Current trends in ESG:

Finding the sweet spot between compliance, risk and opportunities

By Emmanuelle MOUSEL, Partner, Dino SERAFINI, Senior Associate and Antoine PORTELANGE, Associate, Arendt & Medernach SA

ESG and sustainable finance remain the top priority on the list of concerns for governments, decision-making bodies and regulators, and their accompanying considerations have outgrown the financial sector to include regulated and non-regulated actors alike.

Against this background, three main trends have been identified: (i) a broader scope of binding ESG obligations to include both regulated and non-regulated entities, (ii) a growing risk of litigation and (iii) a greater focus among regulators on actively verifying compliance. Whilst these trends illustrate that the current ESG environment still has its challenges, these challenges can also become opportunities for actors who stay ahead of the game, both in terms of ensuring adequate compliance and operational implementation and in terms of strategic positioning.

Trend 1: Broader scope of binding ESG obligations to include regulated and non-regulated entities alike

NFRD, CSRD, Taxonomy Regulation and CS3D

More and more regulations in ESG tend to include both regulated and non-regulated entities within the scope of binding ESG obligations. For example, Directive 2014/95/EU amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (**NFRD**) imposes certain non-financial disclosures and applies to both regulated and non-regulated entities.

Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (**Taxonomy Regulation**), applies to the same range of companies with respect to the reporting obligations on taxonomy-eligible and taxonomy-aligned activities provided for therein.

However, until now the reporting obligations under the NFRD were limited to large European "public-interest entities" with more than 500 employees, which encompassed approximately 12,000 companies in the European Union.

This will change under Directive (EU) 2022/2464 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/ and Directive 2013/34/EU, as regards corporate sustainability reporting (**CSRD**), which will extend the scope of non-financial reporting obligations provided for therein to small listed companies and non-European companies that, regardless of their size, (i) have a subsidiary or branch in the EU and (ii) have generated a net turnover of EUR 150 million in the last two years. As a result, it is expected that the reporting obligations imposed under the CSRD will have a direct impact on approximately 50,000 EU companies, as well as an additional 3,000 companies outside of the EU.

Furthermore, the CSRD requires that, in non-financial reporting, disclosures include information on suppliers and established business partners in companies' upstream and downstream value chains. As a result, entities that are part of an in-scope entity's value chain are not themselves directly targeted under the CSRD will nevertheless be impacted by its requirements.

Lastly, the Proposal for a Directive on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 (**CS3D**), which aims to regulate the behaviour of companies across all sectors of the economy, will also apply to both regulated and non-regulated companies.

The challenges

The main challenge in this respect is that the rules now being imposed on a very large pool of companies are highly complex. Companies that fall within the scope of the CSRD must include in their management report information on their business model and strategy, their sustainability targets and the persons in charge of them, their policies on sustainability matters, their due diligence process conducted on sustainability matters, their incentive schemes linked to sustainability matters, their impacts on the company's value chain and actions to remedy those impacts, the principal risks on sustainability matters and the indicators relevant to all of the above. Such non-financial information must also be disclosed in accordance with the European Sustainability Reporting Standards developed by the European Financial Reporting Advisory Group, which are very technical rules that are constantly evolving.

The opportunities

However, these challenges also create new opportunities. Thanks to the mandatory reporting rules that are now widely imposed on entities, undertakings are forced to reflect on the implementation of an ESG strategy and to focus on identifying the potential business advantages of a stronger commitment to sustainability. For example, there are several academic studies that find a positive relationship between higher ESG scores and financial returns.[1]

Industry experts note five key sources of fundamental business value that explain these findings:
- top-line growth; companies with a stronger sustainability proposal/commitment are more likely to attract customer loyalty and new customers;
- cost savings: companies that are more resource-efficient generally have a lower unit/cost structure;
- facilitating regulatory relationships: companies that are more responsible about their ESG efforts are less likely to attract adverse punitive regulatory outcomes;
- talent recruitment: new generations of talent, who often want to ensure that their work has a wider impact, are more likely to be attracted to and retained by companies with a strong sustainability strategy. This may then lead to higher productivity in the workplace;
- investment optimisation, by using the integration of ESG considerations in the investment decisions to avoid the holding of stranded assets that are at risk of write-downs.

