INDIA'S FIRST MAGAZINE ON LEGAL AND CORPORATE AFFAIRS

LEX WITNESS

Volume 11 Issue 12 | February 2021

₹ 100 US $10 UK £6

IS INDIA INC. ESG READY?

The Great Indian In-House Counsel ESG Survey 2021

Disclosures & More

Vendor Negotiations

Board's Involvement

Beyond Environment

WELCOME TO THE ESG SPECIAL ISSUE

Environmental, Social & Governance - Not Just About Climate Change?

Lex Witness has invited the firm to author a series of articles on Environmental, Social & Governance which shall capture the importance of ESG for companies in India, the global principles, and the evolution of ESG. Besides global case studies, significant changes in law would also be featured in the series.

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The year 2020 witnessed two realities of both COVID-19 and the Black Lives Matter movement, which showcased the importance of ESG and bringing the "S" in ESG to the forefront for society & businesses. ESG is no more only about climate change & carbon emission. Each component of ESG needs better implementation as per local laws & global principles.

ESG - a new age concept that is focused on crucial aspects of sustainability, ethical business functions, and adherence to the requisite global laws and procedures. Environmental, Social, and Governance (ESG), a phenomenon which is here to redirect global financial flows towards low-carbon economic growth. While worldwide, climate change continues to remain the leading concern, a survey on the acceleration of sustainable investing revealed that 58% of respondents believe that concerns over social issues such as diversity and inclusion and fair labour practices are expected to rise the most next 3-5 years .

The Financial Times Lexicon defines ESG as "a generic term used in capital markets and used by investors to evaluate corporate behaviour and to determine the future financial performance of companies." The ESG components are taken into account as factors that help ascertain investment decisions and risk management with a sustainability lens within the organization. The primary objective is to build a culture that encourages, promotes, and achieves business standards that are more conscientious and are more likely to succeed in the long run.

A recent market intelligence report analyzed 17 exchange-traded and mutual funds with more than US$250m in Assets under Management that select stocks for investment based in part on ESG criteria . With the world transformation at its apex today, there has been a surge in investors' demand for companies to disclose their evaluation process of identifying and measuring intangible assets and the ESG valuation that has an impact on the long-term value creation. As evidenced by a recent EY 2020 report , ESG integration is the fiduciary duty of the asset managers and those responsible for managing other people's money. The fiduciary duty exists to ensure that those accountable for investments act in the beneficiaries' interest rather than serving their interests.

BACKGROUND

The ESG journey began in 2004 when former UN Secretary-General Kofi Annan invited over 50 CEOs of major financial institutions to participate in a joint initiative to integrate ESG into capital markets. Subsequently, two reports, titled "Who Cares Wins" and "Freshfield Report" were published respectively. The reports featured how ESG issues are relevant for financial valuation and embedding environmental, social and governance factors in capital markets, and the potential to improve good business sense, thereby leading to more sustainable markets and the societies' overall upliftment. The two reports have served as the backbone for the Principles for Responsible Investment (PRI), a successful global initiative with over 1,600 members representing over $70 trillion Assets under Management (AUM). In 2017, the Network for Greening the Financial System was established as a global network of central banks and supervisory authorities advocating a financial system supports the practice of sustainable development. This was followed by the European Union action plan for sustainable growth.

After that, numerous initiatives have been introduced globally, including stock exchanges, regulatory bodies, and institutional managers, amongst other industry-driven task forces. These are constituted to provide guidelines and recommendations on how to better integrate environmental, social and governance issues in sectors including asset management, securities brokerage services and associated research functions. Research shows that a well-integrated ESG practice can contribute to a healthier and more resilient and trusted financial markets and further facilitate a contribution to sustainable development.

As per a report by the European Fund and Asset Management Association (EFAMA), as much as 45% of total AUM in Europe at the end of 2019 were invested in some sort of ESG selection strategy .

DECODING ESG

The past few years has seen a growing trend of ESG investments, which although has a long way ahead, the investors community has witnessed a significant shift in focus from a pure risk-based approach to real world outcomes. The concept of ESG risk as a screening portfolio test for global investors help transition towards more sustainable business models and further contribute to sustainable development.

Environment signifying the "E" refers to the organization's functioning in the natural environment, which are exposed to major environmental risks including direct financial and operational implications. The environmental aspect of ESG consists of an examination by investors of a company's natural resource usage, impact of its operations and value

chain on the environment, including through resource use and carbon emissions. Some of the environmental components include climate change, carbon emissions, water crisis, renewable energy, and natural capital.

"S" denoting Social in the ESG concept refers to the impact businesses have on their stakeholders i.e. customers, employees and the communities they operate. According to the UNPRI, one of the sectors that will be pivotal for achieving the Sustainable Development Goals while driving business savings and revenues is health and well-being. It includes human capital, labour standards, human rights, diversity & inclusion, privacy & data security, and community engagement.

