# Sustainability Legal Pressure Points for Financial Services

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## Introduction

More than seven years after the financial crisis, the finance sector is still digesting an alphabet soup of regulatory reform projects launched by the G20 and global financial regulators.[1] This includes, among others, Basel III, CRD IV, Too Big to Fail, Dodd Frank, EMIR, MiFID II, FATCA, Volcker, AIFMD, etc. The reforms cover topics including prudential regulation, systemic risk, market infrastructure, market conduct, disclosure, tax and accounting, compensation and culture. A second wave of regulations applicable to the broader corporate sector is now hitting the financial services industry.[2] While it may seem overwhelming to consider even further potential regulatory topics, there is a looming set of legal and regulatory issues related to sustainability topics that will become relevant for the financial services industry over the coming years due to long term social, environmental and economic trends.

Thus, even though many of the laws, regulations and soft law standards related to sustainability are still in a formative stage it is necessary to begin understanding key pressure points today in order to prepare for tomorrow. This article will outline some of the key legal and regulatory pressure points related to sustainability topics for the financial sector. The goal is not to be fully comprehensive or conclusive but rather to introduce the topics for those not as familiar with them. This should help general financial services lawyers and other practitioners identify areas for further research and analysis.

2015 was a very significant year for sustainability. There were three major events that came together to define themes and activities for the future. First, the UN agreed in July on a new financing mechanism for sustainable development.[3] Given constraints facing government budgets and the continued failure by developed countries to meet the goal of devoting 0.7% of GDP to support sustainable development, the UN envisions a strong role for the private sector including the financial sector[4]. Second, the UN agreed in September a new set of sustainable development goals to replace the Millenium Development goals. These goals will set the framework and targets for both public sector and private sector activities related to sustainable development addressing a broader range of topics than just human development targets (e.g. sanitation, water, education, etc)[5] that were the focus of the original goals.

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[1] See the FSB 2nd annual report http://www.financialstabilityboard.org/2015/07/second-fsb-annual-report/ released in July 2015 for an overview of the ongoing global regulatory reform agenda. Some topics, such as the OECD Automatic Exchange of Information, are outside the G20 directed reform process that is driven by the FSB but are still significant reforms for the financial industry.

[2] See, e.g., the EU General Data Protection Regulation http://ec.europa.eu/justice/data-protection/ and the SEC pay ratio disclosure rule https://www.sec.gov/news/pressrelease/2015-160.html which while part of the Dodd Frank Act applies to corporates more generally.

[3] See conference materials and results here http://www.un.org/esa/ffd/

[4] The outcome document http://www.un.org/ga/search/view_doc.asp?symbol=A/CONF.227/L.1 stresses the role of the private sector particularly in the context of public-private partnerships (e.g. par. 5) and commits governments governments to facilitating business efforts to address sustainability issues (par. 36)– "We will develop policies and, where appropriate, strengthen regulatory frameworks to better align private sector incentives with public goals, including incentivizing the private sector to adopt sustainable practices, and foster long-term quality investment. Public policy is needed to create the enabling environment at all levels and a regulatory framework necessary to encourage entrepreneurship and a vibrant domestic business sector."

[5] See https://sustainabledevelopment.un.org/topics/sustainabledevelopmentgoals Among initial goals proposed (https://sustainabledevelopment.un.org/index.php?page=view&type=400&nr=1579&menu=1300) that have particular relevance for the private sector and the financial industry were goal 7 (ensure access to affordable, reliable, sustainable and modern energy for all), goal 8 (promote sustained, inclusive, and sustainable economic growth, full and productive employment and decent work for all), and goal 9 (build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation).

Finally, in December in Paris countries agreed on a successor to the Kyoto Protocol to address climate change under the aegis of the UN Framework Convention on Climate Change.[6] This is expected to trigger a new wave of private sector investment in a range of new technologies and clean energies. Taken together these three developments may set in place a policy framework that influences economies for the coming decades and thus have particular relevant for the financial sector.[7]

While such global policy agreements are a starting point for understanding the role of the private sector broadly and the financial sector specifically they are not sufficient to understand the potential legal implications as corporates and financial firms begin to deepen and integrate sustainability issues into their core businesses. This can be particularly challenging as the norms are often still evolving and there is a broad set of laws, regulations, and soft law standards that may be applicable at any point in time. It can be particularly challenging for the financial sector given the facilitating role it plays in the economy. This means a financial firm may need to take a wider view as its own obligations will be shaped by those of its clients.

Before exploring the specific pressure points, it may be useful to provide some context for the discussion. Sustainability means different things to different people. The most common reference point is the definition of sustainable development (i.e. development that "meets the needs of the present without compromising the ability of future generations to meet their own needs") from the 1983 UN World Commission on Environment and Development report.[8] This is a broad definition that encompasses within it elements of resource scarcities, environmental preservation, demographic challenges, health and human welfare, access to economic opportunity, and social inequalities. Sustainability can also be understood through policy principles that are intended to give it more traction[9]. Among these are principles such as

- the 'polluter pays' principle which states that polluters should bear the expenses of pollution prevention and remediation
- the 'precautionary principle' that suggests refraining from action in situations of uncertainty regarding the environmental risks of development
- various 'social justice' principles that would require fair distribution of the benefits and burdens of environmental policy both across income or wealth levels and intertemporally across generations

While these are useful starting points for framing a discussion about the legal implications of sustainability trends they need to be connected back to issues that may create potential for liabilities. This may be best understood based on a set of constraints or themes for the future. Among these themes are the following:

- *A World of Limits*: The $60 trillion global economy now uses 1.5 times the Earth's capacity to regenerate natural resources per year, a condition known as ecological

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[6] https://unfccc.int/meetings/paris_nov_2015/meeting/8926.php

[7] For some general commentary see Jeffrey Sachs *Earth Calling the Financial Sector* http://www.project-syndicate.org/commentary/sustainability-finance-leaders-by-jeffrey-d-sachs-and-hendrik-j--du-toit-2015-02 and *The Year of Sustainable Development* http://www.project-syndicate.org/commentary/sustainable-development-2015-by-jeffrey-d-sachs-2014-12 For particular implications for the financial sector see the work of the UNEP Inquiry into the Design of a Sustainable Financial System http://web.unep.org/inquiry which is exploring how the financial system can be re-oriented to better facilitate sustainable development outcomes.

[8] See http://www.un-documents.net/wced-ocf.htm

[9] For more on the concept of sustainable capitalism and sustainable companies and particularly the influence of corporate law see *Capitalism, the sustainability crisis, and the limitations of current business governance* University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2015-18 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2646439

overshoot.[10] Demographic trends (population expected to reach at least 9 billion by 2050 with a growing middle and urban class aspiring to live a western lifestyle) will only exacerbate it. In the short run, we may be able to overcome scarcities with expanded production. However, various international agencies estimate demand for water, food, and energy will increase between 30% and 50% out to 2030 which will ultimately require new technology and new production methods as well as conservation efforts.[11] Thus, we need to understand what solutions will allow us continue to develop in a world where energy, land, water, food and carbon are likely to be constrained and subject to additional potential shocks. Finance will help facilitate some of these solutions but also may be criticized for exacerbating negative trends.

- *A World of Inequality*: Taken together, the bottom half of the global population owns less than 1% of total wealth and the richest 10% hold 87% of the world's wealth with the top 1% alone accounting for 48% of global assets in 2014.[12] In a world of limits, questions of equity and fairness of distribution are unavoidable. Such questions become even sharper when there is greater disparity in outcomes and a perception that rules are slanted.[13] However, there are also opportunities in such a scenario. The "impact investing" market that may help address social, environmental, and economic inclusion issues has been growing and is often cited as a key growth area for finance.[14] In addition, those who have been fortunate enough to reap the benefits of globalization are often now seeking to contribute to solutions and give back not only knowledge but also to recycle their wealth through venture philanthropy of other innovative mechanisms.[15] Finance will help design new models to support these efforts but again may be held accountable for not addressing the issues.

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[10] See the WWF Living Planet Report and the corresponding ecological footprint which measures human impact http://wwf.panda.org/about_our_earth/all_publications/living_planet_report/ecological_footprint/ See also the work of the Stockholm Resilience Center for the effort to document planetary limits and boundaries http://www.stockholmresilience.org/planetary-boundaries and *The Trajectory of the Anthropocene: The Great Acceleration* (March 2015) for human impact on Earth systems - http://anr.sagepub.com/content/2/1/81

[11] See, e.g., FAO report *World agriculture 2013* http://www.fao.org/english/newsroom/news/2002/7833-en.html, IEA report *World Energy Outlook 2014* http://www.worldenergyoutlook.org/publications/weo-2014/ and the OECD report *Environmental Outlook to 2050* http://www.oecd.org/env/indicators-modelling-outlooks/oecdenvironmentaloutlookto2050theconsequencesofinaction.htm

[12] See Global Wealth Report 2014 from the Credit Suisse Research Institute https://www.credit-suisse.com/uk/en/news-and-expertise/research/credit-suisse-research-institute/publications.html See also *Capital in the 21st Century* from Thomas Piketty (2014) and a recent report from Oxfam https://www.oxfam.org/en/pressroom/pressreleases/2015-01-19/richest-1-will-own-more-all-rest-2016 both of which were not without controversy in their methodologies and conclusions. See, *Furthering the Fight Against Poverty* (UBS, July 2014) for a perspective on the role of business and finance with respect to inequality issues. www.ubs.com/global/en/bank_for_banks/news/topical_stories/edition_103.html .

[13] See, e.g., *Laudato si*' the encyclical from Pope Francis published in May 2015 - http://w2.vatican.va/content/francesco/en/encyclicals/documents/papa-francesco_20150524_enciclica-laudato-si.html

[14] See, e.g., the World Economic Forum September 2013 report *From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors* http://www3.weforum.org/docs/WEF_II_FromMarginsMainstream_Report_2013.pdf including predictions of a market size up to USD 500 billion. See also A Coming Age for Impact Investing (Aug 2015) from the Stanford Social Innovation Review for the current state of impact investing and the effort to benchmark performance http://ssir.org/up_for_debate/article/a_coming_of_age_for_impact_investing?utm_source=Enews&utm_medium=Email&utm_campaign=SSIR_Now&utm_content=Title

[15] The 'Giving Pledge' initiated by Warren Buffet and Bill Gates probably is the most known example http://givingpledge.org/

- *Greening of Growth*: Major sectors of the economy need to re-engineer to address resource scarcities, help mitigate or adapt to climate change and address inequalities. The top 3000 companies globally were responsible for USD 2.15 trillion in environmental costs in 2008, equal to 33% of their profits, with many of these impacts being felt in countries and populations with limited resources.[16] The Economics of Ecosystems and Biodiversity (TEEB) study in 2010 estimated a future market of between USD 2 and 6 trillion for sustainability related business opportunities by 2050. [17] The UN Green Economy initiative estimated a need for 1-2.5% of GDP to be invested in initiatives such as renewable energy, property and transport, and food and agriculture systems until 2050. The January 2014 Ceres report Investing in the Clean Trillion: Closing the Clean Energy Investment Gap noted the International Energy Agencies call for USD 1 trillion more investment per year over the years until 2050 to have an 80% change of success at limiting the increase in global average temperatures to 2 degrees centigrade. Finance will help facilitate the re-engineering of major systems and value chains but also may be exposed to expectations and liabilities as a result.

