European Leveraged Finance Association

LMA Loan Market Association

DILIGENCE

ESG Series

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Guide for Company Advisors to ESG Disclosure in Leveraged Finance Transactions

Second Edition

Background on ELFA's ESG Disclosure Initiative

Environmental, social and governance (ESG) factors have quickly grown to be a critical part of credit analysis in European leveraged finance. Despite the increasing focus on ESG, efforts to incorporate ESG information into company reporting have been fragmented due to a lack of consensus on the type of ESG disclosure that is necessary.

Beginning in June 2019 with the launch of our ESG Disclosure Initiative, the European Leveraged Finance Association (ELFA) has been supporting market participants as they seek increased ESG disclosure by borrowers and reduce the reliance by investors on individual ESG questionnaires. Beginning in September 2020, we hosted the first of seven workshops with sub-investment grade borrowers, credit analysts, and credit rating agencies to foster a dialogue about what ESG information investors would like companies to disclose, to build consensus and support efficiency.

We have observed a willingness to improve ESG disclosure on all sides, with borrowers and their advisers seeking more specific and consistent guidance on what investors would like to see in company disclosures. For further findings from the workshops, please find the related Insights Series reports here.

The ESG Fact Sheets, first published in January 2021, are the culmination of the first stage of the ESG Disclosure Initiative. The resources are designed to guide the market to a consistent level of disclosure on a sector-level basis, and now cover fourteen sectors (see the table below for a full list). A General ESG Fact Sheet is also available to serve as a sector-agnostic tool for the market.

ELFA and the Loan Market Association (LMA) hosted a workshop in November 2020 to extend the dialogue on ESG disclosure to banks, law firms, and private equity sponsors. Due to the heavily disintermediated flow of information in the leveraged finance market, we view engagement with these market participants to be critical to the success of the ESG Disclosure Initiative.

Participants in the November workshop discussed a summary draft of topics covered in this Guide for Company Advisers on ESG Disclosure in Leveraged Finance Transactions (the "Guide") and provided valuable feedback that was incorporated into the first edition of the Guide.

With this second edition, we build on the learning gained from our second ESG Workshop for Advisers, held in January 2022, and include two additional chapters to expand the scope of the Guide to include issues relating to ESG in private debt and ESG litigation. A full list of the updates and changes made in this second edition can be found in the Appendix.

Introduction to this Guide

This Guide for Company Advisers on ESG Disclosure in Leveraged Finance Transactions (the "Guide") reflects the ideas, experience, and input of hundreds of professionals in the European leveraged finance market. Drafted by a group of senior law firm partners and bankers (the "Working Group")[1], the main points covered in the Guide were discussed during our November 2021 and January 2022 ESG Workshops and this updated second edition incorporates the valuable feedback received during these events.

The Guide is designed to serve a practical tool for company advisers to use in support of their incorporation of the information contained in the ESG Fact Sheets into company offering materials and ongoing financial reports.

In Chapter 1, we describe why there is such an urgent need for increased disclosure on ESG topics from the perspective of credit investors. Chapter 2 outlines the current regulatory landscape and highlights the potential impact of these regulations on borrowers.

Market practice in this area remains at an early stage. As such, the Working Group supports an increased adoption of ESG disclosure by leveraging existing tools and processes already in place in a typical leveraged finance transaction. Chapter 3 describes how the ESG Fact Sheets can be incorporated into due diligence procedures and Chapter 4 sets out an ESG roadmap for disclosure in the high yield offering memorandum.

Chapter 5 continues the discussion about how ESG can be reflected in contractual provisions. There remains potential for huge shifts in this area, with ESG-linked margins increasingly appearing in leveraged loans and sustainability-linked high yield bonds growing in popularity. This chapter's contents will no doubt expand and evolve significantly over the coming years as banks work with their clients to devise creative and innovative ways to leverage investors' increasing focus on ESG and sustainability whilst protecting against the dangers of greenwashing.

As with the first edition, we welcome feedback on the information contained in this Guide – market practice in this area is evolving rapidly, so we will continue the dialogue with market participants so that we can incorporate feedback into revised versions of these resources.

This Guide is the result of many hours of work by the Working Group. We are deeply grateful to the firms below for their involvement in the project. This Guide would not have been possible without their commitment, willingness to share their expertise and resources, and remarkable creativity and innovative approach to ESG disclosure in leveraged finance transactions.

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[1] This Guide was created through individual contributions from multiple lawyers and bankers in the Working Group. The views and opinions set forth herein are the personal views or opinions of those individuals; they do not necessarily reflect views or opinions of the law firms, banks, or institutions with which they are associated.

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Chapter 1
Why Leveraged Finance Investors Need More Disclosure on ESG Topics

Introduction

Credit investors rely on quality financial and business disclosure by borrowers to inform the analysis underpinning their investment decisions. Over the past few years, this analysis has widened to include more information on environmental, social, and governance (ESG) topics. Most investors are now requesting from borrowers ESG information that they consider material to their investment decisions, with many relying on proprietary questionnaires to gather this information.

As the number of investors focused on ESG topics has increased, so has the number of questionnaires that borrowers receive. Borrowers and their advisers have questioned the need for these questionnaires. Some of the questions are driven by regulatory requirements for investors that management may not be aware of and as such cause confusion as they appear unrelated to the company's business. There is also substantial overlap in questions, resulting in inefficiencies when deal teams nonetheless are asked to reply to individual questionnaires.

Borrowers report to us that they are willing to make ESG disclosures, but that they would like more direction from investors on what, where and when to disclose the information. We will continue to engage with companies and their advisers to explain investors' various approaches to ESG integration as well as the drivers behind investors' need for ESG data.

In this chapter, we explore the main drivers behind investors' need for more ESG disclosure from borrowers. We explore the mounting evidence that ESG analysis is additive to the investment process. We review some of the regulatory requirements that continue to emerge obliging asset managers (and borrowers – discussed in Chapter 2) to disclose how they are managing sustainability risks. Further, asset managers are reporting ever increasing demand by their end investors to prove that they incorporate ESG considerations into investment products and processes.

The growing disconnect between the increased demand from investors for ESG information and the existing level of disclosure provided by sub-investment grade corporate borrowers, left unaddressed, will continue to cause inefficiencies. We believe that the best way for companies to disclose ESG information to investors is by way of the existing offering and periodic reporting framework, and our engagement with other market participants supports this approach. We explore several material benefits in this chapter.

