



## **Ep. 51: EU ESG Developments and Risks for Beginners**

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**Jose Garriga:**

Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

This is the closing episode in our three-part miniseries on ESG, or environmental, social and governance, matters featuring Akin Gump financial regulatory partner Ezra Zahabi, and it's been quite a ride. If you've been listening along, as I hope you have, you'll have learned what you need to know about the EU's Sustainable Finance Disclosure Regulation, or SFDR, and the Taxonomy Regulation.

In this episode, then, we look at how the two interact, as well as at other topics you should bear in mind if you're doing business in the EU.

Welcome to the podcast.

Ezra, thank you for returning to the show today to wrap up this great miniseries. So, as I mentioned, let's tie together, then, the themes of the first two episodes, how would you describe the interaction between SFDR and the Taxonomy Regulation?

**Ezra Zahabi:**

The SFDR really sets the framework for a broader disclosure regime relating to ESG matters and, in particular, risk mitigation and approach to risk by investment managers and other financial institutions across a whole range of products. It touches on sustainable investment, but, really, its focus is something else altogether. The Taxonomy Regulation, however, does two things. It introduces, for a subset of products to which the SFDR disclosure obligation applies, it introduces further additional disclosure obligation. And, in addition, it also introduces a kind of framework for defining sustainable investment with respect to green investment, really, and, in particular, in the short-term at least, with respect to climate-related change and then mitigation. They are sort of complementary pieces, but they do different things.

The Taxonomy Regulation requires additional disclosure to some products, but not all products, to which the SFDR applies, and it set forth to try and set out a shared dictionary or a shared taxonomy, as it were, of what, in fact, would be considered

“green” at this stage, and over time, the intention with the Taxonomy Regulation and further iterations of it.

There's going to be further detail on what other types of green products might be or green investments might be, not only climate related, and, in the further future still, a taxonomy for what is meant by “socially sustainable products and activities.”

**Jose Garriga:**

Thank you. As I mentioned in my introduction, let's move beyond then these two and look forward a bit. Do you see any movement upcoming on the legislative or regulatory fronts to supplement or refine or expand SFDR and the Taxonomy Regulation?

**Ezra Zahabi:**

Very good question. There, in fact, is a whole host of legislation that exists currently and that form part of the broader efforts of the European Commission in creating a comprehensive ESG framework. Examples of existing legislation include Low Carbon Benchmarks Regulation and the revised Shareholder Rights Directive that requires quite comprehensive disclosure on shareholder engagement and approach to governance.

But there are a number of legislative initiatives and developments in the works, and some of these are more broadly applicable to financial services firms, but many of these, for investment managers, are of greater concern from the point of view of their portfolio companies and, potentially, in some circumstances, in terms of attributing responsibility and, therefore, potentially incurring liability either at the level of the fund that holds those portfolio companies or, arguably, potentially at the level of the manager.

Examples of more recent legislation and/or legislation in the process of being developed are the EU Conflict Minerals Regulation, which imposes a requirement on EU companies to ensure that they import specified key minerals from conflict-free areas and from providers that have sourced them without the use of forced labor. The types of minerals included, really... I mean, they can be found in many, many types of products. This regulation has, potentially, quite significant impact across multiple sectors.

There is a draft legislation, the Parliament approved a proposal that they submitted to the Commission, so it's in the EU legislative process, on EU corporate social responsibility. The proposed rules would mandate the performance of due diligence on environmental practices and standards of the companies themselves, their own operations, those of their subsidiaries, as well as across their supply chain and their subcontractors. Pretty broad scope, and also on human rights factors, potentially social factors, labor rights, that kind of thing. So, very broad scope. The rules would require this due diligence. They would also require the publication of information regarding these due diligence processes and the findings and, in practice, a mapping of what potential risks identified would be and the establishment of a risk mitigation monitoring framework.

Another thing that this proposal does is that it introduces a new civil liability regime, which would make the undertakings liable to remedy or compensate for any harm that would arise out of adverse impacts on human rights, the environment, good governance that they're failures in their due diligence process have either caused or contributed to. That “contributed to,” I think, is a problematic provision. I mean, clearly these rules are in their infancy yet. But for those to whom these sound like very ambitious rules that would likely be watered down, it's worth noting that they are heavily based on existing law in France that has imposed similar type of liability and similar type of responsibilities on companies headquartered in France. There's good existing precedent on which these proposals are being fashioned.