Each of these themes is worthy of detailed exploration on its own to understand the underlying drivers and the business implications for corporations and the financial sector. This is beyond the scope of this paper which has a more narrow and modest aim. The paper will instead focus on the following pressure points that may arise as global financial firms begin to take actions and support clients:

1) *Risk Management* – the need to have processes in place to manage key risks related to environmental, social and governance issues when dealing with clients and transactions and other due diligence aspects

2) *Sustainable Investing* - the need to understand the implications of environmental, social and governance issues for product and investment standards as well as treatment of clients under potentially expanded notions of fiduciary duty

3) *Corporate Disclosure* – requirements and other standards intended to ensure transparency on activities related to environmental, social and governance issues by a financial institution and the outcomes

4) *Valuation Aspects* – issues related to pricing and valuation particularly related to resource consumption and the potential for trading of permits and other rights to support more sustainable outcomes

The goal for each pressure point section is to outline some of the key legal, regulatory and soft law standards that are developing to better understand the expectations, requirements and potential liabilities for the financial sector. Examples will be given across a range of national jurisdictions and internationally to provide a basis for comparison and to indicate how laws, regulations, and soft law standards may develop in any given jurisdiction. A conclusion will offer some final thoughts on how the financial sector should evolve with respect to its consideration of the issues outlined.

[16] See the April 2011 publication *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* http://www.trucost.com/published-research/43/universal-ownership-why-environmental-externalities-matter-to-institutional-investors-full-report
[17] For the work of TEEB related to business see http://www.teebweb.org/areas-of-work/teeb-for-business/

Pressure Point 1

Risk Management

One of the core competencies for a financial firm is risk management. Traditionally this has been focused on the management of financial risks including credit and market risk and operational risk. More recently standards have been formalized after the financial crisis for liquidity and funding risk as well as for overall loss absorbing capacity as part of the too big to fail regulatory regime.[18] However, there is a broader set of risks that currently pose reputational issues but which may result in regulatory requirements or even legal liabilities for financial firms. These risks relate to environmental (e.g. climate change) and social (e.g. human rights) issues particularly in certain sectors (e.g. mining, forestry, chemicals, agriculture) and countries (largely developing but also in developed countries for issues related to fossil fuels). While there has been some commentary around the impact of the core financial sector regulations on the incentives for banks to finance solutions, for the most part the core financial sector regulations have not yet addressed such risks.[19]

The effort to understand the role of the financial sector in addressing environment and human rights issues can be traced back to initial efforts begun under the umbrella of the UN. The UN Environmental Program was established in 1972 as the "environmental conscience" of the UN system. In 1991, the UNEP launched a finance initiative (UNEP FI) with a small group of commercial banks to catalyze the banking industry's awareness of environmental risks. This led in May 1992, as part of the efforts to prepare for the UN Conference on Environment and Development (the so-called Earth or Rio Summit) to a formal statement called the UNEP Statement by Banks on the Environment and Sustainable Development.[20] The statement, and the UNEP FI initiative, has expanded over the years to included insurance and asset management groups and a broader range of financial institutions.

The statement lays down key principles to guide risk management approaches adopted by the over 200 financial institutions that have joined UNEP FI[21] among which are:

- Sustainable development is "best achieved by allowing markets to work within an appropriate framework of cost efficient regulations and economic instruments"
- Sustainable development is "an institutional commitment and integral part of…both good corporate citizenship and the fundamentals of sound business practice"
- Sustainability management includes a "support [for] a precautionary approach to environmental and social issues, which strives to anticipate and prevent negative impacts on the environment and society" and requires updates "periodically to incorporate relevant developments in sustainability management"
- Sustainability management requires "identifying and quantifying environmental and social risks [as] part of the normal process of risk assessment and management, both in domestic and international operations"

Financial firms have used these to develop environmental and social risk management frameworks to ensure they respect current standards not only in their direct impact (e.g. supply chain management) but, perhaps more importantly, in their indirect impact when providing

[18] Collectively these are international regulatory framework for banks known as the Basel standards. Basel III is the specific set of reforms launched after the financial crisis to improve the quality and quantity of capital, risk management and governance, and enhance transparency. See http://www.bis.org/bcbs/basel3.htm?ql=1 for more detail. These standards are not international law but are implemented into national legal and regulatory frameworks by individuals countries.
[19] See, e.g., World Economic Forum, Financial Regulation: Biased against Clean Energy and Green Infrastructure http://www.weforum.org/reports/financial-regulation-biased-against-clean-energy-and-green-infrastructure Patrick Narbel, The likely impact of Basel III on a bank's appetite for renewable energy financing (Oct 2013) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2341519 ,
[20] The statement can be found here - http://www.unepfi.org/about/statements/statement/
[21] Current members can be found here - http://www.unepfi.org/signatories/

financial services to clients. Often firms develop specific guidelines on a topic (e.g. climate change policy) or sector (e.g. energy) or even subsector (e.g. hydraulic fracking or mountain top removal coal mining) to guide their due diligence and decision making. These guidelines determine risk factors financial firms consider when considering to onboard a client in the first instance or to engage in a specific transaction. These risk factors normally reference international standards (e.g. prohibit financing of transactions in a UNESCO world heritage site area[22] or prohibit financing a transaction that involves potential damage to endangered species listed in the Convention on International Trade in Endangered Species[23]) or other private sector norms (e.g. only support palm oil related transactions where the end product meets the requirements of the Roundtable on Sustainable Palm Oil[24]; only engage in project finance transactions according to the standards outlined in the Equator Principles[25]; operate according to the IFC Environmental and Social Performance standards[26]).

Firms will adopt different frameworks but best practice is to ensure that the approach to risk management is not only a process but is also supported by a robust governance structure. It is key that the risk management approach continually evolve as norms change and the approach must be embedded in the business operations and not be seen as a box ticking exercise to ensure it can be defended. Thus, firms will often establish a formal management body, including representation from the business, risk, legal and compliance, to agree on policy changes in light of the evolution in scientific understanding and changing norms. Ideally there will be a senior manager in the firm (e.g. the Chief Risk Officer) who is tasked with being the senior level champion for environmental and human rights risk management. Some firms will even establish a board of directors level committee to ensure there is independent board level oversight of the approach taken by management to environmental and social risk management.

To date such efforts have largely been voluntary by firms that have become signatories to groups such as the UNEP FI or UN Global Compact[27]. Firms generally employ a risk management system based on a recognized standard (e.g. the ISO 14000 family of standards[28]) and will also make a corresponding external disclosure of compliance with that standard which itself may be guided by specific standards related to its content and format (e.g. reporting according to the standards of the Global Reporting Initiative (GRI)[29]). Thus, while companies may subject themselves to scrutiny and embarrassment for not living up to the standards to which they have

[22] http://whc.unesco.org/en/conventiontext/
[23] See https://www.cites.org/eng/disc/text.php .
[24] The Roundtable on Sustainable Palm Oil http://www.rspo.org/ is an association composed of various palm oil industry stakeholders (including banks/investors), environmental and social NGOs which has developed a set of criteria which companies must comply with in order to produce Certified Sustainable Palm Oil (CSPO).
[25] The Equator Principles (EPs) http://www.equator-principles.com/ are a risk management framework, adopted on a voluntary basis by financial institutions, for determining, assessing, and managing the environmental and social risks of projects. The Principles target four specific financial products: 1) Project finance advisory services 2) Project finance 3) Project-related corporate loans 4) Bridge loans. Currently, 80 firms in 34 countries have adopted the principles covering over 70% of international project finance debt.
[26] www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Our+Approach/Risk+Management/
[27] The UN Global Compact http://www.unglobalcompact.org/ was launched in 2000 to support businesses wishing to demonstrate their commitment to ten specific principles in the areas of human rights, environment, and anti-corruption. Members of the Global Compact must show their determination to implement the ten principles, and also report annually on this progress. It is the largest voluntary corporate responsibility initiative in the world with more than 12,000 corporate members from over 145 nations.
[28] http://www.iso.org/iso/home/standards/management-standards/iso14000.htm
[29] https://www.globalreporting.org/Pages/default.aspx See section on disclosure for more detail.

committed themselves voluntarily, they generally do not subject themselves to legal liabilities currently.[30]

However, there are a number of legal, regulatory, and soft law developments that may change this situation. At the international level, the UN Human Rights Council in 2011 endorsed the *Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework* proposed by UN Special Representative John Ruggie.[31] This is a set of 31 principles to outline how the "protect, respect and remedy" framework can be implemented by corporations with respect to human rights. While the principles are non-binding and do not have the force of international law, they have become the main reference source on business and human rights.[32] Shortly after endorsement, the UN Office of the High Commissioner for Human Rights (OHCHR) began a study of domestic law remedies in order to address liability for gross human rights abuses.

This has led to a number of parallel efforts. At the level of individual countries, a series of "National Action Plans" are being adopted to provide effect to the guiding principles at a national level.[33] The UK was the first to adopt an Action Plan[34] which contains the following key commitments by the UK government

- implement UK Government obligations to protect against human rights abuse within the UK by business enterprises;
- support UK businesses to meet their responsibility to respect human rights throughout their operations both at home and abroad;
- support access to effective remedy for victims of human rights abuse involving business enterprises within UK jurisdiction
- promote international adherence to the UN Guiding Principles on Business and Human Rights, including for States to assume fully their duties to protect human rights and assure remedy within their jurisdiction

The action plan sets out expectations of UK businesses which include the following:

- comply with all applicable laws and respect internationally recognised human rights, wherever they operate
- seek ways to honour the principles of internationally recognised human rights when faced with conflicting requirements

[30] There are a number of NGOs actively monitoring the behavior and compliance of participating companies or have a broader focus on environmental, social, responsibility or sustainability topics and publish related reports, e.g. the 'Greenwash + 10' report by CorpWatch http://www.corpwatch.org/downloads/gw10.pdf or various reports by the 'Business & Human Rights Resource Center' http://business-humanrights.org/en/find-companies .

[31] For the work of the UN Secretary General's special representative on business and human rights see http://business-humanrights.org/en/un-secretary-generals-special-representative-on-business-human-rights

[32] Application of the principles to the financial sector, particularly given its indirect connection to the activities of its clients through financing, has been the subject of work done by the private sector Thun Group https://www.ubs.com/global/en/about_ubs/corporate_responsibility/how-we-do-business/sustainability/thun-group.html which published a paper in October 2013 outlining how Principles 16-21 of the UN Guiding Principles on Business and Human Rights apply in the financial sector.

[33] See for example, announcement by the US on the development of its action plan - https://www.whitehouse.gov/blog/2014/11/20/announcement-opportunity-provide-input-us-national-action-plan-responsible-business- and a related FAQ from the US State Department http://www.humanrights.gov/dyn/2015/usg-national-action-plan-on-responsible-business-conduct/; see also a similar commitment from the German government to develop a legislative proposal during 2016 http://www.auswaertiges-amt.de/EN/Aussenpolitik/Aussenwirtschaft/Wirtschaft-und-Menschenrechte/Wirtschaft-und-Menschenrechte.html

[34] https://www.gov.uk/government/publications/bhr-action-plan

- treat as a legal compliance issue the risk of causing or contributing to gross human rights abuses wherever they operate
- adopt appropriate due diligence policies to identify, prevent and mitigate human rights risks, and commit to monitoring and evaluating implementation;

Notably the legal liabilities of UK firms are limited to operations within the UK. Other countries are considering potentially going further as illustrated by developments associated with the development of a National Action Plan in Switzerland. In response to a June 2012 postulate submitted to the Swiss National Council, the federal government first committed to implementing a National Action Plan.[35] Subsequently another postulate led to a comparative study of regulations concerning human rights and environmental due diligence.[36] When the report was submitted to the Federal Council, a motion by the Foreign Policy Committee called upon the Federal Council to develop a proposal for how Swiss companies with activities abroad can be required to perform human rights and environmental due diligence via a formal legal requirement.