To further this goal, since 2020 we worked to create a set of tools, called ESG Fact Sheets, to support engagement between sub-investment grade corporate borrowers and investors on ESG matters.[2] Through the ESG Disclosure Workshop series, we have developed ESG Fact Sheets and have made available resources for 14 sectors, plus one General ESG Fact Sheet. By promoting consistent minimum levels of ESG disclosure at the sector level and formalising the inclusion of ESG information in offering documentation and periodic reporting, we believe that engagement on ESG topics will become more efficient and effective.

1. ESG Integration is Additive to the Investment Process

The link between financially material ESG considerations and returns is becoming clearer. This has been confirmed by myriad sources, including a comprehensive study carried out in 2015.[3] The study found a positive correlation between ESG and corporate financial performance, and concluded that "the business case for ESG investing is empirically very well founded". In addition, a study from Axioma showed that "in general, increasing exposure to ESG rarely underperforms the market, and often outperforms the market, especially during the last few years".[4]

Further, evidence continues to emerge that systematic incorporation of ESG considerations can lead to more informed investment decisions, with ESG being seen as a proxy for quality. There is a growing recognition that ESG issues are credit-relevant and can pose material risk to investments with the potential for significant losses. As a result, investors are focused on the fundamental ESG factors that can have an effect on cashflows, and will therefore impact enterprise value, and as a result, credit risk.

Given this, participants in our ESG Disclosure Workshops noted that providing disclosure on ESG information will soon become necessary in order for borrowers to continue to get sufficient investor interest and participation. According to a sell side representative, it already appears to be increasingly difficult to find a deep buyer base for a company that has insufficient ESG disclosure. ESG disclosure can present an opportunity for borrowers to access a wider pool of capital.

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[2] We initially co-hosted ESG workshops with the Principles for Responsible Investment (PRI). Our collaboration with the PRI concluded in 2021.

[3] Friede, G., Busch, T. and Bassen, A., (2015). ESG and financial performance: aggregated evidence from more than 2000 empirical studies. Journal of Sustainable Finance & Investment, 5(4), pp.210-233.

[4] Thompson J., (2018). "Companies with strong ESG scores outperform study finds". Financial Times, [Accessed: 28 October 2020]

In this context, it is important to understand ESG risks through the lens of materiality. The Financial Accounting Standards Board (FASB) defines materiality as follows: "Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker"[5], and the Sustainability Accounting Standards Board (SASB) considers financial material issues as "… those issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors".[6] Companies, together with their advisers, ultimately decide what is financially material and should therefore be disclosed, taking into account legal requirements and the views of their key stakeholders.

In reviewing the relationship between a company's performance on ESG issues and its financial performance, not all ESG issues matter equally. Material ESG issues are those reasonably likely to have a material impact on a company's financial performance. There is a broad universe of possible ESG issues, with some being core for all companies and as such reflected in our sector agnostic General ESG Fact Sheet. However, given that each of these issues tends to have a different impact depending on the context in which it arises, what is considered appropriate corporate practice will vary from one sector to another. Since each sector has its own unique ESG or sustainability profile, we will continue to publish ESG Fact Sheets on a sector-level basis.

2. Growing Regulatory Requirements from Governments and Regulators

As a result of the increasingly systematic economic risks posed by certain ESG issues like climate change, regulatory requirements continue to emerge that oblige asset managers (and borrowers) to disclose how they are managing these risks. The regulatory efforts also aim to drive the allocation of capital towards more sustainable economic activities. Whilst this is a global trend, Europe is at the forefront of this movement.

Because they often drive investor questions, borrowers may find it useful to understand the key EU legislative initiatives of particular relevance to asset managers. Obtaining ESG information is necessary for investors to meet applicable legal requirements, and provision of such information may be decisive for inclusion in portfolios.[7] In addition, we note a significant development in the UK ESG regulatory landscape which creates new obligations for asset managers with UK regulated entities.[8]

Whilst it is a voluntary framework, regulators and policy makers are increasingly introducing mandatory reporting requirements (such as in the UK) based upon the Task Force on Climate-related Financial Disclosures (TCFD) reporting framework for listed companies as well as certain financial institutions. The TCFD is described in more detail in Chapter 2 of this Guide, "Regulation and Voluntary Frameworks for Borrowers".

[5] https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171111614&acceptedDisclaimer=true
[6] https://www.sasb.org/standards-overview/materiality-map/
[7] Some investors will also fall within scope of regulations applicable to corporates, such as the European Non-Financial Reporting Directive (NFRD), described in Chapter 2.
[8] See, e.g., https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities.

The EU's investment-related regulations are summarised in the table below, along with implications for asset managers and borrowers.

Regulation	Summary

Sustainable Finance Disclosure Regulation (SFDR) [9]	**In brief**
	▪ New disclosure obligations on how asset managers integrate ESG factors into their investment processes designed to make it easier for end-investors to make informed investment decisions
	▪ SFDR establishes firm- and product-level ESG disclosure requirements and it de facto creates a process for classifying ESG funds.
	▪ Disclosure obligations include the publication by a firm of written policies on the integration of sustainability risks in investment decision making process, as well as explicit pre-contractual disclosures
	▪ Although framed as rules about disclosures, there are significant business and policy decisions which firms need to make in terms of how sustainability impacts on their investment processes
	▪ Relevant to all in-scope asset managers and to all financial products made available by an in-scope asset management firm; whether or not the product has an express ESG focus (although some aspects will be relevant only when a financial product has a specific ESG focus)
	▪ Additional disclosures will be needed where a financial product:
	  ▪ promotes environmental or social characteristics (i.e., Article 8 product); or
	  ▪ has sustainable investment or a reduction in carbon emissions as an objective (i.e., Article 9 product).
	▪ Passed into law on 9 December 2019 and applicable from 10 March 2021
	▪ The European Supervisory Authorities (ESAs) have developed regulatory technical standards (Level 2 RTS) to give more detail on: (i) what information the various disclosures should contain and (ii) how this should be presented. Following a series of changes, the application date of the Level 2 RTS has now been delayed until 1 January 2023.
	