A significant point to note on this is that it would also introduce a basis for civil claims by persons or communities who had been adversely affected by these failures in the due diligence process that have caused or contributed to adverse impacts. There are some examples already of civil actions that have been brought in different EU countries and in the UK against companies for their poor environmental practices or, in some cases, for the harm suffered in the community.

For example, the assassination of community leaders protesting against projects that are big projects of large international companies to which there's local opposition. It introduces a whole different kind of framework across the EU for companies who are failing in terms of the comprehensiveness and appropriateness of their due diligence.

What's also notable for companies outside the EU is that, at least in its current form, it has proposed extraterritorial application. So, it is proposed to apply to non-EU entities which sell goods or provide services in the EU. So, it would potentially have very broad reach indeed. In the U.K. also, there are similar developments. There are plans to amend the existing Modern Slavery Act, and that currently requires certain organizations to prepare and issue public reports on identifying risks on slavery and human trafficking within their operations and their supply chain. The revisions are proposed to enhance the due diligence processes required and the public disclosure made attendant to that. They are not too dissimilar, in principle rather than detail, to the EU corporate social responsibility bill. There are proposed amendments to the UK Environment Bill which would introduce mandatory human rights and environmental due diligence obligations and prohibition on the use of certain illegally produced forestry products.

And another vehicle of development that's just worth mentioning is the European Climate Law. It's a proposal for a regulation directly applicable across the EU that would establish the framework for achieving climate neutrality. It seeks to transform the political promises and the political agenda into a binding legal obligation at the EU member state level.

It would create a legal framework for the irreversible and gradual reduction of greenhouse gas emissions and enhancement of removal of greenhouse gas from the atmosphere by natural and other sinks. It's clearly linked to the Paris Agreement goals and the commitments by the EU to achieve net-zero greenhouse gas emissions by 2050.

Really what it does, it contemplates the powers for various EU institutions and member states to propagate legislation as they see fit to enable measures to be taken and initiatives to be launched in order to actually achieve this net-zero status by 2050. It's very much a framework law, but in it, it contemplates, I think, the possibility of multiple legal initiatives both at the member state level—so, for example, tax initiatives or tax relief measures that are currently the responsibility of the member states rather than EU-wide; tax is not a subject of EU legislation, that's handled at the member state level—but also other measures or legal basis for establishing other projects perhaps that might be either member state-specific or EU-wide. I think that's a roundup of recent legal developments that I think are pertinent to the generation of an ESG legal framework in the EU and the U.K.

**Jose Garriga:**

Thank you. That's interesting. Picking up a thread, something you've said regarding risks and liabilities, what do you foresee as emergent risks and liabilities, in addition to the ones you've mentioned, coming out of this regulatory framework, both the actual and projected?

**Ezra Zahabi:**

It's a great question. I mean, some of it is fairly easily contemplated, but to quote [*former U.S. Secretary of Defense Donald*] Rumsfeld, there's lots of unknown unknowns here. Clearly, the things that we can contemplate, I think, are civil litigation and/or regulatory action on greenwashing or other misrepresentations or inaccuracies in public reporting, whether by issuers or by investment managers in respect of their funds. There might be a risk around historic disclosures, that is, if ESG suddenly is so important, how come you didn't contemplate making these disclosures historically?

There's a risk around whether the existing disclosures, especially given the unsettled state of consensus around what the disclosures actually should look like. I mean, it's a new law. There's a lot that's still unclear and formally subject to clarification, and people are making disclosures at a time when they don't actually have the final settled guidance available. There's risk around inaccuracies perhaps around that.

And, just more generally, there's risk, I think, in terms of trying to balance the opposing drives of, on the one hand, the attractive investment proposition that is an environmentally friendly or sustainable investment product, and then, on the other hand, not really overselling what the fund or the manager actually does and having in place internally sufficiently robust methodologies and systems and processes around considering ESG in the investment process to uphold any challenge to claims of greenwashing.

