital markets.

ESG disclosures in the IPO process remain in early stages

Disclosure – the publication of necessary information which is material to investors to make informed investment decisions – has long been a cornerstone of equity capital markets, with the issuer company being subject to the overarching requirement to disclose all such information in its offering prospectus. In the last few years, we have begun to see companies make more significant ESG disclosures in their prospectuses, for example, ESG references being incorporated in the "equity story" (i.e. the investment rationale). This is generally not the result of ESG-specific disclosure requirements being imposed by regulators, but rather a broader market and societal focus on ESG-related matters which has made these issues more "material" to businesses and investors. This can be seen in recent transactions that the Clifford Chance European network has advised on, for example:

- **Porsche** – a key aspect of its equity story in connection with its IPO on the Frankfurt Stock Exchange focused on pursuing sustainable performance. Several strategic pillars encompassing different aspects of ESG were outlined, including the setting of carbon neutrality targets across its production sites, diversity targets for the workplace, supply chain responsibility and governance targets. Porsche obtained ESG ratings from recognised third-party companies including Sustainalytics, in addition to using its own 'S-rating' designation to measure internal sustainability metrics in relation to supplier selection and procurement. The company also emphasised the importance of

ESG criteria in the Porsche management's short-term and long-term incentive programmes.

- **Volvo Cars** – in connection with its IPO on Nasdaq Stockholm, Volvo Cars made ESG disclosures in its prospectus, regarding its commitment to responsible sourcing of materials within its supply chain, a key aspect of its equity story. Specifically, Volvo referenced its consideration of human rights abuses and unethical business conduct in identifying raw materials.
- **Ming Yang Smart Energy** – in connection with its listing on the London Stock Exchange, Ming Yang Smart Energy made disclosures in its prospectus regarding the company's commitment to green, low-carbon and sustainable product development and supply chain management. The company also set out how it would incorporate its carbon neutrality goals both internally and in its products.
- **Azelis** – in connection with its IPO on Euronext Brussels, Azelis described in its prospectus not only the fundamentals of its sustainability programme but also its objectives to identify, create and promote environmentally friendly products for its customers and to minimise its environmental footprint by reducing the impact of both its own operations and those of its outsourced distribution partners. The prospectus also contained specific ESG-related commitments. For example, Azelis targeted a specific percentage of its revenue as being related to products sourced from suppliers that have been assessed using the Together for Sustainability (TfS) framework and tools as well as specific percentage reductions in its scope 1 and scope 2 emissions per million Euros of revenue by certain target dates.
- **CTP** – in connection with its IPO on Euronext Amsterdam, CTP made disclosures in its prospectus regarding the importance of sustainability to the company's strategy. The equity story highlighted how CTP had conducted its business with consideration to ESG to-date, for example, equipping their developed buildings with solar power capabilities, obtaining a sustainability certification and establishing a reforestation initiative. The prospectus also described the company's goals to be operationally carbon neutral and only issue green bonds in the future.

Whilst these issuers all made ESG disclosures in their IPO prospectuses beyond any formal specific requirements, it is important to consider the driver of such disclosures. It is reasonable to conclude that disclosure is principally occurring because this information is key to the company's business strategy and is therefore material information to both potential investors and its own valuation. In the examples above, electric vehicles and the further electrification of various car models are a key part of Porsche's and Volvo's product strategy, Ming Yang operates in the clean energy sector, and Azelis is in the chemicals sector.

ESG disclosures required from a UK/EU regulatory perspective

From a regulatory standpoint, the UK and EU currently lack a robust framework to support or mandate ESG disclosures in ECM transactions such as IPOs (as discussed further below in this briefing, both regimes are presently undergoing review). Despite this, regulators have sought to fill this gap. By way of example, the UK Financial Conduct Authority (FCA) published a technical note in

