RECENT DEVELOPMENTS IN SUSTAINABLE FINANCE

THE GROWTH OF "SUSTAINABLE FINANCE" HAS BEEN A MAJOR TREND IN GLOBAL FINANCIAL MARKETS IN THE PAST DECADE. THE TERM REFERS TO PRACTICES AND INSTRUMENTS OF THE FINANCIAL SERVICES INDUSTRY AIMED AT PROMOTING DESIRABLE ENVIRONMENTAL AND/OR SOCIAL OUTCOMES. BY CRAIG JONES AND SAM SAUNDERS, SULLIVAN & CROMWELL.

Examples include green and social bonds, green loans, benefit corporations and investment funds with environmental and social investing criteria. This trend has been in response to rising concerns among investors about climate change and other environmental risks and a desire to achieve socially-beneficial outcomes while earning financial returns. Sustainable finance is a part of (and builds upon) corporate social responsibility (CSR) efforts and ESG (environmental, social and governance)-focused or socially-responsible investing.

Since the 2015 Paris Agreement on climate change, sustainable finance activity has accelerated rapidly. As a result, these issues have become increasingly relevant for all market participants, including fund managers, corporates, banks, insurers, regulators, rating agencies and advisers, whether they have a focus on ESG matters or not.

We expect the sustainable finance market to continue to expand and diversify, and consequently it is important for market participants to monitor the evolution of market regulations, standards, practices and perceptions. In this article, we highlight some of the significant recent developments in sustainable finance.

Sustainability bonds

We published in 2016 an article discussing the legal considerations of green bonds, and the market has since continued to grow and diversify globally[1]. Green bonds are, in their simplest form, bonds whose proceeds are used for environmentally-friendly investments. This includes bonds used to pay for renewable energy installations, low-carbon transportation, construction of energy-efficient buildings and water and waste management.

Over US$155bn of green bonds were issued in 2017, a 60% increase from 2016 and representing about 2% of global bond issuances[2]. Over US$109bn of green bonds were issued in the first three quarters of 2018[3].

In addition, the market has seen a growing and increasingly diverse range of issuers and use of proceeds. Most notably, sovereign and sub-sovereign issuers – including Poland, France, Nigeria, Indonesia, Ontario and Michigan – first entered the market starting in late 2016.

There have also been significant new issuers in the transportation sector, such as France's national state-owned railway company, SNCF, and the Mexico City Airport Trust. Use of proceeds for these issuers includes investments in energy-efficient infrastructure and infrastructure increasing access to public transportation.

The Green Bond Principles (GBPs), led by the International Capital Market Association (ICMA), continue to be the baseline market standard for green bonds[4]. The GBPs are a set of voluntary guidelines for issuers, underwriters, investors and their advisors on green bond offerings. The four core principles of the GBPs are:

i) *Use of proceeds* – Bond proceeds should be used to finance or refinance projects that provide clear environmental benefits. Several broad, non-exclusive categories of green projects are listed in the GBPs.

ii) *Process for project evaluation and selection* – The issuer should disclose both the decision-making process and eligibility criteria it follows to identify green projects, as well as its environmental sustainability objectives.

iii) *Management of proceeds* – The net proceeds of green bond offerings should be credited to a sub-account or sub-portfolio or otherwise tracked by a formal internal process.

iv) *Reporting* – The issuer should produce reports at least annually that include a list of the projects to which green bond proceeds have been allocated.

The basic GBPs have remained the same since published in 2014, with modest annual updates providing guidance on reporting and tracking of proceeds. The 2018 update created further categories of eligible green investments and places greater emphasis on disclosure of environmental risks associated with green projects. The ICMA also started a frequently-asked-questions list and published guidelines for third-party reviewers.

In addition, the ICMA launched the Social Bond Principles (SBPs) in 2017. These are a similar set of voluntary principles for issuers of bonds which support projects with positive social outcomes. Examples include projects promoting affordable housing, access to basic infrastructure and food security. Additionally, the ICMA also published a set of Guidelines for Sustainability Bonds, defined as "bonds where the proceeds will be exclusively applied to finance or re-finance a combination of both green and social projects". Social and sustainable bond issuances grew over 80% in the first three quarters of 2018 compared to the same period in 2017, on pace for about $30 billion of issuances in 2018[5].

