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April 2023

Navigating risk in ESG transactions

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OVERVIEW

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2. Regulatory Risk

EU and UK ESG Sustainable Finance Regulation

In March 2018, the EU published its "**Action Plan on the Financing of Sustainable Growth**" its plan to integrate sustainability into the EU financial system. This sits alongside other EU initiatives such as "**The European Green Deal"** and "**Fit for 55**".

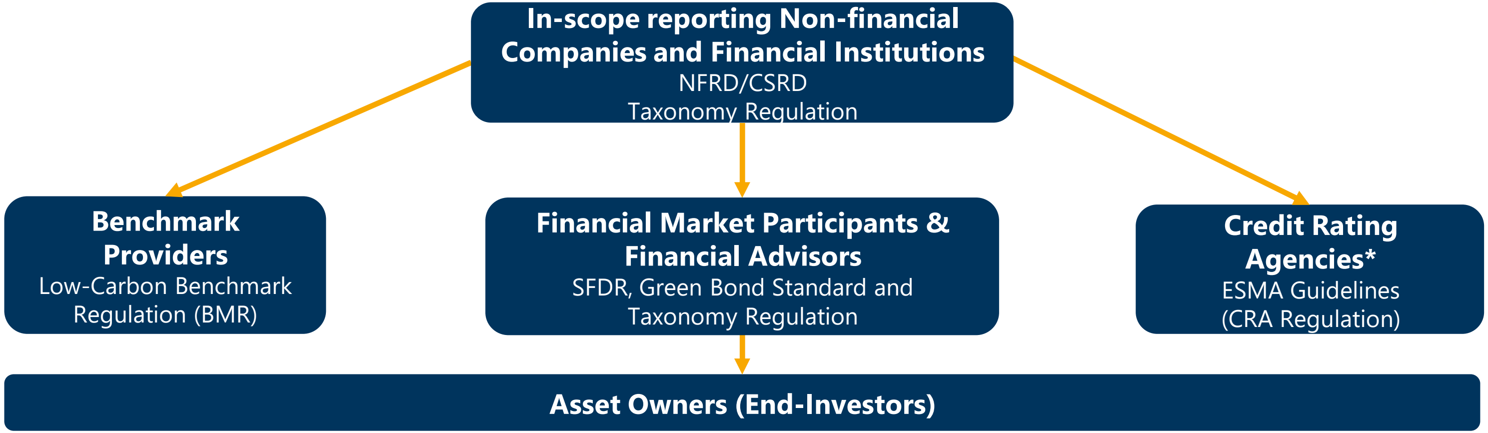
The UK has its own, post-Brexit, **Green Finance Strategy** that aims to harness its financial services sector to support climate and environmental objectives.

Both initiatives will affect, or have the potential to affect, cross-border financing transactions.

ESG Regulation for DCM - Overview

Legislation	What is it?	Who does it apply to?	In force?	Applicability to DCM
Taxonomy	**EU dictionary of what constitutes a “sustainable economic activity”**	Crosscutting but notably applies/will apply as part of CSRD, SFDR, EU GBS, Pillar III.	Yes	**CSRD** – to Issuers, alignment of activity with Taxonomy; **SFDR** – to buy-side, alignment of sustainable funds with Taxonomy; **EU GBS** – to Issuers, alignment of proceeds with Taxonomy; **Article 8 Taxonomy** – to corporates and FIs, alignment of capex, opex and revenue (or GAR for FIs); **Pillar III disclosures** – BTAR
CSRD	**Sustainability reporting requirements for companies**	Certain EU and non-EU companies	Yes	For FY 2024 onwards, many EU and non-EU Issuer clients will be including sustainability information mandated by CSRD in their management report
SFDR	**Sustainability reporting requirements for the buy-side**	Buy-side (not Issuers or underwriters)	Yes	Issuers and underwriters may face increasing demand for sustainability related information from the buy-side
EU GBS	**Voluntary EU gold standard for green bonds**	Issuers of a EU GBS	No	Applies to Issuer clients using the EU GBS label. May also apply to EU GBS securitisations.
MiFID II ESG	**Amendments to MiFID PG Regime**	MiFID II Manufacturers and Distributors	Yes	See ICMA view here for wholesale DCM: ICMA-proposed-approach-MiFID-PG-ESG-amendments-October-2022.pdf (icmagroup.org)
CSDDD	**Detailed supply chain due diligence for EU and non-EU companies**	Certain EU and non-EU companies	No	Unclear. One to watch.
Listing Act	**Reform of the EU PR**	Issuers of PR compliant securities	No	TBD. See proposed updated via new PR Article 13(f)
ESG Ratings	**Currently unregulated**	N/A	No	Use of ESG ratings in offering documents, announcements, SLBs, sustainable CP