In this respect, it is interesting to note that, in practice, there are actors who are not subject to mandatory sustainability reporting rules but still choose to publish information on ESG initiatives or strategies on their websites and in their corporate documentation for the benefit of their clients, business partners and employees.

Trend 2: Growing litigation risk

The global trend

These voluntary disclosures are, however, not without risk, as companies are now increasingly held accountable in court for the information that they publish in relation to ESG strategies and commitments, even if such publications are made on a purely voluntary basis.[2]

Many companies are criticised for publishing sustainability statements that are not representative of reality. This practice is known as "greenwashing", a common definition for which has been proposed by the three European Supervisory Authorities: "*a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services*".[3]

Undertakings are also criticised for other behaviours, such as the failure to actually achieve ESG commitments they have announced, the use of ambiguous wording in ESG disclosures or the failure to make sufficiently ambitious ESG commitments.

These litigation cases are often initiated by what are known as "activist shareholders", who acquire a minority stake in a company in order to launch a lawsuit against it and sometimes also its individual directors, and to use these lawsuits as a means of putting pressure on politicians and decision-makers to impose binding changes in corporate strategies.

The Luxembourg outlook

Although there has not yet been a specific ESG-related litigation case in Luxembourg, there is a risk that claimants may now try to rely on allegedly inaccurate ESG publications or failed commitments to claim damages from the disclosing entity. An unhappy investor who has suffered losses in their investment portfolio could be tempted to sue the issuers or manufacturers of the financial instruments in the portfolio on the basis of inadequate disclosures on the ESG features of the relevant instruments. While the success of such claims is far from certain, any ESG litigation, regardless of its result, brings reputational risks of tainting the company's image. Therefore, undertakings are strongly advised to focus on litigation prevention in terms of reinforcing compliance and to seek guidance on the many implications of making ESG disclosures.

Trend 3: Increased scrutiny from regulators

The new focus

There is a risk of litigation for any type of company, whether regulated or not. In addition, regulated entities have to contend with their supervisory authorities concentrating more strongly on compliance with sustainability-related rules and obligations.

In the asset management industry, the Commission de surveillance du secteur financier (**CSSF**) has recently reviewed and published a report on the success of implementing the sustainability-related provisions introduced by key European sustainable finance regulations, such as Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (**SFDR**) and the Taxonomy Regulation, in industry.[4]

The supervisory authorities have been granted strong administrative powers to enforce compliance with the applicable regulatory rules. The law of 25 February 2022 implementing the SFDR and the Taxonomy Regulation in particular grants specific administrative sanctioning powers to the CSSF and the Commissariat aux Assurances (**CAA**) in the event that financial participants fail to comply with the SFDR and the Taxonomy Regulation.

The balancing factor

Regulators have so far refrained from imposing specific sanctions for sustainability-related shortcomings and instead taken a constructive approach to helping and assisting financial actors in the implementation of the relevant sustainability requirements.

The CSSF has been very open in discussing implementation issues and questions with market actors. Notably, the CSSF has conducted self-assessment exercises on compliance with transparency and risk management obligations with sample groups of banks to give them guidance on the concrete actions required by the implementation of these obligations.[5] Financial actors are thus not left completely on their own. However, both the CSSF and the CAA have repeatedly announced that they have included the verification of compliance with ESG requirements in their current supervisory priorities.[6] It would therefore be wise for all parties, whether banks, investments firms or fund managers, to start preparing for on-site inspections that focus on sustainability.

Conclusion

In the face of a broadening scope of application for binding ESG obligations, growing risk of litigation and targeted regulatory scrutiny, sustainability considerations play an important part in corporate strategy. Open dialogue with regulators and expert support in understanding the implications of voluntary and mandatory adherence to the complex legal framework are invaluable for companies, not only to prevent compliance risk, but also to identify potential sources of business value.