Over the course of 2015-2017, regulators or industry groups in ASEAN, Brazil, China and Japan released green bond guidelines or in the case of China, mandatory rules for Chinese financial issuers. In addition, the Hong Kong Quality Assurance Agency launched a Green Finance Certification Scheme. Most guidelines and standards are based on the GBPs. Rating agencies such as Moody's have also continued to refine and promote environmental and sustainability ratings for bond issuances. At least 10 stock exchanges now have green or sustainable bond segments.

Some recent activity in the market has stimulated debate. This includes Repsol's 2017 issuance of a green bond, the proceeds of which were to be used on investments in energy efficiency projects and low emissions technologies in its downstream refineries and chemical facilities. While Repsol was praised for complying with GBPs and for its commitment to reduce GHG emissions, some objected to the fundamental concept of an oil and gas company issuing a green bond for investments in refining facilities.

Likewise, while China was the world's largest issuer of green bonds in 2017 for the second consecutive year, a portion of Chinese green bonds have drawn scrutiny for not being green enough.

For example, some Chinese issuers allow up to 50% of bond proceeds to be linked to non-green assets or projects. Chinese issuers have also used green bond proceeds to retrofit fossil-fuel power stations to reduce emissions.

Green loans

Labelled green lending is a relatively new market compared with green bonds. So far, sustainability provisions have been incorporated into credit agreements in a variety of different ways, including:

i) *Purpose* – A purpose clause requiring loan proceeds to be applied for a green purpose.

ii) *Margin adjustments* – The loan margin is subject to a ratchet based on certain sustainability criteria such as environmental considerations and the borrower's health and safety record, rather than (only) a financial ratio.

iii) *Green asset pool* – The borrower must ensure that the value of its investments in green assets equals or exceeds the value of its green borrowings.

In March 2018, the Loan Market Association (LMA) together with the Asia Pacific Loan Market Association (APLMA) published the Green Loan Principles (GLPs)[6]. The Loan Syndications & Trading Association (LSTA) has since joined as a sponsor of the GLPs. These set out a framework of market standards and voluntary guidelines that participants are encouraged to adopt across the green loan market, building upon the ICMA's GBPs for the green bond market. The GLPs focus on four key elements which distinguish a green loan from a non-green loan:

i) *Use of proceeds* – Eg for use on green projects.

ii) *Borrower disclosures* – Focusing on clear processes for project selection and evaluation.

iii) *Management of proceeds* – Emphasising transparency to lenders and tracking allocation of funds.

iv) *Reporting* – Regular reporting by the borrower to participating lenders.

In comparison with the bond market, the loan market may offer greater opportunity for experimentation with bespoke sustainable finance structures by borrowers and lenders. This may be particularly true for bilateral loans and direct loans from funds with sustainability objectives where there is less need to widely syndicate the loan.

EU regulatory developments

Europe has been a leader in the development of sustainable finance markets and practices, including issuance of the first green bond in 2007 and the first sovereign green bond in 2016. On the regulatory side, the European Union (EU) has recently proposed the first comprehensive regulatory regime governing sustainable finance practices.

In March 2018, the EU Commission revealed its strategy for reforming the EU financial system to better support the EU's climate and sustainable development agenda. This Action Plan contains 10 action points outlining the Commission's proposals and a timetable for implementation up to Q3 2019[7]. As part of its efforts to implement the Action Plan, the Commission released a set of legislative proposals on financing sustainable growth (the Sustainable Finance Package) in May 2018. The Action Plan and Sustainable Finance Package include proposals on:

i) *Establishing an EU classification system for sustainable activities* – The Sustainable Finance Package includes a proposed new EU Regulation on the establishment of a framework to facilitate sustainable investment. This would involve the creation of a common classification system, prescribing requirements for financial products and green bonds to be labelled as environmentally sustainable.

