EXPERT COMMENTARY

Nothing is plain-sailing when it comes to ESG regulation, but staying one step ahead of legal developments is important for future success, writes Denham Capital's Sabine Chalopin

Navigating ESG regulations and taxonomies

In 2006, when ESG was first mentioned by the UN Principles for Responsible Investment, there were 63 investment companies incorporating ESG issues, representing $6.5 trillion of assets under management. As of June 2022, there are 5,200 signatories, representing $121 trillion of AUM. As investor demand for ESG products has soared, the lack of ESG standards and reporting has resulted in various ESG strategies, data, criteria and reporting. These inconsistencies, particularly in reporting, have made it difficult for investors to benchmark sustainable investment options.

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In addition, some investment managers have jumped on the proverbial 'ESG bandwagon' without clear definition and measurement of their investment impacts, resulting in what is referred to as greenwashing. This too has had an adverse effect on the otherwise sound reputation of the ESG industry as a whole.

Regulators across the globe – notably in the EU, US and UK – are seeking to address this ambiguity in terminology and measurement by requiring specific disclosures, in the hope that it will also encourage the flow of capital in investments that deliver environmental or societal benefits.

Latest regulatory developments

The first significant regulation came from the EU in 2021, with the implementation of the Sustainable Finance Disclosure Regulation. The SFDR introduces ESG disclosure standards for financial market participants, advisers and products. For asset managers, the SFDR requires specific firm-level disclosures regarding how sustainability risks and "Principal Adverse Impacts" are addressed, as well as transparency of remuneration policies. Under the

SFDR, starting January 2023, asset managers under scope will need to report against 14 mandatory and two voluntary Principal Adverse Indicators, which include environmental and social metrics.

The SFDR also aims to help investors choose between funds including Article 6 (sustainability is not a significant factor in the investment process), Article 8 (a fund promoting environmental or social characteristics) and Article 9 (a fund pursuing specific environmental or social targets). The EU Taxonomy regulation goes hand in hand with the SFDR and creates consistent standards for what can be considered environmentally sustainable activities. In essence, the EU Taxonomy helps to provide a definition for what is "sustainable".

The EU Taxonomy covers six environmental objectives, including climate change mitigation, climate change adaptation, water use and marine resources, circular economy, pollution and biodiversity. A set of Regulatory Technical Standards support the SFDR regulation and the EU Taxonomy requiring pre-contractual and periodic disclosures.

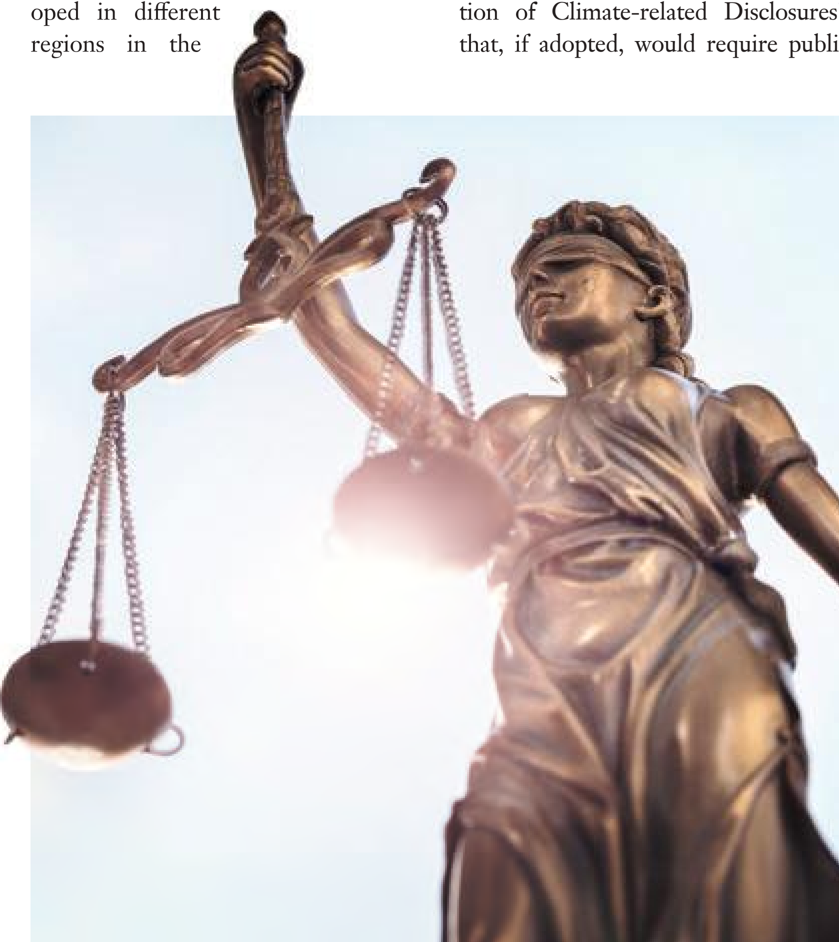
Teething problems

While we believe that the EU SFDR and the Taxonomy are currently the best developed and available frameworks for defining and reporting sustainability, the regulations have been a minefield to navigate. Data can be difficult to obtain, and regulatory delays have resulted in unclear timelines. Different European regulators have issued guidance on the interpretation of certain aspects of the SFDR.