1) G. FRIEDE, T. BUSCH, A. BASSEN, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies", *Journal of Sustainable Finance & Investment*, 2015; R. BOFFO, R. PATALANO, "ESG Investing: Practices, Progress and Challenges", *OECD Paris*, 2020; M. AYDOGMUŞ, G. GÜLAY, K. ERGUN, "Impact of ESG performance on firm value and profitability", *Borsa Istanbul Review*, 2022.
2) Network for Greening the Financial System, *Climate-related litigation: Rising awareness about a growing source of risk*, November 2021; J. SETZER, H. NARULLA, C. HIGHAM, E. BRADEEN, *Climate litigation in Europe. A summary report for the European Forum of Judges for the Environment*, December 2022; J. SETZER, C. HIGHAM, *Global trends in climate change litigation: 2021 snapshot*, Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science, July 2021; J. SETZER, C. HIGHAM, A. JACKSON, J. SOLANA, «Climate change litigation and central banks», *Legal Working Paper Series*, 2021; J. SOLANA, *Climate litigation in financial markets: a typology. Transnational Environmental Law*, 21 November 2019; J. SOLANA, "Climate change litigation as financial risk", *Green Finance*, 2020, vol. 2, iss. 4, pp. 343-372; D. HACKETT, R. DEMAS, D. SANDERS, J. WICHA, A. FOWLER, "Growing ESG Risks: The Rise of Litigation"", *Environmental Law Reporter*, 10-2020, pp. 10849 à 10862; J. SETZER and C. HIGHAM, *Global trends in climate change litigation:2023 snapshot*, London, Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science, June 2023.
3) EBA, *Progress report on greenwashing monitoring and supervision*, EBA/REP/2023/16; ESMA, *Progress report on greenwashing monitoring and supervision*, ESMA30-1668416927-2498; EIOPA, *Progress report - Advice to the European Commission on Greenwashing*, EIOPA-BoS-23/157.
4) CSSF, Thematic Review on the implementation of sustainability-related provisions in the investment fund industry, published on 3 August 2023.
5) See CSSF, *Webinar on the outcomes of the CSSF self-assessment exercise 2022 related to Circular CSSF 21/773 on climate-related and environmental risks*, video published on 27 June 2023.
6) CSSF, *Annual Report*, 2021, p. 13; CSSF, *Annual Report*, 2022, p. 34; CAA, Annual Report, 2022-2023, p. 9; CAA, *Note d'information 23/2 relative à la mise en œuvre des scénarios liés aux risques de changement climatique dans l'ORSA*, published on 24 January 2023; CAA, *Note d'information 22/9 relative aux enjeux réglementaires liés à la finance durable*, published on 10 August 2022.

Private Credit Funds enter age of customisation

New industry research reveals how private credit fund managers are increasingly providing investors with customised exposure to the asset class.

Published by the Alternative Credit Council, the private credit affiliate of the Alternative Investment Management Association, and global law firm Dechert LLP, *In Partnership: Trends in Private Credit Fund Structuring ("In Partnership")* identifies three key trends that are driving this change:
- Greater investor demand for structures that provide customised exposure to private credit strategies;
- Growing appetite for hybrid and evergreen funds; and
- Growing appetite of private credit fund managers to raise capital from retail clients.

In Partnership includes exclusive data and insights into how these trends are shaping the expanding US$1.5 trillion private credit market. 80% of surveyed private credit managers report managing capital through a combination of commingled funds and other vehicles.

Almost all (95%) of the firms offer managed accounts for single investors, with 69% of all respondents expecting investor demand for co-investment to increase.

The report highlights how private credit fund managers operate funds with a range of liquidity profiles and explores the growing role of hybrid or evergreen fund structures. 51% of respondents have funds that offer investors some right to redemption and 48% expect investor demand for liquidity to increase.

In Partnership finds that investors seeking ongoing exposure to private credit value how evergreen funds can offer flexibility and support efficient capital raising and deployment. Leverage is another area where private credit funds are customising their offering, with 41% of respondents including levered and unlevered sleeves and another 12% considering to offer such flexibility for future fundraising. In Partnership also provides insights into the growing appetite of private credit funds to raise capital from retail investors. Two thirds of firms are currently, or are considering, raising capital from retail clients for upcoming fund offerings, compared to 41% who have retail clients today.

The research draws on survey data from 40 private credit fund managers representing an estimated US$800 billion private credit assets under management and interviews with leading private credit fund managers.

Report : https://urlzs.com/QLvrA