

Legal Update

Directors' Duties and ESG – decision-making in the future

As the focus of lawmakers, regulators, shareholders and society at large increasingly turns to Environmental, Social and Governance ("ESG") issues, and the extent of legislation, regulation and expectation in this area grows, directors and officers must be mindful of how their duties are evolving, and of the greater scrutiny, through a perhaps unfamiliar lens, that their decisions, actions, and corporate policies, will come under.

While it may be trite to write this, increasingly, economic considerations alone are insufficient to justify corporate decision-making - it is not only the interests of shareholders, but also those of a wider group of stakeholders, which must be considered. Nowhere is this clearer than in the rapidly-developing context of ESG. However, the pressure to pursue ESG-related initiatives or make enhanced disclosures is not without risk.

In this overview article, which prefaces our forthcoming series addressing specific issues in the context of directors' duties and ESG, we look at the current legislative and regulatory framework as well as certain of the recent, and forthcoming, developments and trends in this area, with which company directors increasingly need to be familiar.

What is ESG?

Over recent years, the more familiar terminology of "corporate social responsibility" ("CSR"), referred broadly to sustainable, responsibly-grounded, business decision-making and practices, with a focus on the impact of corporate decisions on people, communities and the environment, has been replaced by the concept of "ESG". Originally used principally by organisations operating within the financial services sector, and in particular in the context of investing, ESG has established itself in the lexicon of business more generally.

There is no single legal definition of what ESG comprises, but one can identify examples of the types of issues that are commonly considered to fall within one or more of the three limbs, as follows:



Environmental factors may include considerations of climate change, emissions, energy efficiency, hazardous waste; pollution; and resource depletion (for example, deforestation);



Social factors may include considerations of human rights and modern slavery, and working conditions, both in the organisation itself and, increasingly, in its supply chains also; health and safety issues; local and indigenous communities; and employee relations and diversity; and



Governance factors may include considerations of executive remuneration; anti-bribery and corruption policies and procedures; Board structure, independence and diversity; tax strategies; transparency; and shareholder rights.

Corporate businesses and financial institutions, across all sectors, are increasingly subject to scrutiny of their conduct, decisions and policies within these, and other, fields. Whether for reputational reasons only, or because the organisation sees merit and benefit – both financial and ethical – in abiding by strong ESG metrics, the importance of these factors continues to grow. The responsibilities and, indeed, potential liabilities, arising in this context increasingly rest with the directors charged with steering the business.

Directors' duties and ESG

The growing focus on ESG may give rise to potential liabilities – even where ESG initiatives are voluntary – for directors and officers based upon breaches of existing legislation that may or may not already expressly relate to ESG factors. For example, directors may already have had to contend with the patchwork of legislation dealing with environmental issues (such as the Environmental Protection Act 1990, as well as various waste and emission regulations); social issues (such as the Corporate Manslaughter and Homicide Act 2007, the Bribery Act 2010, the Modern Slavery Act 2015 and the Equality Act 2010); and governance issues (including those under the Companies Act 2006).

Company directors will be familiar with their statutory duties, owed to the company, and codified in the Companies Act 2006, as well as their common law and fiduciary obligations. Particularly given the increasing regulatory, investor and media scrutiny of ESG factors, however, directors are increasingly required proactively to consider such factors as an integral element of the framework within which they are obligated to discharge their duties (ESG-type considerations, albeit without being specifically mentioned by that moniker, constituted an element of the legislative intention, and considerations, behind the Companies Act¹). In certain instances, failing to do so may expose the individual to potential regulatory penalties or, indeed, legal liabilities.

¹ <https://publications.parliament.uk/pa/ld200506/ldhansrd/vo060111/text/60111-08.htm>

Company directors are under a statutory duty to promote the success of the company², which requires directors to consider, inter alia:

- (a) the likely long-term consequences of any decision made;
- (b) the interests of employees;
- (c) the need to foster the company's business relationships with suppliers, customers and other stakeholders;
- (d) the desirability of the company to maintain a reputation for high standards of business conduct.
- (e) the need to act fairly as between the members of the company i.e. have all stakeholders been considered; and
- (f) the impact of the company's operations on the community and the environment.