December 2020 (TN/801.1 "*Disclosures in relation to ESG matters, including climate change*") in an attempt to highlight existing UK regulations which may require ESG disclosures. Notably, the technical note highlights the financial materiality of climate and ESG-related risks and opportunities and, consequently, the need for information of this nature to be disclosed where it is relevant. For example, the FCA highlights Article 6 of the UK Prospectus Regulation which provides that a prospectus for an IPO / listing must contain the *"necessary information which is material to an investor for making an informed assessment… of the issuer"*. As a practical example, in the context of the UK government's target to achieve both net-zero carbon emissions by 2050 and, more generally, to achieve the goals of the Paris Agreement, the FCA states that many companies are likely to need to consider significant changes to their business, and that such changes may be material to an investor's assessment of the prospects of the company and the risks and opportunities shaping it. Against this backdrop, it is interesting to note that a court case was lodged by a London-based NGO in February 2023 challenging as unlawful the FCA's decision to approve the IPO prospectus of a company with significant interests in oil and gas fields on the basis that the prospectus did not *"explain how [climate-related] risks affect its business specifically, or how significant these risks are for the company"*. This same NGO had previously criticised the UK regulator for having *"introduced climate-related disclosure requirements for listed companies, but missed the opportunity to impose consistent climate-related conditions and controls at the point a company applies for listing – the point at which the regulator has most leverage over applicant companies"*.

The observations made by the FCA in its technical note could have wider relevance to Continental Europe given that the UK prospectus regime is still largely based on the European Union common standard. Indeed, the European Securities and Markets Authority (ESMA) takes a similar approach in its Guidelines on disclosure requirements under the Prospectus Regulation (04/03/2021), where it highlights, for example, that an issuer's Operating and Financial Review requires disclosure of the company's strategy, which can include ESG matters. At a higher level, ESMA added "ESG disclosure" to its Union Strategic Supervisory Priorities (USSPs) - according to ESMA, this new priority represents an important step in the implementation of the ESMA strategy, which gives a prominent role to sustainable finance, focusing on transparency and comprehensibility of ESG disclosures (including by issuers) and tackling greenwashing. In addition, ESMA has stated that it aims to promote an effective and consistent supervision, by building supervisory capabilities to embed sustainable finance into daily supervisory work.

ESG disclosures required from an accounting perspective

From an accounting perspective, there is also currently no framework or requirement for ESG disclosures. However, reference materials published in November 2020 by the IFRS Foundation emphasised that although climate matters are not explicitly stated within IFRS financial reporting standards, they must be considered "*when the effect of those matters is material in the context of the financial statements taken as a whole*". This reminded companies that, where climate-related matters represent material risks and opportunities for the business, they should consider those matters in financial statements specifically (and not just IPO prospectuses as generally noted above) and disclose material information, such as the assumptions which have been made in their preparation. The FCA, in its Primary Market Bulletin 42 (December 2022), highlighted this and noted the potential impact ESG considerations can have on

the preparation of financial statements, which form a key part of the IPO disclosure package. The Belgian, Dutch and French regulators have similarly adopted guidance that emphasises the growing expectations of investors for companies to consider the effects of climate change and the commitments made in this regard in their financial statements.

Key challenges

There are a number of challenges in the implementation of ESG in IPOs, including (i) the contrast between ESG corporate reporting and IPO requirements, and (ii) the use of third-party ESG data and ratings.

ESG corporate reporting and disclosures required of listed companies present a stark contrast with IPO requirements

As things stand, there is a clear regulatory distinction between companies seeking to be listed and those that are already listed in the UK and EU.

ESG corporate reporting in the UK

Under the UK Listing Rules, listed companies are currently required to make climate-related disclosures on a 'comply or explain' basis (with the regulator currently having announced it is considering a potential move to mandatory compliance).

Moreover, these disclosures are held to a more uniform standard, the Task Force on Climate-Related Financial Disclosures (TCFD) disclosure requirements. Compare this with prospective issuers who may, for example, obtain ESG ratings from one of many rating agencies, each employing often different methodologies. By contrast, the UK has long embedded sustainability into corporate reporting. For example, since 2013, the UK has required companies to include a strategic report in their annual report to facilitate the reporting of non-financial information such as the company's strategy and development. In 2016, the UK added further reporting requirements for large entities with >500 employees - requiring them to disclose information on their environmental impact, social matters, employees, human rights, and anti-bribery and corruption. Since 2019, the UK government has required all large UK companies to disclose their greenhouse gas emissions and this was further extended in 2022 to mandate TCFD aligned climate disclosures in a "Non-Financial and Sustainability Statement" (NFSS) section in annual reports.

Looking forward, the UK regulator noted in 2022 that it has committed to consulting on adopting further ESG disclosure rules to reference the International Sustainability Standards Board (ISSB)'s standards, which are backed by the IFRS Foundation. These aim at delivering a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions.