The EU sustainability data chain



- **NFRD** = Non-Financial Reporting Directive (Directive 2014/95/EU)
- **CSRD** = Corporate Sustainability Reporting Directive (Proposal COM(2021) 189 final)
- **SFDR** = Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088)
- **BMR** = Benchmark Regulation (Regulation (EU) 2016/1011)
- **CRA** = Credit Rating Agencies Regulation (Reg. (EU) No 462/2013)

* Reported data will also be required for ESG ratings. It is unclear whether and to what extent the EU will envisage a regulation for ESG ratings.

Regulatory risk

Tackling greenwashing is a top priority for financial regulators around the world

U.S. SECURITIES AND EXCHANGE COMMISSION

SEC Announces Enforcement Task Force Focused on Climate and ESG Issues

esma European Securities and Markets Authority

PRIORITY 1

Tackling greenwashing and promoting transparency

FCA FINANCIAL CONDUCT AUTHORITY

7 Challenge firms where we see potential greenwashing, clarify our expectations and take appropriate action to prevent consumers being misled

Regulatory risk

FCA, **ESMA** and **HKMA** have begun work to propose new “anti-greenwashing” rules

FINANCIAL CONDUCT AUTHORITY

HONG KONG MONETARY AUTHORITY

EBA EUROPEAN BANKING AUTHORITY

eiopa European Insurance and Occupational Pensions Authority

esma European Securities and Markets Authority

3.3.1 R A *firm* (whether it is undertaking *sustainability in-scope business* or not, including *firms* that *approve financial promotions* for *unauthorised persons*) must ensure that any reference to the *sustainability characteristics* of a product or service is:

(1) consistent with the sustainability profile of the product or service; and

(2) clear, fair and not misleading.

Finally, this paper also provides empirical support on how a well-defined green bond taxonomy and a stricter requirement on environmental impact disclosure could mitigate greenwashing behaviour. These would be important policy implications for policy makers to consider when designing relevant regulations to curb this unscrupulous behaviour and foster a healthier development of green bond markets.

ESAS CALL FOR EVIDENCE ON GREENWASHING

From 15 November 2022 to 10 January 2023

Key Takeaways

1. CSRD preparation is a live issue for many Issuer clients. Consideration needs to be given to how that information may translate into offering documentation. In particular, non-EU companies should consider implication of listing retail debt on reg market in EU. ESG corporate reporting is also a point for consideration via non-EU legislation.

2. EU Green Bond Standard is now provisionally agreed. Final detail is not yet clear but expect more client queries. There is no current plan for a UK GBS.

3. There are range of EU ESG regulations that will have an effect on bond documentation – notably the Taxonomy, CSRD, EU GBS and any ESG amendments via the Listing Act.

4. There is currently less in the way of US and UK regulation but watch out for UK ESG corporate reporting requirements, a UK FCA anti-greenwashing principle and the SEC's Climate Change Disclosure reporting rules.

5. Greenwashing remains a huge concern for regulators in EU, UK, US and HK. We are very likely to see more in the way of regulation to combat this and more litigation.

3. Reputational Risk

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Reputational risk

Repsol: Good on GBPs, not so sure on green credentials

Climate Bonds Initiative

DWS shares slide after greenwashing claims prompt BaFin investigation

FINANCIAL TIMES

Empty ESG Pledges Ensure Bonds Benefit Companies, Not the Planet

Bloomberg

Banks hit by 'fraud' complaint to SEC over Adani SLB coal links

GlobalCapital

Boohoo shares drop 18% as new Leicester factory reports threaten sales

The Guardian

Critics pan Sembcorp's coal sale

IFR

Reputational risk

Examples of Company ESG Incidents

	BOND PRICE HIGH BEFORE THE INCIDENT	BOND PRICE LOW FOLLOWING THE INCIDENT	% CHANGE
Environmental Disaster	107.54	97.33	-9.5%
Social Responsibility	96.15	57.30	-40.4%
Governance Misstep	104.14	2.28	-97.8%

Source: Bloomberg. Each row of data represents one company, as an example, that experienced the ESG incident described. The bond price before and following the incident represents one individual bond that was issued by the respective company taken at the peak bond price right before the incident was made public and at the trough bond price following the incident.