This proposal was at first accepted by a vote of 91 to 90 but a subsequent revote on 11 March 2015 rejected it with a vote of 95 to 86 thus stopping the effort that would potentially have led to an expanded legal liability. However, there is an active campaign in Switzerland for a referendum on a measure that allows Swiss companies to be sued under Swiss law for violations of environmental and human rights norms abroad (i.e. the so-called "Rechte Ohne Grenze" or laws without borders initiative).[37] This would follow in the footsteps of France where a bill holding multinational companies legally responsible for action that harms the environment or violates human rights in third countries has passed Parliament and is awaiting Senate approval.[38] Thus, it may be that the legal liability regime is changing and would provide the basis for lawsuits where a firm's risk management system is deemed deficient even for its operations abroad.

Meanwhile efforts continue at the international level as the OHCHR continues its work program to ensure there are effective remedy rights for human rights violations.[39] In June 2014 the Human Rights Council adopted a resolution[40] requesting the OHCHR to "continue the work to facilitate the sharing and exploration of the full range of legal options and practical measures to improve access to remedy for victims of business-related human rights abuses…. and to organize consultations with experts, States and other relevant stakeholders to facilitate mutual understanding and greater consensus among different views." The Human Rights Council has requested the OHCHR to submit a final report for its consideration at its 32nd session in June 2016. One of the recommendations being considered at the suggestion of Norway is an international legal treaty on business and human rights that would effectively provide a firm international law basis for liability as a supplement to any national efforts.

There are also specific regulatory developments of note. For example, in 2010 the US SEC published binding interpretive guidance requiring companies to analyze climate change related risks and opportunities and to disclose these where material.[41] In order to meet such a disclosure requirement, a firm would need a risk management framework that facilitated the analysis required to make a materiality determination. Other examples are targeted such as the

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[35] http://www.parlament.ch/d/suche/Seiten/geschaefte.aspx?gesch_id=20123503
[36] http://www.ejpd.admin.ch/dam/data/bj/aktuell/news/2014/2014-05-28/ber-apk-nr-d.pdf
[37] http://www.corporatejustice.ch/en/
[38] http://business-humanrights.org/en/opportunity-for-france-to-hold-companies-legally-responsible-for-human-rights-abuses-by-subsidiaries-abroad
[39] For more information see - http://www.ohchr.org/EN/Issues/Business/Pages/OHCHRstudyondomesticlawremedies.aspx
[40] http://ap.ohchr.org/documents/dpage_e.aspx?si=A/HRC/RES/26/22
[41] See http://www.sec.gov/rules/interp/2010/33-9106.pdf. In Europe, the EU Non-Financial Disclosure Regulation requires similar information to be disclosed – see http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0095 .

SEC rule requiring the disclosure of the use of conflict minerals in supply chains.[42] This topic is now being considered for formal legislation within the EU as well demonstrating the ability of a provision in one country being adopted in others.[43] While these measures are general obligations of corporates and not specific to financial institutions (and in fact are likely to not be relevant given the nature of the business of financial firms) they do indicate a trend toward requiring risk management on environmental and human rights issues.

In fact, some countries have included specific requirements related to environmental and social risks in their banking regulatory frameworks. For example, in 2014, the Brazilian central bank introduced a formal requirement for environmental and social risk management systems and asked banks to monitor environmental losses as part of their internal review of capital adequacy.[44] Other regulators are adopting incentivizing approaches as well. For example, the central bank of Bangladesh has introduced discounted refinancing to help banks meet targets to allocate 5% of loans to "green" projects and takes this activity into consideration in its bank (i.e. CAMELS) ratings process.[45] There have even been calls for "green macroprudential regulation" that would, for example, introduce differentiated reserve ratio requirements at central banks to support lending to green sectors or would favor certain kinds of instruments in some of the new ratios (e.g. net stable funding ratio, liquidity ratio) as part of the Basel 3 regime.[46]

Thus banks may find that the regulatory frameworks begin to include direct references to environmental and human rights issues particularly in light of commitments made to a new climate change accord at the end of 2015.[47] This may be seen as part of an effort to develop policy enablers or modifying regulatory frameworks to support long term investment in infrastructure and other forms of "long term finance".[48] In turn this may be part of a broader effort to rebalance the regulatory and policy framework to support growth as highlighted in the EU Capital Markets Union initiative.[49]

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[42] Based on section 1502 of the 'Dodd-Frank' Act, the SEC proposed a first release in December 2010. After considering thousands of comments and roundtable discussions the final rules were adopted in September 2012 – http://www.sec.gov/rules/final/2012/34-67716.pdf).

[43] http://www.conflictmineralslaw.com/tag/european-union/

[44] http://www.bcb.gov.br/pre/normativos/busca/normativo.asp?tipo=res&ano=2014&numero=4327

[45] http://www.ifc.org/wps/wcm/connect/fa14ae00476d60218035f5299ede9589/Millat-BangladeshBank-SBN2014.pdf?MOD=AJPERES

[46] See, e.g., *Beyond carbon pricing: The role of banking and monetary policy in financing the transition to a low-carbon economy*, Emanuele Campiglio, Centre for Climate Change Economics and Policy Working Paper 160 (June 2014) http://www.lse.ac.uk/GranthamInstitute/publication/beyond-carbon-pricing-the-role-of-banking-and-monetary-policy-in-financing-the-transition-to-a-low-carbon-economy/ For the potential for treatment of environmental risks more generally in the Basel framework see Stability and Sustainability in Banking Reform: Are Environmental Risks missing in Basel III? (CISL & UNEP FI, 2014) - http://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/banking-regulation

[47] Of note is the work being conducted by the Bank of England related to climate change http://www.bankofengland.co.uk/pra/Pages/supervision/activities/climatechange.aspx including reporting requirements and the potential for stranded assets. These will be explored in more detail in the sections on Reporting and Valuation.

[48] Space does not permit a full treatment of long term finance. There are a number of reports written after the financial crisis exploring the policy, regulatory and other constraints to long term investment. For more information see Group of Thirty, *Long-Term Finance and Economic Growth* (2013) http://www.group30.org/rpt_65.shtml, Institute of International Finance and Swiss Re, Infrastructure Investing: It Matters (2014) https://www.iif.com/publication/full-report/infrastructure-investing-it-matters and IIF Council for Asset and Investment Management Top 10 Impediments to Long-Term Infrastructure Financing and Investment (2014) https://www.iif.com/press/iif-identifies-top-10-impediments-long-term-infrastructure-financing-and-investment-0 Financial Stability Board, Update on Financial Regulatory Factors Affecting the Supply of Long Term Investment Finance (2014) http://www.financialstabilityboard.org/2014/09/r_140916/

[49] See http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm

Pressure Point 2

Sustainable Investing

The investment process is shaped by a number of norms and conventions including concepts such as risk versus return, portfolio diversification, and asset allocation.[50] Sustainable investing is one of these and can be characterized as a set of investment strategies (e.g. exclusion, integration, impact investing) that incorporate material environmental, social and governance (ESG) considerations into investment decisions. Sustainable investing strategies usually attempt to achieve one or more of the following objectives: positive environmental or social impacts in addition to financial returns, alignment of investments with personal values, and improvements in portfolio risk/return characteristics.[51] The goal for this section is not to discuss sustainable investing strategies but rather the framework in which sustainable investing may occur.

A fundamental concept in this framework is that of fiduciary duty. This governs the responsibilities of those who manage and oversee the investment of other peoples' money and generally is interpreted to include a duty of loyalty (e.g. which requires avoidance of conflicts of interest) and a duty of care (e.g. which requires investing as a so-called "prudent man" would). The concept of fiduciary duty has a long history and has evolved over time. It is currently under debate in multiple jurisdictions for different reasons particularly as evidence gathers on the potential benefits to companies resulting from implementing ESG practices.[52] This section will provide some background on these debates and implications for financial firms.

In the UK, the current debate over the meaning of fiduciary duty started with the so-called "Kay Review"[53]. In June 2011, the UK Secretary of State for Business, Innovation and Skills commissioned a review of UK equity markets and the impact on the long-term performance and governance of UK quoted companies. The review concluded that short-termism is a problem in UK equity markets and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain. The report did not identify a single solution to remedy the situation but instead put forward a number of recommendations to improve equity markets so that they can support sustainable long-term value creation by British companies. Among the recommendations were the following:

- The UK Stewardship Code should be developed to incorporate a more expansive form of stewardship, focusing on strategic issues as well as questions of corporate governance.
- Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should takes steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.
- Companies should seek to disengage from the process of managing short term earnings expectations and mandatory quarterly reporting obligations should be removed.

[50] See, for example, http://www.finra.org/investors/key-investing-concepts
[51] For more on sustainable investment generally see the UBS report Adding Values to Investing (Mar 2015) - https://www.ubs.com/global/en/about_ubs/corporate_responsibility/news_display_page_corporate_responsibility.html/en/2015/03/31/investing-report.html and the followup reports available here https://www.ubs.com/global/en/wealth_management/wealth_management_research/sustainable-investing.html?campID=INTERNAL-HPPROMOTEASER-global_sustainable_investing-en
[52] See, e.g., an overview of the business case for corporate investment in strong ESG practices based on research by The Conference Board Inc. here - http://corpgov.law.harvard.edu/2015/08/05/corporate-investment-in-esg-practices/ The business case is framed based on five pillars- 1) enhancement of market and accounting performance, 2) lowering the cost of capital, 3) a means of engagement with key shareholders, 4) improvement in business reputation, and 5) fostering new revenue growth through innovation.
[53] See www.bis.gov.uk/kayreview

- Regulatory authorities should apply fiduciary standards to all relationships in the investment chain which involve discretion over the investments of others, or advice on investment decisions. These obligations should be independent of the classification of the client, and should not be capable of being contractually overridden.
- The UK Law Commission should be asked to review the legal concept of fiduciary duty as applied to investment to address uncertainties and misunderstandings on the part of trustees and their advisers.

The last recommendation listed above was particularly important as one statement often made is that fiduciary duty prevents investment managers from considering a broader range of environmental, social and governance topics when managing the investments of others. Essentially the claim is made that fiduciary duty requires an exclusive focus on financial returns. The UK Law Commission produced a report in July 2014[54] following this recommendation. The report did not focus on legislative changes but instead aimed to explain the nature of fiduciary and other duties to act in the best interests of savers and how they apply to investment intermediaries. The report concluded that trustees should take into account factors which are financially material to the performance of an investment and that where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should consider them. The report additionally concluded that while the pursuit of a financial return should be the predominant concern of trustees, the law is sufficiently flexible to allow other, subordinate, concerns to be taken into account. In particular the Law Commission stated that the law permits trustees to make investment decisions are based on non-financial factors, provided that:

- they have good reason to think that scheme members share the concern; and
- there is no risk of significant financial detriment to the fund.