ESG corporate reporting in the EU

A similar evolution can be seen in EU regulation. The adoption of the Non-Financial Reporting Directive in 2014, applicable to large listed companies, was an important step towards mandatory non-financial reporting. In March 2018,

the European Commission published [an action plan on financing sustainable growth](). In this plan, the Commission stipulated that "*corporate transparency on sustainability issues is a prerequisite to enable financial market actors to properly assess the long-term value creation of companies and their management of sustainability risks*". Pursuant to the action plan, the Corporate Sustainability Reporting Directive (CSRD), adopted in 2022, provides for a single set of verifiable standards (the European Sustainability Reporting Standards) that will apply to a much broader scope of companies, including both listed and non-listed companies. The objective of the CSRD is to strengthen sustainability reporting in terms of the relevance, reliability and comparability of information. The new disclosure requirements will cover environmental impact, social matters and governance. For each of these, companies will be required to disclose information regarding their business model, strategy and policies as well as the major risks and impacts for them and their stakeholders. The CSRD obligations will be applied on a staggered basis beginning 1 January 2024 for certain large companies up to 1 January 2026 for small and medium sized companies. Additionally, the Taxonomy Regulation establishes an EU-wide classification system to identify economic activities that are considered "sustainable" and requires certain listed companies to publish how their activities align with the taxonomy. This obligation has applied to large listed companies subject to the Non-Financial Reporting Directive from 1 January 2022 and will be expanded to include other companies as they become subject to the CSRD. Therefore, these requirements could eventually have an indirect influence on IPO prospectus disclosure. At the time of writing, as part of its overhaul of the UK's financial services, the UK has delayed development of a UK taxonomy and the related technical screening criteria; however, it is anticipated that there will be a focus going forward on ensuring the international interoperability of the UK taxonomy and the EU taxonomy.

The development and adoption of European Sustainability Reporting Standards by the European Financial Reporting Advisory Group (EFRAG) for the purposes of the CSRD and, as previously mentioned in the context of the UK, of IFRS Sustainability Disclosure Standards by the ISSB, are expected to lead to a consolidation of the corporate reporting landscape. How these standards, and others, will be applied and work, particularly for multi-national companies who operate and engage in financial activity across jurisdictions, is a challenge that is well recognised by regulators.

Bridging the gap between prospectus disclosure requirements and corporate reporting by listed companies

At the time of writing, the UK is undergoing a change to its prospectus regime, presenting a potential opportunity to address the discrepancy between the limited requirements in the IPO sphere and the growing corporate reporting disclosure obligations. However, what is driving this divergence between prospectus disclosure requirements in an IPO context and corporate reporting for already listed companies? Is it a concerted desire to not overburden the IPO process and risk making the capital markets less attractive at a time when regulators are generally trying to reduce the hurdles to listing (cf. [the EU's proposed Listing Act]() and the [UK FCA's proposed reform of the UK listing regime]())?

In this context we note that the EU's proposed Listing Act, which aims at simplifying both listing and post-listing requirements, is proposing to codify the ESG disclosure to be included in prospectuses to a certain extent, although

there is very little detail included in the proposals. The proposed Listing Act provides that when an issuer is already required to undertake corporate sustainability reporting a prospectus will need to reference its sustainability report. In addition, prospectuses relating to non-equity securities will need to include information regarding ESG factors or objectives (what is required in this context is likely to be influenced by the development of the EU Green Bond Standard). Even if the scope of these requirements remains limited, the proposed Listing Act can be seen as the EU moving towards closing the gap between corporate ESG disclosure and prospectus requirements.

Even if steps are not taken towards more fulsome mandated disclosures in the IPO sphere, we believe that the increased prevalence of ESG data and disclosures from listed and large companies will likely organically result in an increase in voluntary ESG disclosures in IPOs.

Third-Party ESG data and ratings providers: an incomplete framework

There are still several challenges in the current framework from an investor's point of view in evaluating the ESG disclosures of different companies. A lack of uniformity of standards means that comparison between companies is difficult, especially with over 150 major ESG data providers worldwide (per IOSCO, 2021) and ESG rating agencies that may provide different opinions on aspects of sustainability performance based on their own in-house methodologies. There are also typically more assumptions made in producing ESG ratings compared with, for example, credit ratings. Additionally, prospective issuers need to be careful not to disclose material information to ESG rating agencies beyond what is disclosed to investors in the prospectus, thereby creating an inherent tension between the desire to ensure positive ESG rating coverage and the risk that having different levels of disclosure can create in an IPO context.