ii) *Creating standards and labels for green financial products* – These will likely be based on the existing ICMA GBPs.

iii) *Fostering investment in sustainable projects* – This initiative includes a proposal for a single EU investment fund, working through the European Investment Bank and other financial institutions, to stimulate investment in sustainable infrastructure.

iv) *Incorporating sustainability when providing* *financial advice* – The Sustainable Finance Package includes proposed amendments to the MiFID II Directive[8] and Insurance Distribution Directive[9]. These changes would require investment firms and insurance distributors to: (1) ask their clients about their ESG preferences, and (2) take these into account when providing advice by including ESG considerations in their description of, and advice in relation to, financial instruments. The Sustainable Finance Package also includes proposed amendments to the pensions-related IORP Directive[10] requiring disclosures relating to sustainable investments and sustainability risks.

v) *Sustainability benchmarks* – The Sustainable Finance Package includes proposed amendments to the Benchmark Regulation[11] addressing low carbon benchmarks and positive carbon impact benchmarks. This would amend the existing Regulation by introducing two new types of benchmarks: (1) a low carbon benchmark, where the underlying assets have less carbon emissions than a standard investment index; and (2) a positive carbon impact benchmark, comprised of assets where their carbon emissions are exceeded by the carbon emission savings.

vi) *Fuller integration of sustainability criteria into ratings and market research* – The Commission is considering amendments to the Credit Rating Agency Regulation[12], which would require credit rating agencies to incorporate sustainability-related factors into their credit assessments.

vii) *Clarifying the scope of investors' duties regarding sustainable development* – This proposal may involve embedding sustainability considerations into the fiduciary duties of investment managers.

viii) *Incorporating sustainability into prudential requirements* – This would involve a potential amendment to the EU's current capital requirements for banks and insurance companies to more accurately reflect the risks associated with climate and environmental factors. It is premised on the belief that sustainable assets are inherently less risky by being more robust to the effects of climate change.

ix) *Improving corporate disclosure of sustainability-related information and accounting* – The Commission has launched a review of EU legislation on public corporate reporting, including the Non-Financial Information (NFI) Directive[13] (which now requires large public interest entities to disclose material ESG-related risks), to assess whether ESG reporting requirements need further standardization.

x) *Developing sustainable corporate governance standards* – This would focus on behavioural change, and it is unclear what form these measures would take in practice.

The Sustainable Finance Package was passed to the European Parliament and to the Council for review and amendments, with enabling legislation expected to be adopted from mid to late 2019.

Implementation of these measures will necessarily require the participation of a broad range of market participants. The EU has been a clear first-mover and may spur further regulatory and legislative changes in other jurisdictions. However, it is unlikely that the US, for example, will quickly follow suit with similar measures.

Fossil fuel policies

Another recent sustainable finance trend has been the change in policies of many financial services institutions towards the fossil fuel industry. Commercial banks in particular have become increasingly less supportive of lending to coal, and, to a lesser extent, oil (tar) sands and/or shale oil and gas projects and businesses.

In the three years following the 2015 Paris Agreement on climate change, over 30 European, US, Australian and Japanese commercial banks have announced global policies limiting financings of new thermal coal mines and/or new coal-fired power plants or businesses dedicated to these activities. However, many banks have retained flexibility to continue coal financings in certain circumstances, and policies often vary in applicability based on a project's:

i) *Location* – Developing/low income countries are often exempt;

ii) *Technology* – Ultra-super critical power plants are often allowed while mountaintop removal mining is specifically banned; and

iii) *Scope of banking services prohibited* – The policy may only apply to lending, not underwriting and/or advisory.

The most recent examples of restrictive bank policies include Standard Chartered, which recently stated that it will not directly finance any new coal-fired power plant projects, including expansions, in any location, and RBS, which now prohibits project finance lending for the construction of new, unabated coal fired power plants. Several Japanese banks and insurers have also implemented policies this year, including SMBC, Dai-ichi Life and Nippon Life.