As a result of the combination of the Kay Review and the Law Commission report the UK government has consulted on potential changes to the law on investments in occupational pension schemes to clarify the role of financial and non-financial factors when taking decisions about investments and the role that a "stewardship" approach can play when taking decisions about investments.[55] The consultation closed in April 2015 and the UK government is considering the feedback and potential next steps.

In the US there is also currently a debate on the concept of fiduciary duty. For the most part this does not touch on the concepts of sustainability or inclusion of environmental, social and governance criteria in investments. Instead the current debate is around the potential application of a "fiduciary" standard to brokers who interact with clients on their retirement portfolios. Specifically the Department of Labor has proposed that a person providing investment advice to an employee benefit (i.e. pension) plan or an individual retirement account (i.e. "IRA") is considered a fiduciary under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code.[56] This would effectively require a broader group of individuals (i.e. brokers who work for broker-dealers and not just independent advisors) to give advice that is in the "best interest" of their clients rather than advice that is merely "suitable" for their clients. This proposal is the subject of considerable debate[57] including potential legislation

[54] See http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/#fiduciary-duties-of-investment-intermediaries
[55] See https://www.gov.uk/government/consultations/changes-to-the-law-on-investments-in-occupational-pension-schemes
[56] See http://www.dol.gov/featured/protectyoursavings/
[57] See for example the comments from SIFMA (http://www.sifma.org/issues/savings-and-retirement/dol-fiduciary-standard/overview/) arguing that the proposal would cause harm – particularly to low and middle-income retirement savers – by limiting investors' access to choice and guidance, while raising the cost of saving. As an alternative SIFMA has proposed a Best Interests Standard for Broker-Dealers, which, if adopted, would establish a best interests standard for broker-dealers serving retail clients. This proposal follows the industry's long established support for such a standard. SIFMA further notes that recognition should be given to the fact that the brokerage industry is highly regulated by the U.S. Securities and

requiring that the regulation not be finalized until the SEC considers whether to establish a new uniform federal fiduciary standard of care for brokers and investment advisors as was required by the Dodd Frank law.[58]

Interestingly, while the debate about the Department of Labor proposal regarding fiduciary status for broker dealers is ongoing the Department of Labor has concurrently clarified further what fiduciary status actually means.[59] The new guidance, Interpretive Bulletin 2015-01, confirms a prior interpretive bulletin issued in 1994 that states that while fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits they may take such benefits into account as "tiebreakers" when investments are otherwise equal with respect to their economic and financial characteristics.[60] The guidance also acknowledges that environmental, social, and governance factors may have a direct relationship to the economic and financial value of an investment and suggests that such factors are more than just tiebreakers but rather are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices.

These two individual national efforts are part of a broader international context in which the concept of fiduciary duty is being rethought. This work began with a study commissioned by the UN Environmental Program Financial Institutions initiative (UNEP FI) in 2005 from the law firm Freshfields.[61] This report was intended to answer the following question:

> *Is the integration of environmental, social and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?*

The report examined seven specific jurisdictions (France, Germany, Italy, Japan, Spain, UK, and US) and came to the conclusion that

> *Conventional investment analysis focuses on value, in the sense of financial performance. As we note above, the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.*
>
> *It is also arguable that ESG considerations must be integrated into an investment decision where a consensus (express or in certain circumstances implied) amongst the beneficiaries mandates a particular investment strategy and may be integrated into an investment decision where a decision-maker is required to decide between a number of value-neutral alternatives.*

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Exchange Commission (SEC), the Financial Regulatory Authority (FINRA), and state regulators, including with respect to retirement accounts, and in particular, recent guidance by FINRA with respect to rollovers.

[58] See, for example, commentary from Ropes and Gray https://www.ropesgray.com/newsroom/alerts/2015/August/Commenters-React-to-DOLs-Proposed-Expansion-of-Fiduciary-Duty-Rules.aspx and PwC http://corpgov.law.harvard.edu/2015/08/29/fiduciary-duty-proposal/

[59] See http://www.dol.gov/ebsa/

[60] The Labor Department previously addressed issues relating to ETIs in Interpretive Bulletin 94-1 (IB 94-1) and Interpretive Bulletin 2008-1 (IB 2008-1). IB 94-1 corrected a misperception that investments in ETIs are incompatible with ERISA's fiduciary obligations. On Oct. 17, 2008, the department replaced IB 94-1 with IB 2008-01. However, the department has now concluded that in the seven years since its publication, IB 2008-01 has unduly discouraged fiduciaries from considering ETIs and environmental, social and governance ("ESG") factors under appropriate circumstances.

[61] See http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

> *In all jurisdictions, investment decisions will not be assessed with the benefit of hindsight, but against reasonable standards of decision-making taking into account the information available to the decision maker at the time of the decision. Provided that all relevant considerations have been taken into account, the weight that the decision-maker gives to each consideration or category of consideration is left to the discretion of the investment manager alone.*

This report has been updated in 2015 with a broader survey of countries (this time the survey covers Australia, Brazil, Canada, European Union, German, UK, Japan, South Africa, and the US) to identify measures taken and barriers preventing investors from systematically integrating ESG into investment decisions as part of their fiduciary duty.[62] The report concludes that the key challenges are the following:

- Outdated perceptions about fiduciary duty and responsible investment. This is particularly the case in the United States where lawyers and consultants too often characterize ESG issues as non-financial factors.
- A lack of clarity within prevailing definitions of fiduciary duty about what ESG integration means in practice and, in particular, whether active ownership and public policy engagement form part of investors' fiduciary duties.
- Limited knowledge of the evidence base for responsible investment, including the strength of the relationship between ESG issues and investment performance.
- Lack of transparency on responsible investment practices, processes, performance and outcomes, limiting investors' accountability to their beneficiaries, their clients and wider society.
- Inconsistency in corporate reporting, including inadequate analysis of the financial materiality of ESG issues, making it hard to assess investment implications.
- Weaknesses in the implementation, oversight and enforcement of legislation and industry codes on responsible investment.

The report therefore makes the following policy related recommendations some of which are clearly moving forward as cited above:

- Clarify that fiduciary duty requires investors to take account of ESG issues in their investment processes, in their active ownership activities, and in their public policy engagement.
- Strengthen implementation of legislation and codes, clarifying that these refer to ESG issues, and require investor transparency on all aspects of ESG integration, supported by enhanced corporate reporting on ESG issues.
- Clarify the expectations of trustees' competence and skill and support the development of guidance on investor implementation processes, including investment beliefs, longterm mandates, integrated reporting and performance.
- Support efforts to harmonise legislation and policy instruments on responsible investment globally, with an international statement or agreement on the duties that fiduciaries owe to their beneficiaries. This statement should reinforce the core duties of loyalty and prudence, and should stress that investors must pay attention to long-term investment value drivers, including ESG issues, in their investment processes, in their active ownership activities, and in their public policy engagement.

Related to the concept of fiduciary duty is the responsibility of an investment manager for voting on corporate issues when they have the ability to exercise the ownership rights of the investor. This is becoming more important as an increasing number of issues related to environmental, social and governance issues are being put on proxy ballots in companies. A recent analysis of shareholder proposals in the US by Ernst and Young found that shareholder proposals on environmental and social topics represented 42% of all shareholder proposals in

[62] See http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf

2015 compared to 46% in 2014 and 39% in 2013 with the most common issues related to political spending/lobbying, climate change/sustainability, corporate diversity, and labor/human rights.[63] The report notes the increased focus on engagement with companies by key institutional investors such as BlackRock and State Street.

The role of institutional investors is generally governed by Stewardship Codes that have proliferated in recent years. Following the development of the UK Stewardship Code in 2010[64], stewardship codes have developed in, among other countries, the Netherlands (2011), South Africa (2011), Italy (2013), Switzerland (2013), Japan (2014), Hong Kong (2015). Largely similar the stewardship codes generally suggest a set of processes for institutional investors similar to the UK code which calls for the following:

- Principle 1 – Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities
- Principle 2 – Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed
- Principle 3 – Institutional investors should monitor their investee companies.
- Principle 4 – Institutional investors should establish clear guidelines on when and how they will escalate their activities
- Principle 5 – Institutional investors should be willing to act collectively with other investors where appropriate
- Principle 6 – Institutional investors should have a clear policy on voting and disclosure of voting activity
- Principle 7 – Institutional investors should report periodically on their stewardship and voting activities

A critique of these codes however is that they do not suggest how to achieve a long term orientation in investments and do not have any binding effect on the signatories.[65]

A final aspect that can be considered under the heading of sustainable investment is that of sustainable investment indices. These indices are taking on more importance as the arbiters of what counts as sustainability. The two most prominent indices are the FTSE4Good Index and the Dow Jones Sustainability Index. The attraction for companies is to be included in such indices as a means to recognize their sustainability credentials which makes them more attractive to investors. Another potential justification may be a financial option that effectively accrues in the form of a "halo effect" which turns into a monetary benefit when engaged with regulatory authorities.[66] Thus, these indices are also becoming a form of soft law standard particularly as they are used to create investment products (e.g. ETFs) composed of the constituent companies. However, there are potential governance issues in how the indices are constructed by private firms and also an inherent tension in that the indices themselves are a financial product whose price becomes disconnected from any given pro-sustainability actions by the companies.[67] It remains to be seen whether they can be liability claims where a company does not live up to its sustainability reputation or the product does not perform with the expected return.

[63] See http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015
[64] https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx
[65] http://corpgov.law.harvard.edu/2015/09/24/is-institutional-investor-stewardship-still-elusive-2/
[66] For a recent study see http://www.economist.com/news/business/21656218-do-gooding-policies-help-firms-when-they-get-prosecuted-halo-effect
[67] See, The Green Economy Paradox: A Critical Inquiry into Sustainability Indexes, Oren Perez (2015) for such a critique - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2653687

Pressure Point 3

Disclosure Standards

Transparency and disclosure have always been core components in the financial regulatory framework. They have taken on new importance after the financial crisis where a number of the regulatory requirements introduced have greater transparency and disclosure as their underlying objective. This can be seen, for example, in the efforts to improve bank financial reporting overall through the efforts of the Enhanced Disclosure Task Force (EDTF) [68] as well as more targeted measures such as the transaction reporting that is one component of the G20 commitment to regulate the OTC derivatives sector.[69] The EDTF is of particular interest given that is the model for the new Task Force on Climate-Related Financial Disclosures launched by the G20 to develop voluntary, consistent climate-related finance risk disclosures.[70]

While not part of the core financial regulatory framework yet, there are a number of developments related to disclosure and transparency on sustainability related topics that impact financial firms and their corporate clients. Some of these are more general in nature and thus analogues to the EDTF work while others are targeted in application similar to the OTC derivatives transaction reporting. In addition, some developments are driven by specific legislation and regulation while others are driven by industry efforts or market infrastructure such as stock exchanges. The following will provide a general overview of some of the main requirements and suggest some potential future trends and their legal implications.

While not a formal accounting or financial statement requirement, most firms now produce some form of sustainability reporting.[71] These reports are produced according to reporting framework standards that effectively define what should be reported and how it should be presented. The most commonly used reporting framework is that of the Global Reporting Initiative (GRI), a non-profit organization founded in 1997.[72] The GRI was established by two US non-profits (the Coalition for Environmentally Responsible Economies (CERES), and the Tellus Institute)[73] to promote universal and standardized sustainability reporting.