	Potential investor impacts
	▪ Meaningful impact despite the fact that application of certain disclosure obligations (i.e., Level 2 RTS) is not immediate
	▪ While the "comply or explain" logic inherent in some of the key disclosure obligations is helpful, managers will be conscious of reputational risks so will seek to ensure that they appropriately incorporate sustainability risks into their investment policies to avoid the perception of inadequate investment processes and risk management.
	▪ The need to make decisions about how they manage sustainability risks in their investments could lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed.
	
	Potential borrower impacts
	▪ Investors will need company ESG data to be able to quantify sustainability risks and evaluate the extent to which they represent investment material risks as well as adverse sustainability risks to society.

[9] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

<table>
<tr><th>Regulation</th><th>Summary</th></tr>
<tr><td>Taxonomy Regulation[10]</td><td>In brief

Establishes a classification system to be used in determining the degree to which an economic activity can be described as being "environmentally sustainable"
Enables asset managers and investors to demonstrate the environmental sustainability of a given investment and / or portfolio
Taxonomy-alignment disclosure requirement applies to asset managers (or other in-scope financial institutions) making available financial products with either an explicit objective of environmentally sustainable investment or which explicitly promote environmental characteristics.
All managers will at least need to make a negative disclosure to confirm that all out-of-scope financial products are indeed out of scope.
Passed into law and applicable from January 2022
The Taxonomy Regulation establishes a phased application of disclosure requirements. Asset managers at an entity level will be required to report their underlying investments eligibility to the taxonomy as a % of total AUM starting Jan 1, 2022.
In-scope financial undertakings will be required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2024.
In February 2022, the European Commission approved in principle a Complementary Climate Delegated Act including, under strict conditions, specific nuclear and gas energy activities in the list of economic activities covered by the Taxonomy.
The Complementary Delegated Act was formally adopted in all EU official languages on 9 March 2022 and transmitted to the co-legislators for their scrutiny on 10 March 2022. It was published in the Official Journal of the European Union on 15 July 2022.

Potential investor impacts

The scrutiny on portfolio taxonomy alignment could potentially amplify investor interest in and demand for such products.
Whilst technically not all managers will need to disclose the alignment of their investments / portfolios to the taxonomy, in practice it is likely that their clients will want to understand how their investment / portfolio stands in terms of alignment with the taxonomy.

Potential borrower impacts

Investors will need company data on the extent to which their economic activities are within scope of the taxonomy, and if so, the revenue / capex / opex spend to determine whether this qualifies as a "significant contribution", as well as to understand whether the business has operated responsibly in terms of not doing significant harm, and ensuring minimum social safeguards.
</td></tr>
<tr><td>Suitability Delegated Regulation[11]</td><td>In brief

This amends the MiFID 2 Delegate Regulation to clarify that ESG considerations and preferences should be taken into account in the investment and advisory process as part of an investment firm's duties towards its clients when performing the "suitability" assessment for portfolio management and investment advice.
Passed into law on 2 August 2021 and applicable from 2 August 2022

Potential investor impacts

Potentially amplifies investor interest in and demand for products that integrate ESG factors, leading asset managers to increase availability of such products. However, the drafting makes clear that the rules apply "where relevant", whilst acknowledging that a client might not have explicit ESG preferences.

Potential borrower impacts

The absence of ESG disclosure by borrowers could be perceived as indicative of weak ESG practices, reducing the likelihood that debt of these companies will be included in such products.
</td></tr>
</table>

[10] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.
[11] MiFID2: draft delegated directive, to amend the MiFID Commission Delegated Directive ((EU) 2017/593) as regards the integration of sustainability factors and preferences into the product governance obligations.

Regulation	Summary
Integration of sustainability into a firm's systems and controls	**In brief** ▪ Additional Level 2 delegated acts make amendments to the existing Level 2 measures under the UCITS Directive[12], AIFMD[13] and MiFID 2[14] respectively, to ensure that sustainability risks and sustainability factors are integrated within a manager's organisational, operating and risk management processes ▪ Passed into law on 2 August 2021. The measures made under AIFMD and the UCITS Directive will apply from 1 August 2022 while the measure made under MiFID 2 will apply from 22 November 2022 **Potential investor impacts** ▪ The explicit references to sustainability risk will inevitably lead to greater scrutiny by firms and investors of such risks, particularly given the obligations placed on senior management. ▪ The need to make decisions on how they manage sustainability risks in their investments could lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed. **Potential borrower impacts** ▪ Investors will need company ESG data in order to be able to quantify sustainability risks and evaluate the extent to which they represent investment material risks

The UK's investment-related regulations are summarised in the table below, along with implications for asset managers and borrowers.

Regulation	Summary

PS21/24 on climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers (Policy Statement)[15]	**In brief**
	▪ The Policy Statement introduces mandatory climate-related disclosure requirements for asset managers, life insurers, and FCA-regulated pension providers consistent with the recommendations of the TCFD
	▪ The FCA aims to increase transparency on climate-related risks and opportunities and enable end investors to make informed choices
	▪ The new rules will apply only to a sub-set of UK regulated asset management entities, and there is an exemption from the general applications provision. The disclosure obligations will not apply to an asset manager with less than GBP 5 billion AUM
	▪ Asset managers in scope will need to fulfill disclosure obligations both at an entity level, as well as for in-scope products
	▪ The FCA published the final rules on 17 December 2021. There is a phased implementation approach:
	  ▪ Rules first apply on 1 January 2022 for asset managers with more than GBP 50 billion (i.e., Phase 1 firms); and
	  ▪ Rules first apply on 1 January 2023 for asset managers with more than GBP 5 billion (i.e., Phase 2 firms)
	Potential investor impacts
	▪ The explicit references to climate-related risk will inevitably lead to greater scrutiny by firms and investors of such risks, particularly given the obligations placed on senior management
	Potential borrower impacts
	▪ Investors will need company ESG data to be able to quantify climate-related risks and evaluate the extent to which they represent investment material risks