The manner in which this duty is satisfactorily discharged can clearly be impacted by what might broadly be categorised as social and governance issues; that is, the 'S' and 'G' of ESG. Where things may become difficult is where the multiple elements that come within the purview of this duty conflict, or potentially conflict, with other – perhaps more traditional – considerations, for example where there is a trade-off between ESG-related factors and financial gain. As investors and other stakeholders increasingly analyse investment opportunities, and corporate performance, through the lens of ESG, such trade-offs will increasingly be viewed in a different light.

Public companies

As one might expect, the obligations on public companies issuing securities are particularly acute particularly with regard to statements to the market; the directors of such companies must, of course, ensure that the listing prospectuses comply with various requirements, including the Listing Rules, Prospectus Regulation Rules and the Disclosure Guidance and Transparency Rules as set out in the Financial Conduct Authority's Handbook. The FCA has considerable powers to sanction breaches of these rules by way of fines in particular. Needless to say, the resulting negative publicity is also a powerful disincentive against breaching the requirements.

The UK Corporate Governance Code (the "CGC"), which was established by the Financial Reporting Council, and with which, by virtue of Rule 7 of the Disclosure Guidance and Transparency Rules, public companies must comply, outlines best practice for boards of directors in protecting shareholder investments and ensuring effective corporate governance. The CGC, which addresses the broad areas of leadership, effectiveness, accountability, remuneration, and relations with shareholders, also touches on social requirements, for example promoting the benefits of diversity of experience, knowledge and skills of board members.

We expect, in the future, that considerations of environmental best practice may be incorporated into the CGC as well. In October 2019, for example, the FCA's feedback statement on climate change and green finance indicated that increases in reporting obligations, covering all ESG factors, for issuers are being considered³. The FCA is also considering broader consultations which may affect directors' duties in relation to the well-publicised practice of "greenwashing", whereby a false or misleading impression is given, or information is provided, about how a company's products are more environmentally sound than they are.

² Section 172 Companies Act 2006

³ <https://www.fca.org.uk/publications/feedback-statements/fs19-6-climate-change-and-green-finance>

When making such disclosures, or disclosures under the CGC, directors are required to adopt a “*comply or explain*” approach, which requires having to explain to the relevant supervisory authority any material deviations from the CGC’s requirements. While this will always be subjective, a key consideration will be where ESG issues determined by the board are sufficiently important to investors and other stakeholders.

Directors with knowledge that statements made (or omitted) in directors’ reports, remuneration reports, strategic reports or any corporate governance statement, are untrue or misleading, will be liable to compensate the company for any loss that the company suffers as a result of that statement or omission. Directors need to be particularly mindful of their obligations with regard to the making of false or misleading statements in the context of the company’s ESG policies, as well as statements concerning progress and commitments in that regard.

Additionally, while they do not have the status of statutory law, under the Advertising Standards Agency’s CAP (non-broadcast) and BCAP (broadcast) Codes in the UK (the “Codes”), the basis of any environmental claims made in marketing material must be clear - marketing communications must not mislead consumers about the environmental benefit that a product offers. Directors should be aware of the risks associated with failures to comply with the Codes, which may result in significant reputational damage, particularly if the advertising campaign is banned, and a consequent negative impact on both investor and consumer confidence in particular products.

The necessity of establishing the veracity of environmental claims associated with products for the purposes of advertising is, of course, nothing new. For example, as long ago as 2007, the Advertising Standards Agency banned the broadcast of an advert for a Toyota Prius over claims made about its CO₂ emissions. More recently, in January 2020 the Italian Competition and Market Authority fined the energy company Eni €5 million, for claiming its palm oil diesel product was “green” because production of palm oil is a contributing factor to deforestation.

The European Commission has recently launched a public consultation on a potential proposal for a regulation on substantiating green claims. This would require companies to substantiate claims about the environmental footprint of their products or services by using standard methods for quantification. The aim of such a regulation would be to make such claims reliable, comparable and verifiable across the EU. According to the European Commission, this should help commercial buyers and investors make more sustainable decisions and increase consumer confidence in green labels and information.