The Governance aspect is denoted by the letter "G" which involves corporate governance and business integrity. While the former pertains to the policies and procedures to be adhered to by organizations. The latter signifies how a company deals with corruption, bribery and avoid engaging with parties who may risk an organization's reputation. Governance covers components such as corruption & bribery, business ethics, board governance, diversity and ownership.

GLOBAL REGULATORY FRAMEWORK

1. Sustainable Development Goals (SDGs): Also referred to as global goals were adopted by all United Nations Member States in 2015 as a universal call to action to end poverty, protect the planet and ensure that all people enjoy peace and prosperity by 2030. The action recognized and integrated 17 SDGs having the potential to balance social, economic and environmental sustainability. These goals are beneficial to businesses as adhering to the same improves the company's corporate security & resilience and further demonstrates its alignment with society's national interest and upliftment.

2. The Sustainability Accounting Standards Board (SASB): An independent organization that has benchmarked standards for disclosure of financially material sustainability information by companies to their investors. These standards have identified ESG issues as most relevant to financial performance across industries.

3. Equator Principles (Eps): A risk management framework, adopted by financial institutions, for determining, assessing and managing environmental and social risk in projects. It is primarily intended to provide a minimum standard for due diligence and monitoring to support responsible risk decision-making. At present, 37 countries have officially adopted the EPs, covering most international project finance debt within developed and emerging markets.

4. International Financing Corporation (IFC): Affiliated to the World Bank, IFC provides financing of private-enterprise investment in developing countries around the world, through both loans and direct investments. It also lays down a set of performance standards that are considered for management of environmental and social risks pertaining to an investment.

5. Global Reporting Initiative (GRI): It helps businesses, governments and other organizations understand and communicate their impacts on climate change, human rights and corruption. Its sustainability standards serve as an

accountable and transparent common ground for organizations to consistently and credibly analyse and report their sustainability impacts.

6. Organisation for Economic Co-operation & Development (OECD): An international organisation that works to build better policies for better lives. The purpose is to shape policies that foster prosperity, equality, opportunity and well-being for all

7. The International Organization of Securities Commissions(IOSCO): Sector Specific Governing Laws & Regulations: Amongst various other regulatory bodies and global standards initiatives, one such standards is IOSCO, which is a task force created with primary focus on ensuring sustainability of finance and to gear up global efforts for an effective resolution of such issues. It includes improving sustainability-related disclosures and collaborating with other international organizations and regulators to avoid duplicative efforts and to coordinate supervisory approaches.

IMPACT INVESTING & SUSTAINABLE FINANCING

We live in a rapidly evolving world with major sustainability challenges such as resource efficiency, climate change impacts and transitional risks, which keeps emerging with the introductions in regulatory and policy changes. For instance, COVID-19 has significantly influenced how stakeholders and organizations approach ESG. While climate change risk is in the forefront, the impacts of the pandemic have been well documented, which indicate the social risks on an equal footing, thus, emphasizing on the need to adapt, to understand and indulge in ESG investments. A comprehensive ESG data analysis can offer respite in identifying and resolving impending hidden financial risks.

Traditionally, investments were focused on financial returns. However, with changes globally, businesses are moving towards more ethical and long term impact investments. Impact investments are investments made with a two-fold intention, i.e., to generate measurable social and environmental impact alongside a financial gain. Today, investors have begun to ack¬nowledge that social and environmental issues also have a material impact to the financial outlook of investments. A noticeable trend shows that the investors are moving towards incorporating ESG aspects into their decision-making processes.

Various studies have evidenced how investments driven good management of ESG issues can contribute to stronger market value creation. The ESG driven investing has matured to the point where it can greatly accelerate market transformation for the better. As conglomerates and investors experience greater responsibilities, influence and status, their operations and commitments contribute significantly in creating the future.

[1]https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-survey-shows-acceleration-of-sustainable-investing, [2]AUM are the overall market value of assets/capital that a mutual fund holds, [3]https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/major-esg-investment-funds-outperforming-s-p-500-during-covid-19-57965103, [4]http://bit.ly/3cFQBKO, [5]https://www.efama.org/Pages/Submitted%20after%202018-03-12T16%2022%2007/EFAMA-publishes-report-on-level-and-nature-of-sustainable-investment-by-the-European-asset-management-industry.aspx

Sonal Verma is currently working as a Partner & Global Leader - Markets & Strategy with the firm. He is well acclaimed for his work in regulatory & compliance programs over the last decade. He had in the past worked with 1800 plus clients in India and 61 other countries globally. He has worked with the top 3 unicorns and many Fortune 500 companies. His clients have been across different industries, viz. Automotive and OEMs, Pharma and Life Sciences, Manufacturing, Chemical Industry, BFSI, Infrastructure and Utilities (including state-owned PSUs), e-Commerce and Fintech Companies, Diversified Conglomerates etc.

Fauzia Khan is an associate with the firm working in the ESG domain. With the emerging change in the business landscape and awareness around sustainability, she contributes her expertise to help clients understand and adapt responsible and sustainable strategies with respect to compliance and ethics in the ESG realm.