Hopefully, these teething problems are just that: initial problems which will settle as regulations become clearer and businesses put in systems and processes to manage reporting and disclosure requirements. Over the next couple of years, we can expect challenges and a steep learning curve as asset managers try to get their heads around what to report, and when. However, in the medium to long term, one hopes that this becomes just 'business as usual'.

Other advanced taxonomies include the Chinese 'Green Bond Endorsed Projects Catalogue (2021 edition)' (referred to as the China Taxonomy), which, as the name suggests, provides a taxonomy for green bonds. In an effort to identify areas of commonality and differences between the EU and Chinese Taxonomy, the Common Ground Taxonomy was launched through the International Platform on Sustainable Finance. The CGT has been through a consultation process, and the IPSF issued an updated version in June 2022. The CGT has been applauded in the industry for trying to address taxonomy fragmentation across jurisdictions.

All in all, there are an estimated 20 different taxonomies being developed in different regions in the world, mostly 'green' taxonomies rather than also covering social objectives. This is largely due to climate commitments made by different countries and an effort to ensure that capital supports the decarbonization of economies. These taxonomies are at different stages of development; some already exist while others are at earlier stages of development, for example under consultation.



Understanding the SEC proposals

Although the implementation of the US Securities and Exchange Commission proposals are at an earlier stage of development than the EU Taxonomy, the proposals indicate that momentum is growing in the US around ESG and climate disclosures. In March 2022, the SEC proposed a new rule, the 'Enhancement and Standardization of Climate-related Disclosures', that, if adopted, would require public

companies to provide detailed reporting on their climate-related risks, emissions and net-zero transition plans. The proposed rules are broadly aligned with frameworks such as the Task Force on Climate-Related Financial Disclosures, and require Scope 1 and 2 greenhouse gas emission disclosures to be subject to limited assurance during a phase-in period, followed by reasonable assurance.

The second SEC rule, 'Environmental, Social and Governance Disclosures for Investment Advisers and Investment Companies', proposed in May 2022, would impact registered funds and investment companies. The proposed rules are two-pronged: (1) relating to investment adviser and registered fund disclosures and (2) to registered names. While the majority of the proposed rules would not directly affect private funds or their managers, certain parts of the proposed ESG Rule would apply to private fund advisers.

While there are some similarities between the EU SFDR and the proposed ESG Rule, the SEC does not define ESG and leaves it to individual funds to do so, instead requiring advisers to describe the ESG factors considered and how they are considered. The EU is more rules based, with the SFDR defining a sustainable investment as an economic activity that contributes to an environmental or social objective.

Depending on how central ESG factors are to a fund's strategy, the SEC proposal differentiates between three types of ESG funds: integration funds, ESG-focused funds and impact funds. The proposal would also generally require certain environmentally-focused funds to disclose information regarding the greenhouse gas emissions associated with their portfolio.

Anti-ESG movement in the US?

Despite the increase in climate- and weather-related disasters, and a growing global acknowledgment of climate change, the level of ESG alignment varies in the US and has increasingly become a partisan issue.

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In August this year, Florida's governor Ron DeSantis's administration approved a resolution to ban the state's $186 billion pension fund from considering ESG factors when making investment decisions, which many perceive as "anti-ESG". According to Reuters, there are at least 44 bills or new laws in 17 states, including West Virginia and Texas, that, among other things, may penalise financial institutions for taking firm positions on issues ranging from gun control and abortion to diversity and climate change. This may result in a trickledown effect to financial institutions, as it may be potentially more difficult to offer a range of investment opportunities in such states.

These anti-ESG developments may impact state investors (such as pension funds) from being able to invest in funds with certain exclusionary policies. There are still, however, investors in such states that are able to and will invest in sustainable infrastructure funds. The key is being able to illustrate that investments in sustainable infrastructure assets not only have a positive environmental impact, but also generate risk-adjusted returns that fit one's overall portfolio construction.

Navigating different requirements

At Denham Sustainable Infrastructure, we classified our 2017 vintage, Denham International Power Fund (SIF 1), as an Article 8 fund. The investment strategy of SIF 1 is to invest in renewable assets and select gas projects. Although SIF 1 closed prior to the implementation of SFDR, the fact we have a well-established environmental and social management system meant it made sense to label this fund as Article 8. We intend to update our management system as regulatory and reporting requirements evolve.

A key part of our work over the last year has been refining the way we track and monitor environmental and social indicators across our portfolio. In 2021, all our portfolio companies reported against Scope 1 and 2 emissions (with some going the additional step of reporting against Scope 3 emissions). We have been working with our portfolio companies to capture additional indicators for the first six months of this year, so that we are in good stead for reporting in 2023.

Our view is that being clear on the investment sectors being targeted and getting robust ESG data is the linchpin to then being able to report against different regulatory regimes. And, of course, getting support from consultants and lawyers along the way helps to make sure that all the pieces of the puzzle come together.

As we consider existing regulations and what may develop in the US, we have amplified the screening criteria and reporting for new investments to align more with the EU Taxonomy. We think this effort helps better define what is "sustainable" while also measuring results, giving investors more comfort that they are making sustainable investments into a GP.

That said, as technologies continue to advance, climate change continues to impact us all and regulation increases, we would expect to further ratchet our policies to align with the realities of the future. We think such evolutions are extremely important to deliver our investors' expected returns in sustainable infrastructure investments. ■

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