Investors and trustees

It is instructive to consider the developing position in respect of investors and trustees also, who are required to act with due skill, care and diligence in determining how to invest trust assets. The world has moved on since the Court held, in *Cowan v Scargill*⁴, that “*the best interests of the beneficiaries are normally their best financial interests.*” While Sir Robert Megarry VC’s statement, of course, remains valid, the increased influence of ESG factors has become more evident. Following the Law Commission’s review of this area of law in 2014, it concluded that when trustees make a long-term investment in a company they may take account of risks to that company’s long-term sustainability, including risks arising from environmental degradation or from the company’s treatment of customers, suppliers or employees. Other non-financial factors may also be taken into account, where trustees have good reason to think that scheme members share their views and that the decision does not risk significant financial detriment.

In 2016, United Nations Environment Programme Finance Initiative (“UNEP FI”, the Principles for Responsible Investment (“PRI”), and The Generation Foundation launched a project which sought to establish some degree of certainty in the long-standing debate over whether fiduciary duties are a legitimate barrier to the integration of ESG issues in investment practice and decision-making. This followed the 2015 publication of “Fiduciary Duty in the 21st Century” by the PRI, UNEP FI, UNEP Inquiry and UN Global Compact which concluded that “*failing to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty*”.

⁴ [1985] Ch 270

The Fiduciary Duty in the 21st Century Programme was established to explore the lack of legal clarity globally about the relationship between sustainability and investors' fiduciary duty. Drawing upon its findings, the European Commission's High-Level Expert Group (the "HLEG") recommended in its 2018 final report that the European Commission clarify investor duties to better embrace long-term horizon and sustainability preferences.

Whilst fiduciary duties in the context of investing remains a complex area of law and policy, directors and officers must understand the pressure that investors are now under to take account of ESG matters when making investment decisions.

The pressure which asset managers and activist investors can bring to bear – and their appetite for doing so – has become increasingly evident in the context of ESG. By way of example, BlackRock announced early this year that it would exit investments with high environmental risks, including thermal coal, which is burned to produce electricity and creates carbon dioxide, a greenhouse gas. BlackRock will also launch new investment products that screen for fossil fuels.

Other organisations are also increasingly applying pressure in this regard. The World Resources Institute, a US NGO, has encouraged investors to adopt the following behaviours:

- Ensure Board Members Support Climate-Informed Corporate Governance
- Require Disclosure of Climate-related Risks and Opportunities
- Push Companies to Set Science-Based Emissions Reduction Target
- Revisit Product Offerings and Underlying Investments.

This trend is also apparent in the context of evolving UK pensions legislation. For example, amendments to the UK Occupational Pensions Schemes (Investment) Regulations 2005 now require UK pensions trustees to disclose how they have considered ESG factors in their investment approach. On 26 August 2020, the Department for Work and Pensions published a consultation on climate risk and governance. The proposals would require large occupational pension schemes with £5 billion or more in assets, all authorised master trusts and authorised collective money purchase schemes to put in place effective governance, strategy, risk management, and accompanying metrics and targets for the assessment and management of climate risks and opportunities, from 1 October 2021. It also proposes requirements to report on climate risk in line with the Task Force on Climate-related Financial Disclosures ("TCFD") recommendations. Future tightening of such requirements are also proposed

Given the importance of institutional pensions investors, these proposals mark a potentially significant shift in the information that investors will want companies to have at their fingertips. Significant momentum has been building over recent years for companies to make climate-related disclosures in line with the TCFD recommendations. In doing so, companies should consider the issues above in respect of the importance of making accurate and well-grounded statements that can be properly evidenced.

Financial services

In the context of financial services and products, sustainable financial instruments have gained considerable popularity over recent years. While there is generally no "hard" law as to which financial instruments, products and services can be labelled as sustainable, they are, of course,, subject to the same requirements as non-financial products with regard to, for example, securities disclosure having to be accurate and not materially misleading.