And, then, I think that those are probably issues at the manager level in respect of the actual products being sold. I think that there are multiple issues at the investment level, really, and the value of the investment. The regulatory discourse around climate risk is very much based on the fact that you have to start thinking about risk more broadly because climate risk affects bottom line. It affects performance of your actual investments, and the climate-related risks can be...they can be broadly dipped into two buckets. One is physical risks, so, what happens if you've got investments in geographical areas, for example, that are subject to significant weather changes or flooding and so forth, and then there are transition risks. And those are risks that may be driven by changes in consumer behavior or perception, which make some products less attractive suddenly than others, or changes in regulation or the lack of availability of subsidies, for example, or government funding, or, in fact, privately available funding for certain types of projects or certain types of companies in certain sectors. Those are performance-related risks. And then, finally, as I was discussing earlier on, you had the legal risks around the actual portfolio companies and their operations.

I think that that's significant. It seems that there have been a few recent cases, I think, that Akin has been following and covering. In The Netherlands, for example, there was a case of Shell where...well, Shell and the Dutch government. Shell was basically ordered to reduce its carbon footprint by 40% by 2030, and similar requirements for the Dutch government to reduce its greenhouse gas emissions.

I think there's some precedent in attributing liability to the parent company for the actions of its subsidiaries, and this expansion of the potential liability, not only to subsidiaries, but also to the supply chain more broadly, I think, those present really that significant commercial risk, and that managers will need to think quite carefully on.

I think that another interesting development, there were some recent U.K. case law that suggests that parent companies that implement groupwide policies could incur liabilities for the breach of those policies by their subsidiaries. The regulatory action for the breach

of these types of requirements at the subsidiary level is an interesting proposition, probably more so because often hand-in-hand with regulatory or public investigations or administrative actions, for example, go then stakeholder litigation.

Stakeholder actions to try and change policy, as well as shareholder or other stakeholder litigation against the company in connection with ESG failures, instead of resulting liabilities from those, I think that's something also for managers to think about and consider what kind of precautions they want to take.

**Jose Garriga:**

Thank you. To wrap up the series, and you've presented so much good material for people to think about and look into, what are a couple of thoughts that you would offer listeners just to distill some of the insights and notions you've presented? What would you say people's takeaways should be from everything that you've covered so far regarding both SFDR and the Taxonomy Regulation and the new material that you've discussed today?

**Ezra Zahabi:**

I think that it is a case of approaching this not from a "we'll try and keep state of business as usual as much as possible, and just try and do what we have to do in order to comply with the letter of the law at the moment." I think that the whole framework and the direction of travel really indicate a larger paradigm shift, not only in investment. I think, yes, like in investments and for investment managers, but just more broadly, I think, in terms of operationally where, structurally, Western post-industrial societies and emerging markets where we are headed structurally. I think it's important to get your head around what the actual legal requirements are and what you need to do at the moment to comply, as well as have some kind of vision as to what is the business of the firm going forward? And what is the relationship with ESG?

Is it something that it will actually start to have an impact, really, on the investment thesis that the managers have internally and their broader approach to investing? Because, I think, that for those who are open-minded and who are fluent in what the requirements are now and going forward and understand the risks, I think there's a lot of opportunity around ESG. I see all of these changes really as part of something that is a change in the common sense. I think, over time, ESG will no longer be something that is still seen as a tag-on to your existing true processes. It will inform all of the processes going forward. I think that the way to look at it is not to look at ESG as a compliance exercise. It's really a way to look at it as an opportunity to reassess philosophically where the firm is in terms of its investment philosophy, where the firm is, where the manager is.

If really looking at risks from the ESG point of view, what are the steps to be taken around risk mitigation and around management and understanding what data is available and what you need?

**Jose Garriga:**

Thank you. Listeners, you've been listening to Akin Gump financial regulatory partner Ezra Zahabi. Thank you so much, Ezra, for making the time to sit for this great miniseries. I know listeners have been learning so much about these critical regulations and the trends shaping them, and I will preview that folks should keep an eye out for our upcoming episode on ESG litigation risks.

Thank you, listeners, as always, for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, YouTube and Spotify.

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Until next time.

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