For illustrative purposes only and should not be construed as how each security have moved, or will move, before and after an incident.

Source: Morgan Stanley Investment Management 2020

4. Litigation Risk

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Litigation risk

- Increasing prominence of claims relating to greenwashing
- **Broader range** of stakeholders in ESG-related matters than in "traditional" litigation – leads to wider pool of potential claimants
- Stakeholders have **different motivations** and **different barometers** for what constitutes "successful" outcome
  - Affect conduct (**en**courage / **dis**courage conduct)
  - Raise public awareness: **issue-** and **sector-**oriented
- Stakeholders are developing **innovative approaches** to ESG-related litigation
- **Sophisticated litigants** with significant **war chests** available
- Interaction with reputational risk

Additional Mayer Brown resources:

Climate Litigation: private actors increasingly becoming the targets of claims | Eye on ESG

The Grantham Research Institute on Climate Change and the Environment publishes its 2022 global trends in climate litigation report | Eye on ESG

New Allegations in World-first Lawsuit Over Clean Energy and Zero Emissions Claims | Eye on ESG

Litigation risk – Illustrative examples

Consistent themes in emerging (non-DCM) greenwashing cases are allegations of **misrepresentation, omissions, misleading evidence** and **mislabelling**

H&M

1. This case is about H&M's labeling, marketing, and advertising that is designed to mislead consumers about its products' environmental attributes, through the use of false and misleading "environmental scorecards" for its products called "Sustainability Profiles." These Sustainability Profiles were prominently incorporated into H&M's website and were displayed on the product listing for hundreds of H&M items. However, on June 28, 2022, an independent investigation revealed that H&M's Sustainability Profiles contained falsified information that did not comport with the underlying data. For example, one Sustainability Profile claimed that a

- Santos' Net Zero representations failed to disclose that:
  - its Net Zero plan does not account for expected production and/or emissions growth from oil and gas exploration opportunities beyond 2025;
  - the 'CCS Expansion' portion of the Net Zero plan actually reflects offsets which Santos will apparently seek to procure. It does not represent modelled reductions in Santos' own emissions, but instead is a nominal number making up the difference to net zero;
  - the 'Hydrogen with CCS' portion of the Net Zero plan also reflects offsets which Santos will apparently seek to procure. Again, it does not represent modelled reductions in Santos' Scope 1 and 2 emissions, but instead depends upon Santos receiving offsets for reducing its customers' Scope 1 and 2 emissions through the sale of blue hydrogen.
  - the 'Hydrogen with CCS' portion of the Net Zero plan also assumed that Santos would blend 30-50% hydrogen into the natural gas network, whereas Santos had no reasonable basis for assuming it could blend more than 10%.

Santos

5. Greenwashing

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What is greenwashing?

greenwashing noun

Save Word

green·wash·ing | \ ˈgrēn-ˌwȯ-shiŋ , -ˌwä- \

Definition of *greenwashing* (Entry 1 of 2)

: the act or practice of making a product, policy, activity, etc. appear to be more environmentally friendly or less environmentally damaging than it really is

"Greenwashing is marketing that portrays an organisation's products, activities or policies as producing positive environmental outcomes when this is not the case"

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- There is **no harmonised legal definition** and the concept of greenwashing will vary by product, regulator and jurisdiction
- However, at its core, greenwashing is fundamentally about **misrepresentation, misstatement and false and misleading practices in relation to environmental credentials**
- It is not purely a legal or regulatory concept – allegations of greenwashing can have **significant reputational impact**

What is greenwashing?

There are some common themes in greenwashing allegations:

- Statement about environmental or ESG credentials is not correct
- Statement doesn’t tell the whole story of a product or service; or relates to one part of the product or service but misleads people about the other parts or the overall impact on the environment
- Caveats or conditions to an environmental or ESG statement are not adequately disclosed
- Statement about environmental or ESG credentials is based on flawed or incomplete evidence
- Statement about environmental or ESG credentials is based on flawed calculations
- A sustainable label, tag or rating in relation to a product or service is misleading
- A regulatory statement or classification is incorrect of misleading
- Transactions that “rearrange the deck chairs on the Titanic”