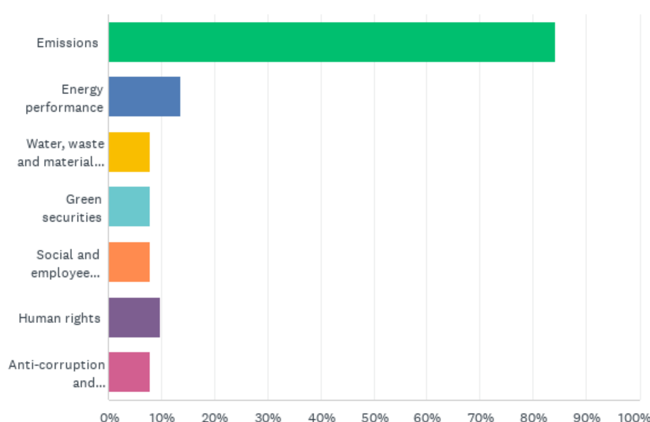
[12] UCITS: draft delegated directive, to amend the UCITS Commission Directive (2010/43/EU) as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS).
[13] AIFMD: draft delegated regulation, to amend the AIFMD Delegated Regulation ((EU) 231/2013) as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers.
[14] MiFID2: draft delegated regulation, to amend the MiFID Commission Delegated Regulation ((EU) 2017/565) as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.
[15] 13 Policy Statement PS21/24 on enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers

3. Demand from Investors and Society at Large for ESG Considerations

Investors are seeing increased demand from their limited partners (**LPs**) and society at large for investment products that take into account ESG considerations. Additionally, increasing societal awareness of environmental and social challenges is shaping consumer behaviour, with significant implications across sectors. The resulting change in consumer behaviour will materially impact the future company performance, and therefore must be taken into account in any investment with a medium-term time horizon.

As their LPs increasingly seek more granular detail on ESG topics, like a portfolio's overall carbon footprint, investors will need to receive this data from companies. According to our ESG Investor Survey 2021 which was conducted in Q4 2021 and collated the views on ESG investing from 66 investors representing 37 organisations, LP information requests are becoming more sophisticated, with 79% reporting that LPs have asked about SFDR reporting requirements – nearly 10% field such questions at every or almost every meeting, another 26% usually do. Climate reporting is top of mind for LPs – of the voluntary SFDR Principal Adverse Impacts (**PAIs**), 85% of our survey respondents receive the most requests for emissions, with all other PAIs requested by LPs from less than 15% of respondents.

Of the voluntary SFDR PAIs, which have you had the most requests to disclose by LPs/investors?



Further, to the extent that companies provide this information, investors can screen-in those with comprehensive disclosure as they will be equipped to conduct their analyses. In addition, as investors increasingly seek to "green-up" their portfolios, they will look to invest in companies that provide the relevant disclosure necessary to further this objective. Companies failing to provide this information risk being excluded from the investable universe of many leveraged finance investors.

4. The Benefits of Incorporating ESG Data and Information into Company Disclosure

Investors broadly agree that the best place for ESG data disclosure is in company offering materials, including as part of dedicated ESG slides in the roadshow presentation. In the first instance, this is viewed as a more effective approach than management answering multiple unique investor questionnaires. The ESG Fact Sheets, which now include an Excel table for ESG Key Performance Indicators KPIs and links to relevant definitions, can serve as a useful guide to borrowers and their advisers.

The following additional benefits could be derived from including ESG information in company offering materials and periodic reports:

- **Investor confidence:** Leveraging off an existing, established process and that all parties are familiar with and trust will provide investors with confidence that the ESG information has undergone an adequate level of due diligence.
- **Timely information:** Investors would have access to the information when they need it, with data refreshed during the new deal process, which is a typical trigger for investor ESG requests. The current timing of investor requests is challenging for banks to manage, and market participants report that it would be better for this process to be front loaded so that ESG information can be incorporated into the due diligence process.

- **Mechanism for updates:** Periodic reporting cycles provide a mechanism for the information to be refreshed.
- **Market consensus:** Reaching consensus on the scope of a core set of ESG disclosure topics and associated metrics by way of our ESG Fact Sheets provides the market with a minimum basis for ESG disclosure, facilitating a level of standardisation within the industry.
- **Consistency amongst borrowers:** Disclosure in offering materials and periodic reports provides a common reference point for ESG disclosure and creates a level playing field for all borrowers in the market. It also provides a foundation to build additional proactive, public ESG communication such as on a corporate website and/or stand-alone ESG reporting.
- **Avoiding selective disclosure:** If companies are reporting directly to investors without seeking advice from counsel, there is a risk they may inadvertently disclose material information to some investors, but not others, potentially giving rise to liability.

Whilst the measures suggested in this Guide cannot completely eliminate ad-hoc investor ESG information requests to borrowers, we believe it would materially reduce the volume of investor requests. Just as borrowers currently respond to individual investor requests relating to information in financial statements, which is driven by each investor's own analysis, we believe that the market would benefit from a similar approach to ESG disclosure.

A standard approach would also help smaller companies with fewer resources to devote to ESG disclosure. Existing frameworks may be too comprehensive and aspirational for smaller-sized leveraged finance borrowers. Investors participating in our ESG Disclosure Workshops agreed that smaller companies should not be penalised for their lack of resources and that a clear trajectory, a sense of progress and management commitment are powerful signals to investors.

Company size may also impact the resources available to collect and report ESG data. Investors need ESG information for both large and small companies, but they are aware that size and maturity need to be taken into consideration. While there is a perception that it is costly to provide ESG information, for many companies, including smaller ones, the benefits of wider access to capital (among other things) can outweigh the costs even if this may not be immediately apparent.

Since providing the market with a foundation for a minimum level of sector-focused information, it has been reported to us that the quality of engagement between investors and borrowers on ESG topics has improved significantly. These resources facilitate moving the dialogue beyond basic facts to more business relevant ESG subject matter, positioning borrowers to better engage with investors and reap the opportunities that a more progressive ESG approach can bring.

Chapter 2
Regulation and Voluntary Frameworks for Borrowers

Introduction

Historically, regulatory frameworks for investment / lending governance have rarely made explicit reference to ESG issues, but this is changing. The identification, measurement and disclosure of climate-related financial risks is now a major focus for global regulators.

There are a number of key initiatives that are already shaping the disclosure landscape, and from which we can draw guidance on how ESG disclosure may evolve. These range from mandatory to voluntary principles. Some will apply directly to borrowers whilst others create an indirect impact due to disclosure requirements on investors, who will seek the required information from the companies to which they lend (some of these are summarised in Chapter 1 of this Guide). We describe several such regulations and initiatives in this chapter.