Several banks have also recently developed policies which restrict lending or necessitate enhanced due diligence and approval of senior management when considering transactions involving companies engaged in oil sands and/or shale oil and gas development and production[14]. Banks have in recent years also implemented lending policies or restrictions with respect to palm oil and deforestation, among other sustainability-focused policies. Bank policies are all generally publicly available on their websites.

Equity

Equity investing in accordance with ESG criteria predates other sustainable finance initiatives. The first socially-oriented mutual fund was launched thirty years ago, and the MSCI KLD 400 Social Index dates back to 1990. However, ESG-focused funds are no longer being viewed as expensive, niche products. One result has been the growing market for green or sustainable exchange-traded-funds (ETFs). BlackRock CEO Larry Fink recently predicted that assets in ETFs incorporating ESG considerations will grow from US$25bn today to over US$400bn in only a decade[15]. Goldman Sachs Asset Management's JUST US Large Cap Equity ETF is a recent example, which launched with over US$250m in assets in June 2018, the largest ESG ETF launch to date. This ETF tracks an index consisting of the top 50% of Russell 1000 companies ranked by how just their business behaviour is – including treatment of employees, customers, communities and the environment – based on various data and metrics. Some additional recent developments in the equity space include:

- *ESG proxy scoring and shareholder proposals* – Companies are now routinely evaluated on the basis of their ESG credentials by third parties. Leading proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis have each recently launched detailed criteria they now use to rate companies on their ESG-related risk disclosure[16].

In the 2018 US proxy season, more environmental/social/political (ESP) proposals were submitted than any other type of shareholder proposal[17]. The most common subjects among proposals that reached a vote continued to be environmental issues, and average shareholder support and pass rate for ESP proposals increased year-on-year in 2018. This suggests that these issues continue to be relevant considerations for shareholders. However, as in the past, the rate of withdrawal for many of these proposals was high, with less than a third reaching the shareholder vote stage – and few ultimately being passed.

- *SEC and DOL guidance* – Not all recent developments have been aimed at promoting the sustainable finance market. In April 2018, the U.S. Department of Labor (DOL) released a Field Assistance Bulletin stating that fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA) must always put first the economic interests of the ERISA plan and, accordingly, ERISA fiduciaries:
- Must avoid too readily treating ESG issues as being economically relevant to any particular investment choice; and
- May not incur significant plan expenses to (i) pay for the costs of shareholder resolutions or special shareholder meetings, or (ii) initiate or actively sponsor proxy fights on environmental or social issues.

This Field Bulletin clarified a 2015 DOL interpretation issued under the Obama administration that suggested ERISA fiduciaries may consider ESG factors in making investment decisions without violating their fiduciary duties when the ESG factors have a direct relationship to the economic and financial value of an investment.

The DOL Field Bulletin follows Staff Legal Bulletin 14I (SLB 14I) issued by the US Securities and Exchange Commission (SEC) in November 2017. The SEC stated in SLB 14I that shareholder proposals that raise issues of social or ethical significance may be excluded from an issuer's proxy statement under SEC Rule 14a-8(i)(5), notwithstanding their general or abstract importance, based on the application of quantitative analytics of the proposal's economic relevance to the issuer's business. In addition, SEC Staff Legal Bulletin 14J, issued in October 2018, indicates that environmental proposals which impose specific timeframes or methods for implementing complex policies are also excludable on the basis of micromanagement under SEC Rule 14a-8(i)(7).

- *Benefit entities and Delaware legislative developments* – Public benefit corporations (PBCs) must be managed in a manner that balances their shareholders' financial interests, the interests of those affected by the corporation's conduct, and the public benefit(s) identified in the certificate of incorporation[18]. Directors of PBCs are therefore required to engage with ESG factors when making corporate decisions. The first benefit corporation statute was adopted by Maryland in 2010, and today 34 US states, including both New York and Delaware, have enacted provisions in their corporate statutes to allow for this type of corporation[19]. Over 5,000 PBCs have now reportedly been created in the US[20] and 2017 saw the first initial public offering of a PBC when Laureate Education raised US$490mn. Internationally, similar legislation was adopted by Italy in 2015, and analogous social enterprise structures exist in the UK and elsewhere.