Directors of financial services institutions serving UK clients and customers will be familiar with the UK's Senior Managers & Certification Regime ("SMCR"), the principal aim of which is to encourage individuals to take greater responsibility for their actions in order to make it easier for both firms and regulators to hold individuals, particularly those in senior management, to account. The SMCR was also introduced in the UK (with extraterritorial reach to senior managers based outside the UK) to reduce harm to consumers and strengthen market integrity by making individuals more accountable for their conduct and competence.

The FCA's guiding belief is that consumers who receive fair, clear and not misleading information about financial products and services (which is a regulatory obligation which regulated firms must satisfy) are less vulnerable to buying or being sold unsuitable or poor value products or services. By receiving balanced and unambiguous information in financial promotions, consumers will be better informed about the products and services being marketed or sold to them. So when supervising financial promotions, the FCA's main focus will be on the content of the promotions, i.e. that they are fair, clear and not misleading. While these obligations do not expressly relate to ESG factors, such factors will plainly be relevant, particularly as directors of financial services institutions have the regulatory obligation under the UK's Senior Managers Regime to *"take reasonable steps to ensure that the business of the firm for which [they] are responsible complies with relevant requirements and standards of the regulatory system"*.

Additionally, for directors overseeing market participation in the securities lending market in Europe and the UK, the amount of disclosure now required under Europe's Securities Financing Transactions Regulation (the "SFTR") represents a significant advance in transparency requirements for this particular area of the financial services sector. The provisions in the SFTR are well-aligned with the regulators' goal of increasing visibility in the marketplace. They also provide reassurance to market participants that strong corporate governance frameworks support securities lending programmes that are transparent and are therefore more responsible and safer.

The role of "soft law" and norms

The realm of ESG is impacted not only by statute and regulations. Statutory and regulatory frameworks regarding sustainability have increasingly been supplemented with so-called "soft-law" tools, including guidelines, supervisory statements, and codes of conduct. Whilst not strictly enforceable in the sense of statutory obligations, courts and regulators will often be guided by such tools that commonly address themes such as disclosure of environmental matters; social, green and sustainable bonds; carbon offsetting; and marketing of complex financial instruments using ESG-themed filters, when adjudicating disputes or alleged transgressions.

The European Commission's non-binding guidelines on methodologies for reporting climate-related information, for example, consist of a new supplement to the existing guidelines on non-financial reporting. The guidelines integrate the TCFD (a recurring theme) and take account of the forthcoming EU taxonomy of environmentally sustainable economic activities that is under development.

Additionally, the UK's Climate Financial Risk Forum (jointly established in March 2019 by the UK's FCA and Prudential Regulation Authority ("PRA")), published its guide in June 2020 to help the financial services industry address climate-related financial risks. The guide provides practical recommendations to regulated firms of all sizes on the disclosure of climate-related finance risks, effective risk management, scenario analysis, and opportunities for innovation in the interest of consumers.

Particularly in the financial services markets and the context of "green bonds", various procedural norms or rules impact matters such as which outcomes qualify as being green or sustainable; how specific bonds may be linked to business or investment activities with sustainability attributes; and what post-issuance reporting the issuer will provide to investors. Compliance with globally-accepted standards, including the Green Bond Principles (the "GBP", focusing on environmentally-beneficial activities), the Social Bond Principles (the "SBP", focusing on socially-beneficial activities) and the Sustainability Bond Guidelines (the "SBG", focusing on a combination of environmental and social objectives), is increasingly important. Such frameworks, which aim to improve transparency and disclosure, and promote integrity in the development of the green/ social/ sustainability bond market, also assist investors by ensuring availability of information necessary to evaluate the environmental, social or sustainability impact of such investments.

The GBP/ SBP/ SBG recommend, but do not require, that an issuer obtains a third-party opinion or certification on the sustainability credentials of its bond offering.