1. International Sustainability Standards Board (ISSB)

Background: On 3 November 2021, the IFRS Foundation Trustees announced the creation of a new standard-setting board – the International Sustainability Standards Board (ISSB)– with the intention to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions.[16]

Application: The G20 Leaders have welcomed the IFRS Foundation's work programme to develop a global baseline for sustainability disclosure. The ISSB will develop – in the public interest – standards that result in a high-quality, comprehensive global baseline of sustainability disclosures and develop the standards in such a way so that they can be mandated and combined with jurisdiction-specific requirements or requirements aimed at meeting the information needs of broader stakeholder groups beyond investors. Consistent with the approach taken for the IASB's Accounting Standards, it is for jurisdictional authorities to decide whether to mandate use of the ISSB's standards.

To achieve this, the ISSB will build on the work of existing investor-focused reporting initiatives, including the Climate Disclosure Standards Board (CDSB), the Task Force for Climate-related Financial Disclosures (TCFD), the Value Reporting Foundation's Integrated Reporting Framework (IRF) and SASB Standards, and the World Economic Forum's Stakeholder Capitalism Metrics, to become the global standard-setter for sustainability disclosures for the financial markets.

It is expected there will be a great deal of overlap between the information needs of investors and broader stakeholder groups on sustainability matters. However, the focus of the ISSB will be on meeting investors' needs, as the Foundation's remit and expertise is to set standards that provide information for the capital markets.[17]

On 31 March 2022, the ISSB released for consultation two exposure drafts of proposed sustainability-related standards – one covering general sustainability-related disclosure requirements and the other specifying climate-related disclosure requirements. The ISSB will review the feedback on these proposals in the second half of 2022 and aims to issue the new Standards by the end of the year, subject to feedback.[18]

2. Task Force on Climate-related Financial Disclosures (TCFD)

Background: In April 2015, the G20 Finance Ministers and Central Bank Governors asked the Financial Stability Board (FSB) to review how the financial sector could take account of climate-related issues. In response, the FSB established the TCFD to develop recommendations for more effective climate-related disclosures "to promote more informed investing, lending, and insurance underwriting decisions" which, in turn, "would enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system's exposures to climate-related risks".[19]

The Recommendations: In June 2017, the TCFD released its recommendations for consistent, climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and other stakeholders. The recommendations are based around four thematic areas that represent core elements of how organisations are

[16] https://www.ifrs.org/news-and-events/news/2021/11/ifrs-foundation-announces-issb-consolidation-with-cdsb-vrf-publication-of-prototypes/
[17] https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/
[18] https://www.ifrs.org/news-and-events/news/2022/03/issb-delivers-proposals-that-create-comprehensive-global-baseline-of-sustainability-disclosures/
[19] Task force on climate related financial disclosures, October 2021: https://www.fsb.org/wp-content/uploads/P141021-4.pdf

organised: governance, strategy, risk management, and metrics and targets. These recommendations are supported by specific disclosures that organisations should include in financial filings or other reports in order to provide decision-useful information to investors and others. The recommendations can be found at: https://www.fsb-tcfd.org/.

Support: The TCFD recommendations have been strongly supported and endorsed by a wide range of national and international regulators and policymakers and form the basis of many national and international initiatives emerging in this space. As of January 2022, the number of TCFD supporters surpassed 3,000 organisations from 92 countries with a combined market capitalisation $27.2 trillion.[20]

3. European Non-Financial Reporting Directive (Directive 2014/95/EU) and the Corporate Sustainability Reporting Directive (CSRD)

Background: The Non-Financial Reporting Directive (NFRD) came into effect in 2018 and requires large Public Interest Entities with more than 500 employees to include a non-financial statement as part of their annual public reporting obligations. In its Communication on the European Green Deal, the European Commission committed to review the NFRD as part of the strategy to strengthen the foundations for sustainable investment, launching a public consultation in February 2020.

On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD. The proposal:

- extends the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises);
- requires the audit (assurance) of reported information;
- introduces more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards; and
- requires companies to digitally "tag" the reported information.

On 21 June 2022, the EU Parliament and Council announced that they had reached provisional political agreement on the CSRD.

Application: The NFRD integrates the recommendations of the TCFD and requires companies to disclose information about their business model, policies, outcomes, risks, risk management and key performance indicators (KPIs) relating to four key sustainability issues: environment, social and employee issues, human rights, and bribery and corruption. Companies should disclose how sustainability issues may affect the company, as well as how the company affects society and the environment.

The Commission's proposal for a CSRD envisages the adoption of EU sustainability reporting standards. The draft standards would be developed by the European Financial Reporting Advisory Group (EFRAG) and it is envisaged that the first set of standards would be adopted by October 2022.

4. The Taxonomy Regulation

Background: The European Commission put forward its action plan on financing sustainable growth in March 2018. Action 1 of the action plan calls for the establishment of an EU classification system for sustainable activities (the Taxonomy). On 22 June 2020, the Taxonomy Regulation was published in the Official Journal of the European Union and entered into force on 12 July 2020.[21]

Key elements of the Taxonomy: The Taxonomy is a tool to help investors, companies, issuers and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy. It sets performance thresholds (referred to as "technical screening criteria") for economic activities which make a substantive contribution to one of six environmental objectives (see below); do no significant harm to the other five, where relevant; and meet minimum safeguards.

The six environmental objectives defined in the Taxonomy are:

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

[20] https://www.fsb-tcfd.org/about/#history
[21] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities

Under the Taxonomy Regulation, the European Commission was required to develop delegated acts containing technical screening criteria to further specify elements of the Taxonomy Regulation.

On 9 December 2021, a delegated act[22] supplementing the Taxonomy Regulation and establishing the technical screening criteria for climate change mitigation and climate change adaptation objectives was published in the Official Journal and has applied since 1 January 2022. A draft second delegated act for the remaining objectives is expected to be published in 2022.

The Taxonomy Regulation has also introduced new disclosure requirements for financial market participants offering financial products in Europe and for companies subject to disclosure requirements under the NFRD. On 10 December 2021, a delegated act[23] supplementing Article 8 of the Taxonomy Regulation was published in the Official Journal which has applied since 1 January 2022 (the **Delegated Act**). The Delegated Act specifies the content, methodology and presentation of information to be disclosed by financial and non-financial undertakings concerning environmentally sustainable economic activities.

On 2 February 2022, the European Commission approved in principle a Complementary Climate Delegated Act including, under strict conditions, specific nuclear and gas energy activities in the list of economic activities covered by the Taxonomy. The Complementary Delegated Act was formally adopted in all EU official languages on 9 March 2022 and transmitted to the co-legislators for their scrutiny on 10 March 2022. It was published in the Official Journal of the European Union on 15 July 2022.