The Guidelines offer guidance for the preparation of sustainability reports, regardless of the organization's size, sector or location. They have been developed since 2000 in a worldwide multi-stakeholder process involving representatives and experts from a wide variety of sectors and industries. The third set of guidelines (termed G3 and released in 2006) introduced sector-

[68] The Enhanced Disclosure Task Force is a private sector group of senior officials and experts representing financial institutions, investors and analysts, credit rating agencies, and external auditors with the objective to (i) develop principles for enhanced disclosures, based on current market conditions and risks, including ways to enhance the comparability of disclosures, and (ii) identify leading practice risk disclosures presented in annual reports. Its recommendations are reported to the FSB http://www.financialstabilityboard.org/source/edtf/

[69] See, for example, the latest progress report on the implementation of OTC derivative reforms produced by the Financial Stability Board http://www.financialstabilityboard.org/2015/07/progress-in-implementing-otc-derivatives-market-reforms/

[70] For more details on this new initiative see here https://www.fsb-tcfd.org/

[71] Analysis by the Governance & Accountability Institute found that while only 19% of the S&P 500 companies produced a corporate responsibility or sustainability report in 2011 by 2014 72% of the S&P 500 companies were doing so. This figure is likely comparable in the EU and other jurisdictions and will increase based on some legislative requirements that will be discussed. http://www.ga-institute.com/nc/issue-master-system/news-details/article/flash-report-seventy-five-percent-75-of-the-sp-index-published-corporate-sustainability-rep.html?tx_ttnews%5BbackPid%5D=1&cHash=9070e24b5e019ba79002c6dbc46987b3

[72] https://www.globalreporting.org/information/about-gri/what-is-GRI/Pages/default.aspx

[73] CERES (http://www.ceres.org/) is a NGO advocating for sustainability leadership with the purpose of mobilizing investors, companies (specifically business leadership) and public interest groups to build a sustainable global economy. The Tellus Institute (http://www.ceres.org/) is an interdisciplinary research and policy NGO, promoting the transition to a sustainable and equitable economy.

specific reporting guidelines. The Global Reporting Initiative's latest reporting guidelines, G4[74], were released in May 2013. Among the most important changes included in G4 are a requirement to include information on why certain disclosures (e.g. greenhouse gas emissions) are relevant to the organization (i.e. a materiality requirement) and to outline whether and how an organization's board of directors monitors sustainability matters.

In general such reporting is still voluntary.[75] However, such reporting is becoming a formal requirement through individual initiatives[76]. This effort began in part with the establishment of the Sustainable Stock Exchanges (SSE) initiative in 2009 through the joint efforts of the UN-supported Principles for Responsible Investment, the UN Conference on Trade and Development, UN Environment Program Finance Initiative, and UN Global Compact.[77] The SSE offers a global platform for stock exchanges to demonstrate leadership and understanding of the sustainability-related opportunities and challenges facing the capital markets today. The SSE members (which now include most major exchanges including the NYSE, Nasdaq, LSE, Deutsche Borse) commit to encourage responsible investment and enhanced environmental, social, and governance (ESG) disclosure and performance reporting among listed companies.

Spurred on in part by the efforts of the SSE, the World Federation of Exchanges (WFE)[78] discussed at its October 2013 annual meeting a joint proposal from the New York Stock Exchange and the NASDAQ OMX on mandatory environmental, social and governance (ESG) listing standards. While not adopted, this led to the formation of a dedicated working group in March 2014. This working group published its most recent report in July 2015 with the results of a survey of WFE members that found the following developments related to sustainability reporting requirements[79]:

- Thirty seven percent of exchanges (21 out of 56) require listed companies to disclose at least some ESG information, whether on a mandatory or voluntary basis, which goes beyond corporate governance criteria. Most exchanges make disclosure voluntary.
- Exchanges are in charge of gathering and maintaining disclosure records more often than their local regulators.
- At least 22 sustainability- and ESG-related indices have been launched by WFE members as exchanges respond to growing investor demand. Four new ESG indices were launched in 2014 and five exchanges are seeking to launch them.

As a supplement to the GRI and in recognition that the GRI definition of materiality goes beyond that of the US SEC in terms of what should be contained in a report, a new organization was created to develop specific guidance for sustainability reporting that would meet the US regulatory requirements on materiality. The Sustainability Accounting Standards

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[74] The G4 standards are available here https://www.globalreporting.org/standards/Pages/default.aspx with the sector specific supplements here https://www.globalreporting.org/standards/sector-guidance/sectorguidanceG4/Pages/default.aspx

[75] For the potential for legal action against companies for social responsibility statements and reports on the basis that they are fraudulent statements or false advertisements see *Chevron, Greenwashing, and the Myth of "Green Oil Companies"* Miriam A. Cherry & Judd F. Sneirson, Journal of Energy, Climate and the Environment, Vol. 3, 2012 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1953329

[76] See the compilation of initiatives taken by governments, market regulators and other bodies maintained by the GRI at https://www.globalreporting.org/information/policy/initiatives-worldwide/Pages/default.aspx

[77] http://www.sseinitiative.org/

[78] The World Federation of Exchanges http://www.world-exchanges.org/ is the trade association for the operators of regulated financial exchanges. With 60 members from around the globe, the WFE develops and promotes standards in markets, supporting reform in the regulation of OTC derivatives markets, international cooperation and coordination among regulators. WFE exchanges host more than 45,000 listed companies.

[79] www.world-exchanges.org/insight/reports/exchanges-and-esg-initiatives-%E2%80%93-swg-report-and-survey

Board (SASB)[80] defines and disseminates sector specific sustainability accounting standards that provide guidance on how US public companies and foreign private issuers disclose "material" risks in the Management Discussion and Analysis of Financial Condition and Results of Operations (MD&A) or equivalent section of their annual reports on Forms 10-K and 20-F filed with the SEC. At the SEC's request, SASB meets quarterly with the SEC to brief the regulator on its standards setting process. The SASB is also working with the PCAOB on potential external auditing standards for sustainability disclosures.[81]

The European Union has gone beyond the US by formally requiring non-financial reporting by large corporates. In April 2013 the EU Commission proposed a new directive to amend the Accounting Directive to require large EU companies to provide more transparency and performance on environmental and social matters. The new directive[82], which was adopted by the EU Council after approval by the EU Parliament in October 2014 takes a "report or explain" approach. That is, companies with an average number of employees exceeding 500 during the financial year must either include in its management report or explain why not

> " a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters, including:

- a brief description of the undertakings business model;
- a description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented
- the outcome of those policies
- the principle risks related to those matters linked to the undertaking's operations including, where relevant and proportionate, its business relationships, products, or services which are likely to cause adverse impacts in those area and how the undertaking manages those risks
- non-financial key performance indicators relevant to the particular business.

The Directive must be transposed into national law by December 2016 with applicability to reporting for financial years starting 1 January 2017. According to the European Commission approximately 6000 EU companies will be impacted. By December 2016, the European Commission must prepare non-binding guidelines on methodologies to be used for non-financial reporting. Presumably guidelines that may be recognized include the Global Reporting

[80] See http://www.sasb.org/ .

[81] For a view on potential liability considerations related to sustainability reporting under SEC rules with specific reference to the BP Deep Horizon lawsuits by investors see Matthew Mattila, *Sustainability Reporting and the Law: Practical Considerations for Avoiding Liability* http://www.triplepundit.com/2012/12/sustainability-reporting-law-practical-considerations-avoiding-liability/.

[82] http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1419244851208&uri=CELEX:32014L0095 This directive builds on an approach that was implemented first in France as early as 2001 when the French Loi sur les Nouvelles Regulations Economiques (NRE) required companies to include information on the social and environmental consequences of their activities in their annual reports. This was enhanced in 2010 with the Grenelle II Bill that formally required companies with more than 500 employees to report on commitments to sustainable development and on their environmental, social, and societal impacts of their business activities and to have these statements validated by external auditors. More recently the French Energy Transition Law contains an innovative Article 173 that will require disclosure not only by corporates but also by institutional asset managers on how their investment decision-making process takes ESG criteria into consideration and the greenhouse gas emissions associated with assets owned. For more information see the briefing report from 2 Degrees Investing available at http://2degrees-investing.org/#!/page_Resources

Initiative, the Integrated Reporting (IR) Framework and potential other standards such as the Prince's Accounting for Sustainability Project.[83]

These types of general disclosure requirements are reinforced by the recently updated G20/OECD Principles of Corporate Governance[84] which states that companies are encouraged to publish non-financial information such as environmental and human rights policies and performance. The Principles also refer to the observance of environmental and social standards in the context of board responsibility, as the board is expected to give due consideration to the interests of stakeholders other than its shareholders, including those of employees and local communities. Overall, the Principles recognize the relevance of environmental and ethical concerns in the decision-making process of a company, and thereby reference other instruments such as the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

While the above are examples of general reporting requirements there are also examples of targeted sustainability reporting requirements. Among the more well- known and controversial are the Dodd-Frank Section 1502 and 1504 requirements for disclosure of "conflict minerals" used in supply chains and disclosure of payments to governments by companies in extractive industries. The SEC adopted a section 1502 rule on conflict mineral disclosure in October 2012[85] and a section 1504 rule on payments by companies engaged in the commercial development of oil, natural gas or minerals in August 2012[86]. Both rules were subsequently subject to lawsuits which have complicated their implementation.

The rule on conflict mineral disclosure requires companies to disclose their use of conflict minerals originating from the Democratic Republic of the Congo (DRC) or an adjoining country. Specifically the rule applies to certain minerals including tantalum, tin, gold or tungsten where the minerals are "necessary to the functionality or production" of a product manufactured directly by or under contract for that company. The rule requires companies to first conduct a reasonable "country of origin" inquiry to determine whether its minerals originated in the covered countries. This must be disclosed on SEC Form SD and the company's website. If based on that inquiry the company knows or has reason to believe that its minerals may have originated in the covered countries and the company knows or has to believe the minerals may not be from scrap or recycled sources then the company must undertake "due diligence" on the source and chain of custody and file a Conflict Minerals Report as an exhibit to Form SD. The additional due diligence leads to a statement that the minerals are "DRC Conflict Free", "Not Found to be 'DRC Conflict Free'", or "DRC Conflict Undeterminable". Where a statement of DRC Conflict Free is made this must be supported by an independent audit.

The SEC was sued by the National Association of Manufacturers on the claim that its rule was an unconstitutional violation of free speech by forcing companies to effectively state whether they are using inputs that are conflict free or not. On April 14, 2014, the United States Court of Appeals for the District of Columbia Circuit (the Court) ruled[87] that the requirement for issuers to report whether any of their products have "not been found to be 'DRC conflict free'" did violate the First Amendment. However, the Court upheld the remainder of the Conflict Minerals Rule. Thus, the SEC issued guidance ahead of the first reporting deadline of June 2, 2014[88] stating that while the reporting date would hold issuers would not have to make a statement

[83] See https://www.globalreporting.org/, http://integratedreporting.org/ and https://www.accountingforsustainability.org/ for additional information.

[84] See http://www.oecd.org/corporate/principles-corporate-governance.htm

[85] http://www.sec.gov/rules/final/2012/34-67716.pdf

[86] http://www.resourcegovernance.org/sites/default/files/Final_SEC_Rules_CardinLugar_08222012.pdf

[87] See http://cases.justia.com/federal/appellate-courts/cadc/13-5252/13-5252-2014-04-14.pdf?ts=1411135623 for the initial ruling on April 14, 2014 and http://www.conflictmineralslaw.com/files/2015/08/Conflict-Minerals-Opinion.pdf for the confirmation of the earlier ruling in August 18, 2015.