In August 2018, Delaware enacted a number of amendments to the Delaware Limited Liability Company Act to permit the formation of statutory public benefit limited liability companies[21]. These are similar to public benefit corporations and permit a balance between members' financial interests and the public benefit to be promoted set out in its certificate of formation.

Delaware also enacted in 2018 the Certification of Adoption of Transparency and Sustainability Standards Act. Under the Act, a Delaware entity can obtain a certificate from the state evidencing its adoption of sustainability standards and transparency in related disclosure. Other states may look to enact similar measures.

Conclusion

As sustainable finance continues to develop and diversify, it is important for all financial market participants to monitor the evolution of market regulations, standards, practices and perceptions. Companies without a sustainability focus can still be affected by market developments, such as new bank lending policies. For investors, funds, corporates, banks or others considering how to be more active in the sustainable finance market, there are a multitude of options, and each needs to be assessed carefully to ensure it will meet their desired objectives. What qualifies as green or sustainable remains a key consideration, along with ensuring transparency and compliance with the relevant sustainability commitments. ■

Footnotes

1 – See Czerniecki and Saunders (2016) 'Green Bonds: An Introduction and Legal Considerations,' 48 SRLR 275, available at https://www.sullcrom.com/publications-czerniecki-saunders-author-bloomberg-bna-article-green-bonds-2016.
2 – 'Blossoming green-bond market growing toward US$250bn year' (Bloomberg Intelligence, March 8, 2018) https://www.bloomberg.com/professional/blog/blossoming-green-bond-market-growing-toward-250-billion-year/ accessed December 10, 2018.
3 – See 'Green Bonds – Global: Issuance in the first three quarters of 2018 flat compared with 2017' (Moody's Investors Service, November 6, 2018).
4 – The Green Bond Principles are available at: https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp/.
5 – See 'Green Bonds – Global: Issuance in the first three quarters of 2018 flat compared with 2017' (Moody's Investors Service, November 6, 2018).
6 – The Green Loan Principles are available at: https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green_Loan_Principles_Booklet_V8.pdf
7 – These can be found at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097.
8 – Directive (EU) 2014/65
9 – Directive (EU) 2016/97
10 – Directive (EU) 2016/2341, the Institutions for Occupational Retirement Provision.
11 – Regulation (EU) 2016/1011
12 – Regulation (EU) 462/2013 amending Regulation (EC) 1060/2009 on credit rating agencies
13 - Directive 2014/95/EU
14 – BNP Paribas, Crédit Agricole, Goldman Sachs and JPMorgan, among others, have enacted such policies.
15 – 'BlackRock stakes claim on 'sustainable investing' revolution' (Financial Times, October 23, 2018) https://www.ft.com/content/f66b2a9e-d53d-11e8-a854-33d6f82e62f8 accessed December 10, 2018.
16 – 'Environmental, Social, and Governance Quality Scores to be Reflected in ISS Proxy Research Reports' (ISS Governance, February 5, 2018) https://www.issgovernance.com/iss-announces-launch-of-environmental-social-qualityscore-corporate-profiling-solution/ accessed December 10, 2018.
17 – See: '2018 Proxy Season Review' (Sullivan & Cromwell LLP, July 12, 2018), available at https://www.sullcrom.com/files/upload/SC-Publication-2018-Proxy-Season-Review.pdf.
18 – See, e.g., Sections 361 through 368 of the Delaware General Corporation Law, available at http://delcode.delaware.gov/title8/c001/sc15/.
19 – According to B Lab, http://benefitcorp.net/policymakers/state-by-state-status.
20 – Gilbert, 'For-Profit Higher Education: Yes, Like This Please' (Forbes, January 4, 2018) https://www.forbes.com/sites/jaycoengilbert/2018/01/04/for-profit-higher-education-yes-like-this-please/#7b4610277937 accessed December 10, 2018.
21 – See Sections 18-1201 through 18-1208 of the Delaware Limited Liability Company Act, available at http://delcode.delaware.gov/title6/c018/sc12/index.shtml.