
Regulatory Update:

Sustainability Regulation

Corporate Governance Reform

The Wates Code

UN PRI Fiduciary Duties Project

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Sustainability Regulation in Europe

Background

- May 2018: European Commission proposed a package of measures (inspired by Paris Agreement targets):
 - requirement for asset managers to take sustainability decisions into account in their investment decision-making
 - a taxonomy for environmentally sustainable investment products to create unified standards and avoid “greenwashing”
 - low and positive carbon benchmarks [text now agreed]
- July 2018: Commission request to ESMA and EIOPA for advice on changes to UCITS, Solvency II, MiFID II, IDD and AIFMD
- March 2019: European Parliament agreed text on the disclosures to be given by firms on the integration of sustainable investments and sustainability risks in their investment process (the “Disclosure Regulation”)
- Expected implementation in 2021

Scope of the Regulation

- Relevant “financial market participants” and advisers must publish / disclose information on how “sustainability risks” are incorporated into their investment decision-making process and the impact on returns (where relevant)
- “Financial market participant”: broadly defined and includes AIFMs, MiFID portfolio managers and managers of EuVECA and EuSEF funds, and most regulated EU investors
- “Sustainability risk” means an “ESG event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact.”

Scope of the Regulation (cont'd)

- In addition:
 - Firms that consider “principal adverse impacts of investment decisions on sustainability factors” must publish details of due diligence processes
 - Firms that do not, must explain why, give clear reasons for not doing so and indicate if and when they intend to consider such factors
 - Comply or explain not available for large firms
- Sustainability factors: “environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters” (Note: no requirement to affect value)

Scope of the Regulation (cont'd)

- Additional disclosure required where a financial product has sustainable investments as its objective
- “Sustainable investments”: broadly defined as investments in an economic activity that contribute to an environmental or social objective, and which follow “good governance practices”
- [Detailed] disclosure requirements (yet to be defined)

Remuneration Policies

- Firms in scope of Regulation must include in their remuneration policies information on how their policies are consistent with the manner in which they take into account sustainability risks
- Firms must publish this information on their website
- This provision does not tie remuneration awards to the firm's overall sustainability achievements

Changes to MiFID

- Proposed changes to MiFID to require investment firms to:
 - incorporate ESG risks in their risk management procedures
 - consider ESG preferences for product governance purposes
 - ask their clients about their preferences concerning sustainability issues and to take any such preferences into account

Changes to AIFM Directive

- ESMA has recently published technical advice to Commission on how sustainability risks should be incorporated into AIFMD operating requirements
- AIFMs will be required to take into account sustainability risks in their procedures for internal decision-making and resolving conflicts of interest
- Principles-based proposals welcomed by industry

Changes to AIFM Directive (cont'd)

- AIFMs must, where required to consider the “adverse” impact of their investment decisions on “sustainability factors” under the Regulation, develop engagement strategies (such as the use of voting rights to influence a company’s strategy) to apply sustainability factors at investee companies
- The proportionality principle — that takes account of a firm’s size, scale and nature of its activities — applies to these new requirements

UK Corporate Governance Reform and the Wates Principles

Corporate Governance Rules for Large UK Companies

- New corporate governance reporting requirements for large companies
- Apply for reporting periods from 1 January 2019 (so first reports in 2020)
- Coincide with new corporate governance principles for large private companies (the “Wates Principles”)

The Regulations: Overview of New Requirements

- Section 172(1) statement (large companies)
 - Statement in strategic report
 - Describe how directors considered factors in s172(1) Companies Act 2006 when carrying out duty to promote success of the company
- Employee engagement (>250 employees)
 - Additional disclosure on how directors have engaged with employees and had regard to employees' interests
- Corporate governance statement (very large companies)
 - Statement in directors' report
 - Identify corporate governance code, explain how applied or departed (“comply or explain”)
 - Could choose Wates Principles as corporate governance code

The Wates Principles

- Wates Corporate Governance Principles for Large Private Companies
- Final Principles published 10 December 2018
- Recognise “one-size-fits-all” approach is not appropriate: high-level approach
- Six principles and related guidance
- “Apply and explain” approach
 - Supporting statement for each principle in directors’ report and on website: how corporate governance processes operate and achieve desired outcomes
- Focus on employees as key stakeholder to be engaged
 - Trades Union Congress involvement in consultation
 - Tension with directors’ strict company law duties (broadly, shareholder value) – potential to cause confusion?

The Six Principles

THE SIX PRINCIPLES



PRINCIPLE ONE

PURPOSE AND LEADERSHIP

An effective board develops and promotes the purpose of a company, and ensures that its values, strategy and culture align with that purpose.

PRINCIPLE TWO

BOARD COMPOSITION

Effective board composition requires an effective chair and a balance of skills, backgrounds, experience and knowledge, with individual directors having sufficient capacity to make a valuable contribution. The size of a board should be guided by the scale and complexity of the company.

PRINCIPLE THREE

DIRECTOR RESPONSIBILITIES

The board and individual directors should have a clear understanding of their accountability and responsibilities. The board's policies and procedures should support effective decision-making and independent challenge.

THE NORTH STAR

PRINCIPLE FOUR

OPPORTUNITY AND RISK

A board should promote the long-term sustainable success of the company by identifying opportunities to create and preserve value, and establishing oversight for the identification and mitigation of risks.

PRINCIPLE FIVE

REMUNERATION

A board should promote executive remuneration structures aligned to the long-term sustainable success of a company, taking into account pay and conditions elsewhere in the company.

PRINCIPLE SIX

STAKEHOLDER RELATIONSHIPS AND ENGAGEMENT

Directors should foster effective stakeholder relationships aligned to the company's purpose. The board is responsible for overseeing meaningful engagement with stakeholders, including the workforce, and having regard to their views when taking decisions.

CHARACTERISTICS OF GOVERNANCE

SPECIFIC MATTERS

UN PRI Fiduciary Duties Project

Duties of Private Equity-Appointed Directors

- UN PRI Memorandum, designed for NEDs
- Duty to consider ESG factors
 - Duty of loyalty
 - Duty of care
- Enforcement issues
- Specifics of private equity boards

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