Application: The Taxonomy applies to individual Member States, companies and firms within the scope of the NFRD and financial market participants. Under the Delegated Act, in-scope non-financial undertakings have been required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2023. In-scope financial undertakings have been required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2024.

5. Principles for Responsible Investment (PRI)

Background: In early 2005, the then United Nations Secretary-General Kofi Annan invited a group of the world's largest institutional investors to join a process to develop the PRI. A 20-person investor group drawn from institutions in 12 countries was supported by a 70-person group of experts from the investment industry, intergovernmental organisations and civil society. The PRI were launched in April 2006 at the New York Stock Exchange.[24]

The Principles: The six PRI are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The primary goal of the PRI is to understand the investment implications of ESG issues and to support signatories in integrating these issues into investment and ownership decisions.

Signatories to the PRI commit to the following six Principles where consistent with their fiduciary responsibilities:

1. Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
2. Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
5. Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
6. Principle 6: We will each report on our activities and progress towards implementing the Principles.[25]

Support: To date, over 4,300 investment organisations, representing over US$121 trillion, have signed up to the PRI.

6. The Science Based Targets initiative (SBTi)

Background: Through the 2015 Paris Agreement, world governments committed to curbing global temperature rise to well-below 2°C above pre-industrial levels and pursuing efforts to limit warming to 1.5°C. In 2018, the Intergovernmental Panel on Climate Change warned that global warming must not exceed 1.5°C to avoid the catastrophic impacts of climate change.

To achieve this, SBTi defines and promotes best practice in science-based target setting. Offering a range of target-setting resources and guidance, the SBTi independently assesses and approves companies' targets in line with its strict criteria.

[22] (EU) 2021/2139
[23] (EU) 2021/2178
[24] https://www.unpri.org/download?ac=10948
[25] https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment

Application: Defines and promotes best practices in emissions reductions and net-zero targets in line with climate science, providing target setting methods and guidance to companies to set science-based targets in line with the latest climate science. Over a thousand organisations worldwide are leading the zero-carbon transformation by setting emissions reduction targets grounded in climate science through the SBTi.[26]

7. Taskforce on Nature Related Financial Disclosures (TFND)

Background: An initiative to bring together a Taskforce on Nature-related Financial Disclosures was announced in July 2020, with the preparatory phase of the initiative running from September 2020 until June 2021.

In June 2021, the TNFD formally launched to widespread support from financial institutions, corporates, governments and civil society[27]. The G7 Finance Ministers and G20 Sustainable Finance Roadmap have endorsed the TNFD. The G20 and G7 Environment and Climate Ministers have also recognised the establishment of the TNFD. Other individual leaders have also endorsed TNFD, including Mark Carney, UN Special Envoy on Climate Action and Finance; UN Secretary General António Guterres, President of France, Emmanuel Macron, and former Prime Minister of the UK, Boris Johnson.

The principles: The TNFD's work build on seven principles[28]: market usability, science-based, nature-related risks, purpose-driven, integrated & adaptive, climate-nature nexus and globally inclusive.

Application: In June 2022, TNFD released the second version of its beta framework for market consultation, building on the v0.1 released in March 2022. A further two iterations of the beta versions are planned – November 2022 (v0.3) and February 2023 (v0.4) – before the release of version v1.0 of the framework in September 2023.

8. GenderSmart

Background: The GenderSmart community is made up of 2,500 investors and investment influencers, intermediaries, and others, in over 50 countries. They come from across the finance ecosystem and are at different stages in their gender lens investing journeys. Some have a priority focus on gender equality, some focus on the power of women making markets. Some have a primary commitment to issues such as the climate crisis, education, health, or human rights.

Application: GenderSmart is a global field-building initiative dedicated to unlocking the deployment of strategic, impactful gender-smart capital at scale and maintains a list of gender benchmarks and indices.[29]

9. ESG Investor Associations, Standards and Codes

Investment managers and investors have committed to a range of voluntary associations and networks in the field of ESG, corporate governance, climate change, and related issues. Below is a non-exhaustive list of some key international examples in each of these fields.[30] Some of the requests coming from credit investors to borrowers may derive from recommendations in these resources.

[26] https://sciencebasedtargets.org/
[27] https://tnfd.global/about/endorsements/
[28] https://tnfd.global/the-tnfd-principles
[29] https://www.gendersmartinvesting.com/gendersmart-home#gendersmart-community
[30] Inderst, G. and Stewart, F., (2018). Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment. World Bank Group Publication.

Responsible and sustainable investment[31]	Corporate governance, accounting and disclosure
▪ UN Global Compact (UNGC) ▪ EuroSIF, UKSIF, USSIF, SIF Japan, ASrIA, RIA Canada, RIA Australasia, etc. ▪ Global Sustainable Investment Alliance (GSIA) ▪ The Equator Principles ▪ International Capital Market Association (ICMA) Green Bond Principles (GBP) and Social Bond Principles (SBP)	▪ International Corporate Governance Network (ICGN) ▪ Global Reporting Initiative (GRI); ▪ Global Sustainability Standards Board (GSSB) ▪ Sustainability Accounting Standards Board (SASB) ▪ The FSB Task Force on Climate-related Financial Disclosures (TCFD)
Green and climate change investment associations ▪ Institutional Investors Group on Climate Change (IIGCC) ▪ Investor Group on Climate Change (IGCC) ▪ Asia Investor Group on Climate Change (AIGCC) ▪ GIC global platform ▪ Ceres	**Initiatives** ▪ Carbon Disclosure Project (CDP) ▪ Asset Owners Disclosure Project (AODP) ▪ Montreal Carbon Pledge ▪ Portfolio Decarbonization Coalition ▪ Climate Action 100+ ▪ Net-Zero Asset Owners Alliance ▪ Net Zero Asset Managers Initiative
Impact investing ▪ Global Impact Investing Network (GIIN)	**Industry Guides** ▪ Asia-Pacific Loan Market Association (APLMA), Loan Market Association (LMA) and Loan Syndications and Trading Association's (LSTA) Green Loan Principles (GLP), Sustainability-Linked Loan Principles (SLLP) and Social Loan Principles (SLP) ▪ ICMA Sustainability-Linked Bond Principles (SLBP) and Climate Transition Finance Handbook ▪ AFME Recommended ESG Disclosure and Diligence Practices for the European High Yield Market

[31] We have updated this following chart, which originally appeared in the World Bank Group publication cited in footnote 30 above.