6. Product Specific Risk – SLBs

Top tips for Sustainability-Linked Bonds

1. **Additional guidance from ICMA available** (including updated ICMA Q&A document and KPI registry)
2. **Risk factors and disclaimers** are increasingly detailed and sophisticated
3. **Sustainability Agent/Coordinator** – Not "Advisor"; increasing prevalence of Sustainability Agent mandate letters
4. **Are the SLB Terms and Conditions clear?**
5. **Failure to report** as Event of Default "by mistake"?
6. **Recalculation language** increasingly popular
7. **EBA Monitoring Report June 2021** – SLBs not appropriate for EU regulatory capital issuances
8. **Are targets ambitious? Are targets appropriate?**
9. **Not just step-ups** – Also step-downs, redemption premia, charitable donations, purchase of carbon credits

Sustainability-Linked Bonds – Our resources

INSIGHT: SUSTAINABILITY-LINKED BONDS

SOME PRACTICAL CONSIDERATIONS FOR DOCUMENTING AND STRUCTURING TRANSACTIONS

Sustainability-linked bonds ("SLBs") have fast become an important feature of the sustainable finance market. According to Climate Bonds Initiative, SLB issuance reached US$76.3 billion in 2022[1] and we have seen an increasingly wide variety of corporate and sovereign issuers take advantage of the structure[2].

Issuing a SLB can indicate an issuer's commitment to sustainability principles and offer a practical alternative for those issuers without sufficient sustainable assets to take advantage of the sustainable "use of proceeds" structure. By embedding corporate commitments in their funding, SLBs can be particularly valuable to issuers that wish to demonstrate their commitment to their transition strategy away from carbon intensive business.

However, the market has not grown without incident or controversy. Some issuances have attracted accusations of "greenwashing" for a lack of ambition in their targets, the lack of meaningful consequences if a target is not met or where the structure of the SLB does not address the true sustainability challenges of their business. SLBs carry with them some particular considerations that should be kept in mind when structuring a transaction and preparing the relevant legal documents and marketing materials.

We take a look at some of these key points in this note.

Sustainability-linked bonds – A (very) brief recap of the basics

SLBs are bonds where the financial and/or structural characteristics vary depending on whether or not predefined sustainability performance targets ("SPTs"), determined by reference to key sustainability performance indicators ("KPIs"), are met.

Unlike "green bonds", there is no requirement that the proceeds be allocated to a sustainable project or purpose. The proceeds from an SLB may be used for general corporate purposes or, indeed, any other purpose.

The SLB market is based upon the International Capital Market Associations ("ICMA") Sustainability-Linked Bond Principles (the "Principles"). In addition to the Principles, ICMA have produced a range of additional materials to assist the growth of the market and maintain market integrity, notably:

- a set of Related Questions providing guidance on common questions about SLBs (the "ICMA SLB Q&A"); and
- an Illustrative KPI Registry, a set of high-level recommendations as well as illustrative examples to assist issuers with the selection of relevant and material KPIs.

Some key points to think about when structuring and documenting SLBs

1. ***Align the SLB terms and conditions with the SLB framework***

It is important to ensure that the issuer's SLB framework - the document typically setting out its sustainability strategy, goals and objectives as well as the description of SPTs and KPIs - aligns with the terms and conditions of the SLBs.

Whilst this may seem obvious there can be a disparity between the way in which the framework, primarily a marketing document, and the terms and conditions, a legal document, are drafted. It is important to ensure consistency. This is particularly true where using detailed, technical language to describe the KPIs. By way of example, for greenhouse gas emissions targets, it is key that it is consistently clear whether Scope 1, 2 or 3 metrics are being applied in the KPI.

1 See Green and other Labelled Bonds Held Market Share in 2022 Amidst Fall of Global Fixed-Income | Climate Bonds Initiative
2 Issuance by financial institutions has been limited owing to reservations expressed by regulators from a regulatory capital perspective. See, for example, para 187 et seq. of European Banking Authority

To learn more about structuring and documenting SLBs, see our recent **Insight** publication on some of the key practical and legal considerations. Available at:

[Sustainability-Linked Bonds Resources | Free Writings & Perspectives]

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7. Navigating Risk

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General

- Much of the mitigating ESG risks lies in **existing principles of good practice** plus **an understanding of the sustainability profile of the client, industry and the transaction**
- In particular, attention should be paid to:
    - **Disclosure**
    - **Due diligence**
    - **Understanding emerging market practice**
    - **Understanding the sustainability profile of the client and the transaction**