[88] http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541681994

about whether the minerals are conflict free or not although companies that conclude that the minerals are conflict free were permitted to make that disclosure. Ultimately 1315 companies in 58 industries submitted filings to the SEC in 2014.[89]

The payments rule would have required all companies engaged in the commercial development of oil, natural gas or minerals to annually disclose payments to federal and foreign governments by type and amount for each project and by government for all payments equal to or greater than USD 100 K. This rule was also the subject of a lawsuit by the US Chamber of Commerce. In this case the claim was that the SEC misinterpreted Dodd-Frank by forcing public disclosure of detailed data on payments, and failed to consider associated competitive effects including risks associated with revealing trade secrets and pricing strategies. The plaintiffs also claimed that the SEC failed to include exemptions for countries with laws prohibiting payment disclosure such as China and Qatar. The Court agreed[90] with the plaintiffs and vacated the rule remanding it to the SEC for revised rulemaking. A revised rule is expected no earlier than 2016.[91]

Other jurisdictions have gone ahead with similar requirements. For example, In October 2011, the European Commission issued two proposals to amend the EU's Transparency and Accounting Directives to include a requirement to disclose payments to governments by certain large undertakings and public interest entities engaged in natural resource extraction or logging. The final Directive was approved in June 2013[92]. While several elements of the EU rule are similar to the SEC rule, there are some differences including the scope of companies to which the reporting rules apply. Canada and Australia are also implementing requirements as part of the broader Extractive Industries Transparency Initiative.[93]

It is foreseeable that this may be extended to financial sector participants where they conduct business with such companies. Switzerland provides a potential example of this. In April 2013, the Swiss National Council was asked to consider transparency regulations applicable to commodity companies engaged in the extraction of raw materials and more broadly rules for the commodity sector.[94] A bill was submitted to parliament in November 2014 that would require large and listed companies engaged in extracting minerals, oil, gas, and timber to disclose payments exceeding CHF 120 K per year.[95] The bill did not specifically include commodity traders but did give the Federal Council the option to extend the rule to commodity traders if international regulation develops. The lack of coverage for commodities traders was criticized by several NGOs who in parallel called for a dedicated supervisor for commodity trading and developed a website for a new fictive regulator (called ROHMA) modelled on the current financial sector regulator FINMA.[96] Thus, this illustrates how transparency regulations may spill over to the financial sector.[97]

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[89] In April 2015, NGOs Amnesty International and Global Witness released a report claiming that US companies are failing to verify conflict minerals in their supply chains. The groups reviewed the 2014 regulatory filings (as required under the 2010 Dodd-Frank Act) of 100 companies and found that only 21 percent were following the provision on conflict mineral filings. Only 15 percent had contacted processing facilities they use for their products, and 40 percent had no policy in place to recognize risks.
[90] http://d2zyt4oqqla0dw.cloudfront.net/cdn/farfuture/GGQEQeuqBB0XL7XYvq6ybTdk00cTW5zr3d_pfPjxXkk/mtime:1372783492/sites/default/files/documents/api-v-sec-decision-granting-summary-judgment.7.2.2013.pdf
[91] https://www.complianceweek.com/blogs/the-filing-cabinet/sec-punts-extraction-payments-rule-to-2016
[92] http://www.europarl.europa.eu/news/en/news-room/content/20130607IPR11387/html/Oil-gas-mineral-and-logging-firms-obliged-to-disclose-payments-to-governments
[93] EITI is a global standard to promote open and accountable management of natural resources through disclosure of information related to tax payments, licenses, contracts, production and other key elements around resource extraction which is published in an annual EITI report – https://eiti.org/.
[94] http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20133365
[95] https://www.news.admin.ch/message/index.html?lang=de&msg-id=55451
[96] http://www.rohma.ch/en/
[97] For more on commodities sector regulation globally and in Switzerland see *Background Report: Commodities, Report of the interdepartmental platform on commodities to the Federal Council* (Mar

## Pressure Point 4

### Valuation Aspects

Oscar Wilde famously defined a cynic as someone who knows the price of everything and the value of nothing.[98] In this era of cynicism about the financial sector and markets generally this quote may have particular relevance for sustainability topics. There is significant skepticism about the pricing of certain activities and assets given the potential for mis-valuation due to unpriced externalities. The discussion is most active with regard to the potential for a "carbon bubble" or "stranded assets" in the energy sector but applies more generally to a range of environmental assets where externalities are not priced into their use. In addition, there is a debate about whether so-called "environmental markets" generally will be helpful in providing incentives for more sustainable outcomes or whether the monetization of nature is fundamentally flawed. This section will provide a brief introduction to some of these topics and potential legal implications but will not be able to address them in full detail.[99]

The potential for a "carbon bubble" or "stranded assets" was brought to prominence by the Carbon Tracker Initiative.[100] The basic argument is that in order to limit the rise in global surface temperatures to 2 degrees Centigrade above pre-industrial levels[101], emissions of climate-altering gasses would need to be cut by approximately 80% by 2050. This would essentially mean that up to two-thirds of the proven fossil fuel reserves (coal, oil, natural gas) would not be capable of being used unless there were a means to capture and store the carbon emissions resulting from burning these fossil fuels. Given that carbon capture and storage is still an unproven technology at scale this cannot be counted on. Thus, Carbon Tracker has suggested that the valuations of significant portions of the energy sector, assuming they are based on proven reserves to which the companies have access, are wrong.

When first proposed this argument received significant criticism but has subsequently received validation from mainstream entities. For example, the International Energy Agency has stated that two-thirds of proven reserves will not be accessible if there is a binding global agreement to limit carbon dioxide levels to 450 particles per million which is the best scientific estimate of

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2013) http://www.seco.admin.ch/aktuell/00277/01164/01980/index.html?lang=en&msg-id=48319 The report notes that the Swiss Federal Council expects all companies operating inside or outside Switzerland to conduct themselves responsibly, and with integrity, by complying with human rights, environmental and social responsibility standards, both in Switzerland and abroad. The report has 17 recommendations (see chapter 6) endorsed by the Federal Council to safeguard Switzerland's attractiveness as a business location while also providing greater transparency and continuing the commitment to responsible corporate governance at multilateral and bilateral levels.

[98] "What is a cynic? A man who knows the price of everything and the value of nothing". Oscar Wilde, in *Lady Windemere's Fan* (1892).

[99] The 'Unburnable Carbon' report (http://www.carbontracker.org/report/carbon-bubble/) by the Carbon Tracker Initiative was the original report to pioneer the carbon bubble concept. For additional information related to stranded assets refer to other work by the Carbon Tracker Initiative (http://www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carbon-2-Web-Version.pdf) or the papers published by Oxford University's 'Stranded Assets Programme' (http://www.smithschool.ox.ac.uk/research-programmes/stranded-assets/publications.php) or most recently the Economist Intelligence Unit report *The cost of inaction: recognizing the value at risk form climate change* http://www.economistinsights.com/financial-services/analysis/cost-inaction which estimated a VaR to manageable assets from climate change of USD 4.2 trillion in present value terms.

[100] The 'Unburned carbon 2013: Wasted capital and stranded assets' report "revealed that fossil fuel reserves already far exceed the carbon budget to avoid global warming of 2°C, but in spite of this, spent $674billion last year to find and develop new potentially stranded assets." (see above), while the 'Unburnable Carbon' report discovered, among other things, that only 20% of the total reserves can be burned unabated, leaving up to 80% of assets technically unburnable (see above).

[101] Limiting global warming to 2 degrees Celsius is the internationally-agreed target, at least partially based on the understanding that with temperatures increasing more than 2 degrees, the climate related risks become unacceptably high, i.e. have consequences that exceed greater frequency and intensity of extreme weather and related catastrophic events, e.g. food and water security.

the limit needed to keep the global surface temperature increase to 2 degrees C.[102] Some analysts have estimated that the oil industry alone faces revenue losses of up to USD 28 trillion over a period of two decades and has stranded assets of approximately USD 19 trillion in such a scenario.[103] While many are skeptical that such a global agreement will be reached at the year-end 2015 climate conference in Paris, the fact that the US and China have both announced updated emission targets is evidence that policy shifts are occurring and such a scenario cannot be entirely ruled out.[104]

A number of NGOs and investors have begun to question the fossil fuel industry as a result of this analysis. For example, in September 2013 institutional investors with USD 3 trillion of asset asked the 45 largest quoted oil firms how climate change may impact their business and, in particular, whether they believed any of their oil reserves might become "stranded assets".[105] Most notably Exxon Mobil and Shell responded with a risk assessment that none of their assets were potentially stranded[106]. Their assessments were largely justified with three arguments:

- Growth in world population and income will increase energy demand such that fossil fuels will account for approximately 75% of demand in 2040 and renewables only 5%.
- Governments are not taking actions consistent with a scenario in which carbon emissions are constrained to a level that would meet the 2 degrees C goal and thus this is outside reasonable planning assumptions
- Proven reserves only have an average life in the range of 10 to 20 years and thus will be unaffected by regulatory actions that occur in a timeframe of 20 to 30 years.

The Carbon Tracker group has taken issue with these arguments and suggested that the energy majors are making a fundamental valuation mistake when planning approximately USD 500 billion of capital investment per year with a breakeven point of USD 80 oil price.[107] Ultimately, the question of whether in fact the assets are stranded and the valuations of the energy companies are inflated comes down to both policy action (including changes in the subsidies provided to both fossil fuels and to alternative energy) and market developments (e.g. continued decreases in the price of solar, wind and other alternative energy generation methods towards grid parity).

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[102] See the *International Energy Agency report Energy and Climate Change* (2105) at www.iea.org/publications/freepublications/publication/WEO2015SpecialReportonEnergyandClimateChange.pdf

[103] "We calculate that the net impact of the volume and price effects assumed under the 450S would be to reduce the projected revenues of the global upstream fossil-fuel industry relative to the NPS by USD28 trillion (in constant 2012 USD) over 2013-35. This breaks down as USD19.3trn of lost revenue for the oil industry, USD4trn for the gas industry, and USD4.9trn for the coal industry (again, all in constant 2012 USD)", in: http://www.longfinance.net/images/reports/pdf/kc_strandedassets_2014.pdf.

[104] On 12 November 2014, during an official visit of U.S. President Barack Obama, the US and China released a joint statement announcing their respective post-2020 actions on climate change (http://www.wri.org/news/2014/11/us-china-climate-announcement responding to a previous call by EU leaders to take appropriate actions to address greenhouse gas emissions reduction targets (http://europa.eu/rapid/press-release_STATEMENT-14-1663_de.htm). The US announced the target to cut greenhouse gas emissions between 26 and 28 percent (below 2005 levels) by 2025, while China targets to peak $CO_2$ emissions around 2030 and to increase the share of non-fossil fuel energy to around 20% by 2030.

[105] http://www.economist.com/news/business/21607838-managers-biggest-oil-firms-clash-investors-over-climate-change-elephant

[106] Both Shell (http://s02.static-shell.com/content/dam/shell-new/local/corporate/corporate/downloads/pdf/investor/presentations/2014/sri-web-response-climate-change-may14.pdf) and Exxon (http://corporate.exxonmobil.com/en/environment/climate-change/managing-climate-change-risks/carbon-asset-risk) replied with extensive reports arguing as described in the text above.