Chapter 3
Diligence Practices

Introduction

As discussed in the first chapter of this Guide, investors today view a borrower's ESG profile as key to investment decision-making. Many are bound either by regulation, the terms of their funds' investment strategies, requiring them to comply with strict reporting requirements relating to ESG and sustainability. It is therefore important to give ESG factors appropriate consideration from the outset of both high yield bond and leveraged loan transactions, particularly in connection with the due diligence process.

In Rule 144A/Reg S high yield bond offerings, due diligence and disclosure are inextricably linked, as the diligence process illuminates the information relating to a company's business that will be disclosed in the offering documents. Identifying best practices for undertaking ESG due diligence is therefore an important first step to ensuring relevant and accurate ESG disclosure by companies.

Given this relationship between diligence and disclosure, this chapter should be reviewed in conjunction with Chapter 4 of this Guide entitled "Drafting Considerations and ESG Roadmap". It is important to remember that in bond offerings, diligence is conducted by investment banks and their counsel (working with an issuer and their counsel) in order to assist in the establishment of a due diligence defence against potential liability under Section 11 of the US Securities Act of 1933, relating to offering documents containing material misstatements or omitting material facts. Relevant securities laws in some jurisdictions, including the UK and the EU, also afford a due diligence defence to both issuers and arranging investment banks to the extent issuers have exercised due care in ensuring the offering materials prepared by them, or on their behalf, meet this disclosure standard.

Thus, bond investors do not directly participate in the diligence process and, as a result, do not have access to the documentary and oral diligence conducted by investment banks. Therefore, the challenge for companies seeking to address investors' increasing focus on ESG is to translate ESG diligence into accessible disclosure, whether through offering documents and/or an issuer's website.

While the focus on disclosure in the leveraged loan market is different than in the bond market, diligence plays an equally important role in the preparation of information memoranda and related lender presentations in connection with loan syndication. Further, lending banks and funds undertake direct due diligence and may have direct access to borrower group information, for example via access to a data room, making the collection of ESG-related diligence just as important in the leveraged loan syndication process as it is for the bond issuance process.

It is also worth noting that as ESG becomes more pervasive through both bond and loan documentation, diligence will need to be addressed with increasing levels of scrutiny, particularly given risks regarding greenwashing and other related considerations.

This chapter sets out certain key points to consider when conducting ESG-related diligence in connection with leveraged finance transactions. It primarily explores the following areas:

- the legal and regulatory framework for ESG diligence;
- the importance of assessing the "materiality" of ESG factors;
- processes used to ensure ESG information is properly captured; and
- factors to consider in developing diligence questions.

1. Legal Requirements

ESG diligence for leveraged finance transactions will be driven by two key factors, which are explored in the first two chapters of this Guide. First, investors are increasingly focused on a company's ESG risks, policies and disclosure when making investment decisions.[32] Second, there are a growing number of regulations addressing ESG policies and disclosure requirements.[33]

Companies falling under the scope of regulations giving rise to an ESG reporting framework, such as the proposed European Sustainability Reporting Standards under the EU's CSRD, will be obliged to comply with applicable requirements, and diligence will be crafted accordingly. In some cases, such regulations will dovetail with investor expectations and internal compliance requirements. However, in circumstances where there is a gap between regulatory requirements and investor expectations, companies may find that they will have greater access to capital if they voluntarily address the more robust investor-based ESG disclosure standard when carrying out ESG diligence.

[32] Please see our discussion in Chapter 1 of this Guide entitled "Why Leveraged Finance Investors Need More Disclosure on ESG Topics".
[33] Please see our discussion in Chapter 2 of this Guide entitled "Regulatory Considerations for Borrowers".

The importance of ESG-related disclosure is reflected in the prevalence of global reporting frameworks and regulatory requirements, both existing and emerging. For a detailed discussion of the key legal and regulatory points impacting ESG diligence and reporting by borrowers, see Chapters 1 and 2 of this Guide.

2. Materiality and Thresholds

One of the primary objectives of the due diligence process is to identify company information that may be material to investors and to ensure that all such information is considered when preparing an offering memorandum or prospectus. Materiality determinations tend to be fraught exercises for the senior management of borrowers or issuers, particularly for first-time market participants or those without large finance teams or the support of a prominent sponsor.

In this section we explore the origins of the concept of "materiality" in the context of leveraged finance transactions, and suggest factors that management can consider with its advisers when determining whether certain information is "material" in the context of the diligence exercise.

a. Founding Principles of "Materiality" Viewed Through the Lens of ESG

It is a well-recognised principle in Rule 144A/Reg S high yield bond offerings that companies have a duty to disclose all information a "reasonable investor" would consider material to its decision whether or not to invest in a business. This is the founding bedrock of securities laws in many jurisdictions including the US, the European Union, the United Kingdom, Hong Kong and Singapore.

This principle requires a company to ensure that disclosure made to investors does not contain an untrue statement of a material fact, or omit to state a material fact necessary in order to ensure such disclosure is not misleading. In many jurisdictions, these principles are also reflected in on-going disclosure obligations placed on issuers of public debt, where such obligations are typically linked to the price-sensitivity of information relating to the issuer and its business, as it affects that public debt.

As a general rule, materiality of ESG-related factors should be reviewed consistently with the methods used by companies in determining whether other information relating to their business more generally is "material". Such an approach has been endorsed by certain market stakeholders, including SASB and the sustainability disclosure standards being developed by the ISSB, which identifies financially material issues as "the issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors."[34] This approach, often referred to as "dynamic materiality", focuses on material sustainability-related financial information that is subject to ongoing reassessment to cater to changes in a business' circumstances.

It should be noted, however, that other institutions and stakeholders focused on ESG have adopted contrasting materiality principles compared to the traditional position on materiality. For example, the EU's NFRD, as expected to be amended under CSRD, adopts a "double materiality" principle for matters relating to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters that requires companies to disclose information "to the extent necessary for an understanding of the development, performance, position and impact of [the company's] activities"[35]. Thus, a company is required to assess and disclose financial materiality (e.g., how climate change impacts a company's financial position) as well as environmental and social materiality (e.g., how a company impacts the climate).