Therefore, more extensive ESG disclosure may be welcome, but it would likely be beneficial to investors and the wider market if there were established benchmarks or other means of comparison between companies, as is the approach followed by the adoption of European and International Sustainability Reporting Standards. In addition, the CSRD requires auditors to verify and express an opinion on sustainability reporting's compliance with the requirements of the CSRD (including reporting according to the Taxonomy Regulation and its delegated acts). In the US, the approach to ESG verification may go even further, with the Securities and Exchange Commission (SEC) recently having proposed rules requiring emissions data to be included in offering documents and periodic reports. Moreover, in certain circumstances, under the proposed rules this data may be subject to assurance by an independent qualified third party.

Initiatives to standardise and regulate ESG data

One anticipated initiative is the FCA establishing a Code of Conduct for ESG data and ratings providers. This is currently being developed and which is intended to be "internationally consistent" (for example, by contributing and seeking alignment with the International Organisation of Securities Commissions' (IOSCO) work on ESG data and ratings). The aim of the Code is to improve transparency in the market with respect to ESG data and relevant ratings services. The UK government has previously noted, in its Roadmap to Sustainable Investing from 2021, that it was considering bringing these firms

within the scope of FCA authorisation and regulation – it has since taken steps in that direction by launching a consultation on 30 March 2023 as to whether regulation for providers of ESG ratings should be introduced and on the potential scope of any such regulatory regime.

Besides potential regulation / standardisation of ESG data and ratings providers, the recent development of various relevant ESG designations may address some of the difficulty of comparing ESG performance between companies, as these create a measurable standard of evaluation. The Green Economy Mark is one such accreditation provided by the London Stock Exchange which is awarded to companies and funds that generate between 50% and 100% of their total annual revenues from products and services that contribute to the global green economy (for example, i(x) Net Zero, which is involved in direct air capture and carbon removal, is one of its recipients). This may be a useful tool but it has inherent limitations such as not of itself accounting for the company's internal processes or net ESG impact, particularly the social and governance aspects. A more recent initiative by the London Stock Exchange, the Voluntary Carbon Market (VCM), which is a designation for listed funds and companies that invest in climate change mitigation projects that are expected to yield carbon credits, may provide a more comprehensive answer to the designation issue, at least from an environmental perspective. As part of the VCM process, relevant companies are required to produce additional disclosures relating to the projects they are financing, including information about the qualifying bodies whose standards will be applied to the project, expected carbon credit yield and the extent to which the UN Sustainable Development Goals will be met.

Finally, the concept of a 'sustainable initial public offering' (an IPO conducted in accordance with the Sustainability Principles and Objectives Framework, or 'SPO') involves the issuer committing to certain environmental, social and governance standards at the time of the IPO and beyond, not unlike similar green or sustainable bond frameworks in the debt capital markets sphere. This voluntary framework was developed by sustainable business consultancy Business for Social Responsibility (BSR) with the intention of creating a simple, credible mechanism for prospective issuers to demonstrate their commitment to ESG. It is managed by a group of sustainability experts spanning a range of industries including data, business, and law, with representatives from companies including Baillie Gifford, Sustainalytics and MSCI. As of the date of writing, one notable company to seek to IPO under the SPO framework has been Allbirds back in 2021 in the US. Time will tell if this initiative gains a wider appeal and is able to successfully address some of the challenges discussed above.

Lessons to learn from other jurisdictions?

It is evident that ESG considerations are increasingly playing a role in the IPO process and beyond in the UK and Continental Europe, with new initiatives being established such as the award of designations and evidence of companies providing more detailed disclosure. However, the lack of a consistent legal or market adopted ESG framework for IPOs and the equity markets demonstrates that there is still a growing gap between pre- and post-listing reporting/disclosure requirements. There is also a contrast with debt capital markets where ESG disclosure and processes are more formally entrenched.

There may be lessons to be learnt from regulatory initiatives on ESG reporting in other jurisdictions. In Hong Kong, IPO applicants are required to make climate-related disclosures in their listing documents, including information about the company's environmental policies, how the company looks to manage climate-related risks and descriptions of the environmental impact created by the company's activities. These are more extensive, and crucially, more specific requirements for disclosures in the listing document compared with the regulatory framework in, for example, the UK or EU. Similarly, as mentioned above, in the US the SEC has proposed rules expected to be finalised later in 2023 that would require extensive climate-related disclosure, including data on GHG emissions data, to be included in both offering documents and periodic reports. Observing these differences may provide direction for regulators to provide guidance and improve the approach taken towards ESG in the European equity capital markets.

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