[107] http://www.carbontracker.org/wp-content/uploads/2014/09/CTI-Oil-Gas-Majors-Company-Factsheets-August-2014-FULL.pdf

Given the uncertainties involved policy makers have started to look into the question. Most notably Bank of England Governor and FSB Chairman Mark Carney wrote in a letter to the UK Parliament House of Commons environment audit committee in October 2014 that the Bank of England Prudential Regulatory Authority (PRA) would conduct an inquiry into the financial stability risks of fossil fuel companies having significant amounts of stranded assets due to potential future climate change rules.[108] Subsequently the G20 Finance Ministers and Central Bank Governors asked the Financial Stability Board "to convene public and private sector participants to review how the financial sector can take account of climate-related issues" in their April 2015 communique.[109] Most recently Mark Carney spoke about the potential financial stability risks to the financial sector in light of climate change.[110] While the work by the financial regulators is still in an early stage it does illustrate the potential for further regulatory or policy activity particularly in light of the increased use of macroprudential measures to try to address the potential for asset bubbles.[111] Thus, while there may not be direct legal risks currently as a result there is certainly the potential for abrupt changes in asset values due either to specific policy actions or to market anticipation of market actions.

There is an active debate currently on how investors should respond to this emerging thinking under the heading of whether to take a "divestment" or "engagement" approach toward investing in fossil fuel companies. Those favoring divestment, advocated most forcefully by the NGO campaign 350.org[112], argue that if a critical mass of investors refused to own shares or bonds of a company then the reduced demand would raise the cost of capital and force change. In addition, they state that there is broader goal of denying fossil fuel companies the social legitimacy that allows them to effectively lobby against climate change regulation. On the other side are those that argue that divestment will not work as it merely passes the problem on to a new owner of the assets. Thus, they argue for engagement whereby fossil fuel companies are encouraged to support investment in cleaner technologies and alternative energies.[113]

The proponents of divestment cite the historical precedent related to the boycott of South African firms in the 1980s to protest against apartheid. To date more than 220 cities and institutions have decided to divest at least some of their holdings from the fossil fuel sector.[114] A

[108] Letter from Mark Carney, Governor of the Bank of England to House of Commons Environmental Audit Committee, 30 October 2014, (http://www.parliament.uk/documents/commons-committees/environmental-audit/Letter-from-Mark-Carney-on-Stranded-Assets.pdf).

[109] https://g20.org/wp-content/uploads/2015/04/April-G20-FMCBG-Communique-Final.pdf

[110] See the speech here http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx and the associated report of the impact of climate change on the UK insurance sector here http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf

[111] In Switzerland, the Federal Council was asked to state how it is addressing the potential risks of a carbon bubble http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20143234. In its response issued in May 2014, the Federal Council noted that the impact of any potential carbon bubble depends to a large degree on how the international policy framework around climate change develops. Given uncertainties there the Federal Council stated that it is too soon to assess the risk for the Swiss financial sector but that the issue was important and should continue to be monitored. Interestingly, Switzerland is often cited as a country that has made successful use of macroprudential measures to help address the potential for asset bubbles in its housing market. See, e.g., the document prepared by the IMF as part of the its Financial Sector assessment of Switzerland – *Switzerland: Technical Note-Macroprudential Institutional Arrangements and Policies* (Sep 2014) https://www.imf.org/external/pubs/ft/scr/2014/cr14269.pdf and more generally a working paper from the US Federal Reserve, Akinci, Ozge, Olmstead-Rumsey, Jane (2015). *How Effective are Macroprudential Policies? An Empirical Investigation*. http://dx.doi.org/10.17016/IFDP.2015.1136

[112] http://www.350.org/

[113] For more on pros and cons of divestment as an approach see the *Journal of Environmental Investing* 6, No. 1 (2015) which devoted an entire issue to the topic. For one institution's specific considerations see the report published by the Expert Group to advise the Norwegian pension fund on how to proceed https://www.regjeringen.no/contentassets/d1d5b995b88e4b3281b4cc027b80f64b/expertgroup_report.pdf

[114] See, *Divestment Campaigns: Fight the Power*, Economist (27 June 2015) pp 62-64.

recent report from Mercer consultancy stated that average annual returns from coal could fall anywhere between 18% and 74% over the next 35 years due to climate change regulation and that therefore eliminating this potential risk would be compatible with fiduciary duty.[115] This may be something that does have legal implications given potentially revised notions of fiduciary duty where asset managers and advisors may be required to consider a broader range of environmental factors when choosing investments for clients particularly where such asset managers and advisors have made public commitments on climate change themselves in terms of reducing their own emissions.[116]

The discussion around stranded assets and a potential carbon bubble is one element of a broader topic around natural resource pricing and investment. Following the adage of what gets measured, gets managed there has been a developing interest in the need for better pricing and the organization of dedicated markets for natural resource use and environmental externalities.[117] This includes not only carbon, but also water, forests, and ecosystems more generally.[118] The goal is to find ways to recognize the beneficial aspects of natural assets that have not historically been priced and to turn them into income streams that will encourage investment.

One specific instrument used is what has been termed a "green bond". These are essentially bond instruments where the proceeds of the bond issue are tied to some form of environmentally friendly investment (e.g. building wind farms or less polluting infrastructure). Initially sold by the World Bank, such bonds have rapidly expanded to not only other public sector financing bodies but also private corporates (e.g. GDF Suze, a utility, issued the largest private sector bond to date at USD 3.4 billion) as well. The Climate Bonds Initiative is a research group that attempts to track the market size and have estimated that there were around USD 37 billion of bonds issued at the end of 2014 and approximately USD 19 billion issued in the first half of 2015 (out of a total bond market of approximately USD 80 trillion).[119] Investors are

[115] The complete Mercer report (Investing in a time of climate change) can be found here: http://www.mercer.com.au/services/investments/sustainable-growth/climate-change-report-2015.html
[116] See, e.g., *Are Firms and Managers at Risk When Contributing to Climate Change?* Olivier Jaeggi and Simon Hutter, MIT Sloan Management Review (Sep 2014) http://sloanreview.mit.edu/article/are-firms-and-managers-at-risk-when-contributing-to-climate-change/ and Are countries legally required to protect their citizens from climate change? http://sustainability.thomsonreuters.com/2015/07/22/executive-perspective-are-countries-legally-required-to-protect-their-citizens-from-climate-change/ for a description of the recent Dutch court decision that the Dutch government must act faster in its duty to protect its citizens against the effects of climate change.
[117] The NGO Trucost estimated that the cost of the environmental damage from the world's 3000 largest publicly-listed companies amounted to USD 2.15 trillion in 2008 and that the top 100 externalities of business in 2009 had unpriced natural capital costs of USD 7.3 trillion. See, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* (2011) http://www.trucost.com/published-research/43/universal-ownership-why-environmental-externalities-matter-to-institutional-investors-full-report and *Natural Capital at Risk: The Top 100 Externalities of Business* (2012) http://www.trucost.com/published-research/99/natural-capital-at-risk-the-top-100-externalities-of-business
[118] See generally the resources available on the Ecosystem Marketplace for an overview on environmental markets http://ecosystemmarketplace.com/ and particularly the survey documents on carbon markets http://forest-trends.org/releases/p/ahead_of_the_curve_state_of_the_voluntary_carbon_markets_2015, water Investments http://forest-trends.org/dir/sowi_2014/ and biodiversity markets http://www.ecosystemmarketplace.com/pages/dynamic/resources.library.page.php?page_id=7491§ion=our_publications&eod=1 For a critical review of payments for environmental services and a selection of case studies showing that the sustainable provision of environmental services is mostly ensured through the creation of markets for environmental goods that create business opportunities via private sector investment, innovative local entrepreneurs and an enabling public sector, see *The Sustainable Provision of Environmental Services: From Regulation to Innovation*, Philipp Aerni, Springer Publishing (August 2015). http://www.springer.com/de/book/9783319193441?countryChanged=true
[119] https://www.climatebonds.net/

often pension funds that are exposed to climate risks and can use green bonds as a means of diversification as well as showing a commitment to climate change short of divestment.

One key support needed for further growth in the market is standardization of product terminology and structure. To encourage this a group of 13 banks established a set of shared principles, the Green Bond Principles, to govern different categories of bonds in January 2014. This effort has now attracted more than 130 institutions acting in the capacity of investors, issuers, or underwriters. The effort is now supported by the International Capital Market Association trade group.[120] As the market has matured further supporting infrastructure has developed including the first green-bond indices issued by MSCI and S&P.[121] However, there will be questions of what counts as a green activity (e.g. is nuclear power green?) and a need for systematic rating criteria. In addition there may be unique risk factors and liabilities associated with green bonds given their connection to policy developments (e.g. climate regulation as noted above) and environmental topics (e.g. the EU Environmental Liability Directive ).[122]

Green bonds are related to a broad set of activities that include what some have described as the "conservation finance" sector and suggest may be a market on the order of USD 200-300 billion.[123] As described by Credit Suisse, McKinsey and WWF this market includes:

- *Investments in underlying ecosystems with the goal of capital protection*: the acquisition of forests, freshwater, or deserts, or usage rights tied to a long-term conservation commitment with the option to recover the principal, or to serve as collateral for further financing. Attention must be given to traditional use rights of local and indigenous people to prevent undue expropriations.
- *Investments in the infrastructure and sustainable management of ecosystem services to achieve financial returns*: these investments can create economic value under the constraint of conservation, for example with lodges and trails to foster ecotourism or solar arrays for power generation. Ecosystem services (such as watershed protection) and goods derived from sustainable forestry, agriculture, or aquaculture can also provide cash flows. Such cash flows depend on regulatory requirements or certifications.
- *Investments in ecosystem market and regulatory mechanisms to enhance returns*. These are financial instruments such as securities and derivatives and corporate intermediaries leveraging regulatory requirements. Examples include voluntary or mandatory offsets, subsidized power production, or permit and rights issuance and trading.

In many ways the legal issues involved in this emerging market or asset class will be similar to those in the known infrastructure asset class or the securitization markets. However, there may be novel issues as well given the public interest involved and the role governments have had in regulating resource access and use. Thus, there may be a need for enhanced due diligence, clear standards for lender and investor liability, and "safe harbors" or other policy measures to mitigate legal risk when investing in such assets. When developing these market opportunities further specialized legal skills may be required by those experienced in conservation and environmental legal issues.