Checklist - Disclosure

Approach to disclosure in offering documents, marketing materials and corporate reporting is important

- ✓ Disclosure, marketing materials and public statements – accuracy is essential
- ✓ Simple and clear
- ✓ Don't overstate, do explain
- ✓ ESG legislation is complex and developing. "Adherence" should be caveated where possible (e.g. EU Taxonomy)
- ✓ Use risk factors; disclaimers; forward looking statement language
- ✓ Use of common metrics and describe limitations of those metrics; third party verification (e.g. SBTi)
- ✓ Discrepancies between what is "said" and what is "done" – identify and cure
- ✓ Alignment between offering documents, marketing materials and corporate sustainability reports
- ✓ Alignment with institutional policies, commitments and after market publicity

Checklist – Due diligence

Addressing ESG issues in diligence is important

- ✓ "Kicking the tyres" on the framework
- ✓ Flush out other ESG risks or controversies the group may be facing
- ✓ Example questions:
  - *Please confirm that the [framework document] is accurate and consistent with the Prospectus and other marketing materials.*
  - *Please discuss any ESG issue or controversy (including negative news media coverage) affecting the Issuer over the last 3 years.*
  - *Please describe your internal controls and procedures in relation to ESG risks? How do you identify and address ESG risks?*
  - *You have publically committed to "X", please describe what you are doing to achieve "X".*
- ✓ Further sources of questions: External counsel; OECD report on ESG due diligence; AFME ESG HY DDQs

Checklist – ESG bonds

Points to consider for ESG bonds

Prospectus

- Focus on disclosure
- Underwriter disclaimers
- Risk factors
- Use of proceeds / framework disclosure

Subscription Agreement

- Generally disclosure rep. is very helpful
- Potentially:
  - Undertaking regarding UoP
  - Undertaking to report (but not to deliver the report to banks)
  - Commitment to listing on green exchange (if relevant
  - Appointment of second party opinion provider
  - Accuracy of framework
  - Confirmation of right to distribute the framework

Investor Presentation, announcements and other materials

- Consistency between the IP and the Prospectus.
- Is the ESG information included appropriate/necessary?
- Disclaimers

Due Diligence

- What does the framework say? Is there information that needs to be included in the Prospectus?
- Additional questions, e.g. in relation to the accuracy of the framework, other ESG risks the Issuer may be facing.
- Client screening. Are you aware of any ESG controversies?

Other

- An SPO from a reputable provider is also helpful protection for underwriters
- Mandate Letter – additional protection required if acting as Sustainability Bank/Coordinator?
- Use of ESG ratings. Disclaimer?

Checklist – Understanding the sustainability profile

- ✓ What are the positive and negative impacts of the transaction on the borrower's reputation? The lender/underwriter's reputation?
- ✓ How does the transaction fit in with the client's sustainability profile and industry? Are there any red flags that need to be addressed?
- ✓ What else has the client said publically around sustainability and ESG?
- ✓ How is the transaction aligned with institutional policies, commitments and after market publicity?
- ✓ Are we using a client's ESG ratings appropriately?
- ✓ Are we being sufficiently transparent?
- ✓ Are the KPIs and SPTs sufficient to incentivise meaningful change by borrowers in their sustainability practices?

8. Q&A

Today’s speakers

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Peter Pears is a partner in the Banking & Finance practice of the London office. He acts for issuers and underwriters on a range of domestic and international capital markets products including Eurobond, medium term note, commercial paper, regulatory capital, corporate hybrid and liability management transactions.

Peter has considerable experience in sustainable debt and ESG principles and regularly advises on green, social and sustainable bonds, sustainability-linked bonds and ESG regulatory matters. He currently serves on the Advisory Council to the ICMA Green Bond Principals Executive Committee. Peter chairs the Firm’s Sustainable Finance product group and on the steering committee for the Firm’s disability awareness network, Enable.

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James Taylor is a partner in the Banking & Finance practice of the London office.

James’ practice focuses on public and private offerings of debt and equity-linked securities, advising issuers and underwriters on the standalone issue and offering of retail and wholesale medium term notes, commercial paper, certificates of deposit, warrants, convertible and exchangeable bonds and covered bonds, as well as the establishment and update of platforms for the issuance of multiple types of securities, the structuring of liability management transactions and the provision of ongoing advice on securities laws, corporate governance and stock exchange requirements related to them.

Our resources

Our Global Thought Leadership: *Eye On ESG*

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