The PRA's supervisory statement, issued in April 2019, set out its expectation that the boards of PRA-regulated firms (such as banks and insurance firms) should understand and assess the financial risks from climate change that affect those firms. The PRA stated that *"the board and the highest level of executive management should identify and allocate responsibility for identifying and managing financial risks from climate change to the relevant existing Senior Management Function(s)"*. It expects the board to *"ensure that adequate resources and sufficient skills and expertise are devoted to managing the financial risks from climate change."*

These developments evidence the evolving landscape within which the decisions, actions and statements of companies, and their directors, are increasingly being assessed.

Forthcoming developments

Nor is the trend limited to the UK. The clear message from recent regulatory developments across the globe is that scrutiny of, and accountability for, companies' ESG-related behaviours and disclosures will continue to increase.

Increasingly, the "soft law" and norms-driven approach in this field is being, and will be, supplemented by "hard law". Most immediately, the EU's Low Carbon Benchmarks Regulation (amending the current Benchmarks Regulation) will, broadly, require benchmark administrators to include details of how ESG factors are reflected in their methodology documents and benchmark statements.

Similarly, the Taxonomy Regulation, which came into force in July 2020, establishes an EU-wide environmental classification framework, or taxonomy, to enable financial market participants to identify which economic activities are environmentally sustainable. It also imposes new disclosure requirements for certain financial services firms and large public-interest entities.

The main provisions of the forthcoming Disclosure Regulation are still expected to apply from March 2021 (notwithstanding calls from some sectors to delay the implementation date). They will require companies to implement policies and make certain disclosures to investors as to how ESG factors are being integrated into investment decisions and internal processes. They set out requirements on what firms must disclose and maintain on their websites, the information that must be provided to investors, and period reporting expected to be provided to investors.

In June this year, the European Commission published draft texts of delegated legislation that will integrate sustainability into the frameworks of various European directives and regulations, including MiFID II, AIFMD, the Insurance Distribution Directive and the UCITS Directive. These will, for example require firms providing financial advice and portfolio management services to conduct mandatory assessments of clients' sustainability preferences. Fund managers would also be expected to include the consideration of sustainability risks in their due diligence requirements.

The European Commission's ongoing review, and subsequent amendment, of the Non-Financial Reporting Directive will provide further direction to ensure that reliable, comparable and relevant ESG information can be disclosed by issuers. The EU generally is seen as moving ahead of the rest of the world in enacting this type of legislation to help classify ESG - in the US, the SEC has hesitated to standardise ESG disclosure, relying instead on the "marketplace evolution of sustainability disclosures".

Finally, the implementation of the EU's Sustainable Finance Action Plan (an update of which is being consulted on), Green Deal and Circular Economy Action Plan all indicate that the general direction of travel for ESG-related matters is for greater environmental, social and governance accountability.

Concluding remarks

As we approach the end of the first year of the new decade, ESG remains in its relative infancy, but it is growing fast. Recent years have seen an unprecedented rise in the profile of companies' sustainability performance; this trend will continue to grow. High profile social issues, and a generalised increase in individual accountability for governance failures and corporate missteps, as well as the recent rocketing up the corporate agenda of environmental concerns, continue to impact heavily on how businesses are run, and how they are assessed. This is playing out in a number of ways, both in terms of specific governance requirements and also, relatedly, in how investors are approaching the companies in which they invest. What is clear is that stricter parameters will continue to apply, and higher standards will govern, as the decade progresses.

From the perspective of those charged with running companies, these developments cannot be ignored; as "soft" and "hard" law intersect to alter the governance landscape, directors will need to consider their duties in a new light.

The risks for companies, and their directors, associated with the increasing focus on ESG factors, are not merely hypothetical. Nor are those risks limited, as perhaps they might once have been, to adverse publicity and reputational damage in the event of non-compliant, or simply poor, corporate decisions and practices. Litigation is, increasingly, a real risk, not only for organisations found to have breached their obligations, but also for directors who are charged with steering the organisation through the sustainability landscape.

We will look at some of the specific issues arising for directors discharging their duties in the context of ESG in future articles.

If you have any questions about the issues raised in this legal update, please get in touch with your usual Mayer Brown contact or:

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