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[120] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/
[121] https://www.msci.com/esg-indexes and http://us.spindices.com/indices/fixed-income/sp-green-bond-index
[122] See, e.g., the report from the 2 Degrees Investing Initiative *Shifting Private Capital Towards Climate-Friendly Investments: The Role of Financial Regulatory Regimes* for the policy framework and risk factors in green investments. www.2degrees-investing.org/IMG/pdf/2deg_policy_framework_working_paper_v0.pdf and the CEO Briefing from the UNEP Finance Initiative *Demystifying Materiality: Hardwiring biodiversity and ecosystem services into finance* for a similar treatment of ecosystem investments. http://www.unepfi.org/fileadmin/documents/CEO_DemystifyingMateriality.pdf
[123] See, e.g., the 2014 Conservation Finance Research Report by Credit Suisse, WWF, and McKinsey available at www.credit-suisse.com/pt/en/about-us/corporate-responsibility/banking/environment/microfinance/conservation-finance.html

Conclusion

This article has attempted to provide a guide to understanding pressure points from emerging sustainability related legal and regulatory developments for the financial sector. Given the broad scope of issues related to sustainability it should not be a surprise that pressure points manifest themselves across the full scope of a financial firm's activities particularly as many have some or all of the following activities in their current business mix[124]

- *Impact / values based investing and philanthropy advice and services* in the wealth management and private banking businesses
- *Socially and/or environmentally responsible investment funds* and sustainability thematic funds (e.g. water, clean energy) in the asset management businesses
- *Alternative energy, environmental finance, climate change and other sustainability related solutions (e.g. green bonds*) in the investment banking and corporate banking businesses
- *Environmental, social and governance (ESG) research teams* in investment banking sell side teams and in wealth management and private banking to provide recommendations to private clients
- *Dedicated programs to support small and medium sized enterprises and other sustainability products (e.g. green mortgages*) in corporate and retail banking
- *Environmental and social risk management processes across all business lines to perform due diligence* on clients and transactions as part of broader reputation risk management activities
- *Corporate responsibility and sustainability management processes* including stakeholder (e.g. NGO) relations and corporate level disclosures according to defined standards (e.g. Global Reporting Initiative)
- *Community affairs and other corporate philanthropy activities including memberships* in key sustainability related global initiatives (e.g. UN Global Compact, Clinton Global Initiative, UN Environmental Program Finance Initiative, World Business Council on Sustainable Development)

At some point, the notion of sustainability should fade as the relevant issues and themes are embedded fully into strategy and operations. This is an evolutionary journey as a majority of global CEOs across continents and industries indicate sustainability issues are critical to future success of their business.[125] The financial sector is currently travelling this path as well.[126]

[124] See corporate responsibility / sustainability reports of UBS https://www.ubs.com/global/en/about_ubs/corporate_responsibility.html, Deutsche Bank https://www.db.com/cr/en/docs/Corporate_Responsibility_-_Report_2014.pdf and HSBC http://www.hsbc.com/~/media/hsbc-com/citizenship/sustainability/pdf/140519-hsbc-sustainability-report-2013.pdf. In some cases, firms have issued separate reports outlining their sustainable investment products and services, https://www.db.com/cr/en/responsible-business/sustainable-products.htm)

[125] See the third survey of global CEOs conducted by Accenture and the UN Global Compact in 2013 https://www.accenture.com/sk-en/insight-un-global-compact-ceo-study-sustainability-2013 which found 63 percent of CEOs expect sustainability to transform their industry in five years and 76 percent believe that embedding sustainability into core business will drive revenue growth and new opportunities.

[126] See, e.g., strong growth rates of sustainable business models such as those firms in the Global Alliance for Banking on Values http://www.gabv.org/. Institutional investors also are focusing more on these issues out of fiduciary duty obligations or risk management strategies - e.g., see the publication *21st Century Engagement: Investor Strategies for Incorporating ESG Considerations into Corporate Interactions* co-published by Blackrock and Ceres. http://www.blackrock.com/corporate/en-us/literature/publication/blk-ceres-engagementguide2015.pdfwhich which outlines a range of approaches by 37 firms across six countries. See also *Banking on Shared Value: How Banks Profit by Rethinking Their Purpose* for an overview of actions in the banking sector http://sharedvalue.org/banking-shared-value following the shared value concept outlined by Harvard Business School professor Michael Porter.

In the interim, the importance of embedding sustainability into the core business may have even more importance for the financial sector than others. The combination of the financial crisis, the sovereign debt crisis, the continued slow recovery, and high profile losses and corporate misbehavior continue to create skepticism about the role of the finance sector particularly in the western developed economies.[127] While the core financial regulatory reforms attempt to address this skepticism none of them touch sustainability topics.[128] This may be a task for the industry itself as being part of sustainability solutions and returning to a role as facilitator of the real economy may be part of how the sector restores trust.[129]

There are groups that suggest more proactive action by the industry to head off the need for such developments.[130] Some of these focus on specific issues (e.g. the Equator Principles group on project finance investing[131]) while others are done in industry collaborations (e.g. WWF Sustainable Finance initiative, World Business Council on Sustainable Development, World Economic Forum Role of Financial Services in Society[132]) or take a sector wide perspective (e.g. G30 program on long term finance; UNEP Inquiry into the Design of Sustainable Financial System[133]). Without proactive action it may be the case there will be further regulatory responses with impact on direct business strategy and operations.[134] Thus, it is important for financial services firms and their legal advisors to start to come to grips with the issues as the regulatory environment and legal system evolve[135] to reflect sustainability concerns and to build out the structures and processes to ensure firms understand and respond to the issues.

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[127] See, e.g., the 2015 Edelman Trust Barometer http://www.edelman.com/2015-edelman-trust-barometer/in which the financial industry ranks as the least trusted industry, with only 54% of .the respondents to the survey trusting to the financial services industry as a whole.

[128] And in fact some miss an opportunity to do so – see, e.g., the US Department of Labor Fiduciary Duty standard and the MiFID 2 investor protection standards neither of which takes up the broader notion of fiduciary duty that suggests a need to consider environmental, social and governance aspects when making investments or, e.g., revisions to the Basel Accords which while seeking to address gaps in risk assessment make no attempt to consider the need for mandatory environmental and social risk assessments despite some individual countries (e.g. Brazil) now mandating this for their banking sectors..

[129] See, e.g., statements by Mark Carney www.bis.org/review/r140528b.htm and Christine Lagarde www.imf.org/external/np/speeches/2014/052714.htm at the Fair and Inclusive Capitalism conference

[130] For an attempt to catalogue these efforts see the Renewing Capitalism work at the Cranfeld University Doughty Centre on Corporate Responsibility which outlines more than 30 such initiatives http://www.som.cranfield.ac.uk/som/p20852/Research/Research-Centres/Doughty-Centre-Home/Research/Renewing-Capitalism

[131] http://www.equator-principles.com/

[132] http://www.wbcsd.org/home.aspx, http://www.weforum.org/projects/role-financial-services-society, http://wwf.panda.org/what_we_do/how_we_work/key_initiatives/transforming_china/sustainable_finance

[133] http://www.group30.org/rpt_65.shtml, http://web.unep.org/inquiry The latter is of particular relevance given its comprehensive survey of legal, regulatory and policy measures and recommendations (see appendix) made for action in the final study report *The Financial System We Need: Aligning the Financial System with Sustainable Development* (Oct 2015) - http://web.unep.org/inquiry/publications

[134] See, e.g., examples such as the New York City Responsible Banking Act, which created an 8 member Community Investment Advisory Board (CIAB) charged with collecting data on community lending from the 21 commercial banks eligible to receive some of New York City's USD 150 billion in annual deposits with the goal of developing benchmarks and best practices related to topics such as investment in affordable housing, policies toward foreclosures, and general product and service offerings. The CIAB was charged to produce an annual report which would be considered by the City's Banking Commission in designating eligible deposit banks. The Act was subsequently struck down by the US District Court for the Southern District of New York in August 2015 on the basis that it was preempted by federal and state banking law. However, a number of cities and states have similarly intended statutes on the books. For more information see https://www.sullcrom.com/court-strikes-down-new-york-city-responsible-banking-act-as-preempted-by-federal-and-state-banking-laws

[135] See, e.g., *The Role of Business Law in the Jigsaw puzzle of Sustainability*, University of Oslo Faculty of Law Legal Studies Research Paper 2015-20 for proposals for an evolution of corporate law in the EU based on Article 11 of the Treaty on the Functioning of the European Union to provide an explicit company law requirement to consider sustainability issues or the growth of B corporations in the U.S.

# Appendix

## Recommendations from UNEP Inquiry Into the Design of a Sustainable Financial System final report *The Financial System We Need: Aligning the Financial System with Sustainable Development* (Oct 2015)

### Fig 16 International Cooperation Across Specific Asset Pools and Actors

| Area | Description |
|---|---|
| *Incorporate systemic environmental risks within global banking standards* | Building on growing national practice, there is now a case for the articulation of how systemic environmental risks affect international banking standards, notably through the Basel Accords. This could be advanced through a leadership of national banking authorities and commercial banks working with the Bank forInternational Settlements (BIS) and other key bodies to evaluate the critical linkages and policy implications. |
| *Develop an international code on investor duties and sustainable development* | A growing numbers of countries istaking action to encourage and direct institutional investors such as pension funds to include material sustainability factors into their investment activities. An international code would help to crystallize good practice and provide a platform for wider adoption of higher standards. This could be developed through a combined working group of leading institutional investors and pension regulators, working closely with the International Organisation of Pension Supervisors, the OECD and the World Bank. |
| *Establish a green capital markets coalition of investors and governments* | Efforts to harness debt and equity capital markets for green investment have accelerated rapidly. However there is no common platform to ensure convergence of standards and to drive essential cross-border cooperation so that global bond and equity markets can most effectively raise capital to serve sustainable development. This could be initiated through a leadership group that captures the full ecosystem, including issuers, credit ratings, development banks, institutional investors and independent agencies such as the Climate Bonds Initiative. |
| *Introduce guidance for regulators and supervisors on sustainable insurance markets* | Considerable progress has been made to broaden access to vital insurance products. The next step is to build on this practical experience to ensure that critical environmental and sustainability risks are effectively incorporated into the implementation of the international Insurance Core Principles. A key element for success would be a leadership group of supervisors at the national level who have started to address environmental risks (such as climate change), working closely with the IAIS and the A2ii. |

### Fig 17 International Cooperation in Advancing Governing Architecture

| Area | Description |
|---|---|
| *Principles for a Sustainable Financial System* | The global financial system is governed by soft law principles and standards – but none exist for the advancement of sustainable development. Developing such principles could provide broad orientation to financial system rule-setting and development, and moreover could inform governing mandates of national and international bodies with financial system stewardship roles. Such principles could be developed under the auspices of the G20, or through and with a group of leading experts and practitioners. |
| *Convergence in sustainability disclosure standards* | The need for enhanced transparency cuts across institutions, markets and sectors. Progress has been made, but now is the time for an international task force to accelerate convergence and broader adoption, learning lessons from G20-related initiatives such as the Enhanced Disclosure Task Force. While disclosure is needed across all asset pools, a focus on harmonization across stock exchanges might make most progress initially, with a second focus on institutional investors. |
| *Sustainability stress test methodologies* | Bringing future shocks into today's decisions is critical in overcoming the "tragedy of horizons" in factoring sustainable development into financial decision-making. Now is time to pool resources and begin to build connectivity between different initiatives and approaches. Such a task force approach might include the Bank for International Settlements and the Financial Stability Board and other key standards institutions, as well as financial institutions themselves and selected reporting initiatives. |
| *Optimization of fiscal measures in the financial system* | There is no baseline understanding of the sustainable development impacts of public finance, in effect, the subsidies that accrue to financial institutions, or otherwise influence financial decision-making. It is only recently, for comparative purposes, that fossil fuel, and more broadly, energy subsidies have become more visible and treated a mainstream policy issue. Establishing a review process of the sustainability impacts of public financing associated with the financial sector might well reveal significant opportunities for enhancing such impacts through the realignment of some public financing flows. |
| *Sustainable financial system performance framework* | Work is needed to build on the Inquiry performance framework, relevant to the development of a sustainable financial system. In order for environmental aspects to be included in international peer review and assessment processes, such as the IMF/World Bank's Financial Sector Assessment Program (FSAP) they would have first to be codified into some an international standard and the data required to operationalize approach would need to be developed lacking at a country level. |