Some ESG-related metrics are qualitative rather than quantitative in nature, making a materiality analysis more difficult than for other factors. However, robust, standardised methodologies for calculating ESG-related data points are increasingly becoming more readily available to businesses, allowing for a more quantitative approach. Companies should look at the impact of ESG factors on their current financial performance and potential future impact going forward.

ESG factors may not always directly affect a company's financial returns, or may do so only when considered in longer time frames than have historically been the focus of leveraged finance providers. However, these issues increasingly have material direct and indirect impact on a company's reputation, ability to recruit, retain and motivate staff, ability to win business and, ultimately, on the market value of its securities. Such issues should therefore be disclosed if a company is to meet the reasonable-investor test outlined above.

Increasing numbers of investors view ESG factors as material to investment decisions. In some cases, similar weight may be given to ESG factors as would be given to financial information, and investors might even decide not to invest if certain ESG-related risks are seen to be particularly economically harmful. Nonetheless, ESG factors will have varying levels of impact depending upon the industry, location and size of a business. Materiality should therefore be considered on a case-by-case basis and may differ greatly depending upon the context.

[34] https://www.sasb.org/standards-overview/materiality-map/

[35] Directive 2014/95/EU – also called the non-financial reporting directive (NFRD)

b. Qualitative or Quantitative?

Depending on the type of underlying information, materiality determinations may be quantitative or qualitative in nature.

Quantitative materiality determinations are often easier to address, as they are generally based on a financial threshold (e.g., a percentage of consolidated EBITDA, revenue or assets). Any obligation, financial metric, occurrence or agreement exceeding a pre-determined threshold will be presumed material. Qualitative materiality determinations are less straightforward and require management to assess whether information would be viewed by a "reasonable investor" as material, or, as the US Supreme Court has held, whether there is a substantial likelihood that undisclosed information would be viewed by a reasonable investor as having significantly altered the total mix of information made available.

Increasingly, ESG factors are capable of quantitative evaluation based on key performance indicators and other measurable and comparable data points. To the extent that companies are already measuring and reporting on such data, due care will need to be given, based on a materiality assessment, as to whether, and to what extent, such data is interrogated in the due diligence process and disclosed in any offering materials.

Nevertheless, the environmental and social impact of and risks facing a business, including its policies on corporate governance, still largely lend themselves to qualitative determinations. Throughout the diligence process, companies, investment banks and their respective counsel should seek to focus on credit relevant, financially material ESG information. However, it may be difficult in practice to determine whether ESG information would be deemed material by a reasonable investor, especially where ESG factors do not directly link to a return on an investment. The difficulty of the task is amplified by the fact that ESG disclosure is in relatively early stages in the bond and loan markets and definitive, harmonised market practice has yet to develop. Ultimately, this guides how ESG provisions can be applied in practice contractually (see Chapter 5 – Contractual Considerations).

c. Future Impact

Companies should analyse the genuine impact on financial performance and investor return as a result of both their ESG practices and their exposure to ESG-related risks and opportunities. In particular, companies should consider whether there is likely to be an effect on performance going forward.

For companies in the early stages of ESG implementation, future performance will likely be a key factor in determining materiality. This is particularly true of ESG-related R&D and current Capex, where the fruits of such investments will not be borne until a later date. In addition, organisations may find certain assets (e.g., certain E&P in oil and gas, forestry and agricultural assets) become stranded, and cannot be used effectively going forward. This may occur due to issues such as climate change, shifts in governmental policy or labour relations, resulting in unexpected future losses, inefficiencies and even litigation. In some cases, such financial impact may be long-term rather than short-term, and may be relatively indirect. Nonetheless, such risks may still be material.

d. Impact on Reputation

One of the ways in which ESG factors can represent either a direct risk to financial performance, or an opportunity for investor return, is through the impact of such factors (whether positive or negative) on the reputation of a business.

Reputation is critical with respect to a wide range of stakeholders, including current and future employees, customers, suppliers and the public in general, as well as investors. Managing risks and opportunities of reputational impact is particularly fundamental when looking at societal changes in response to matters such as climate change, diversity in the workplace, transparency of governance structures, supply-chain integrity and wildlife conservation, to name just a few. Companies that are not addressing these changes are highly likely to face a materially adverse impact on their reputation. The reputational effect of addressing, or failing to address, such factors may have a knock-on effect on access to liquidity.

e. Differences Between Sectors, Company Size and Location

The materiality of ESG information will differ depending upon the nature of the business. In certain sectors like manufacturing or energy, the material financial impact of a company's policies on issues such as clean energy solutions, recycling or reducing water usage will likely be more easily identifiable, as cost savings or new investments will lead to greater returns.

In the financial services industry, the impact on companies is likely to be intimately connected with the products, enterprises and projects in which they invest or otherwise provide financial services.

For industries such as healthcare, analysis of ESG factors may be broken down into granular sub-sectors, as impact can vary even within the wider sector.

In the technology sector, the ESG analysis will focus on topics such as data protection and digital inclusion. Due to the disparate application of ESG across sectors, we have taken a sector-focused approach to our ESG Fact Sheets in addition to offering a sector-agonistic resource.

The size of the company will also impact the ESG analysis. Larger, more well-established companies with a high number of employees or wider global reach may also see certain ESG factors as more material, particularly social issues such as security, labour policies, diversity in the workplace and corporate governance, where they may face pressures from external forces including governments or regulatory bodies.

Furthermore, the geographical location of a business may have an impact on the materiality of ESG factors, such as exposure to sanctioned countries, the protection of biodiversity or indigenous communities, or exposure to low-lying coastal regions.

Ultimately, materiality is a matter of judgment for a borrower's management and its advisers and will differ greatly between businesses. Nonetheless, borrowers should act consistently with their approach, analysing materiality of ESG factors in the same manner as used in relation to their business and financial performance as a whole, and always having regard to the reasonable investor test outlined above.

f. ESG Disclosure in Leveraged Buyouts

In the context of a leveraged buyout, a target's new owners and advisers may find it difficult to respond to many of the topics requested by investors. As they do not yet have control over the company, and the management team will likely change following the acquisition, private equity sponsors may be limited in their ability to provide historical data.

Investors will be keen to understand the sponsor's plan for implementing or continuing a sustainability strategy once the acquisition is closed, and to receive ESG data once it is available (even if this means waiting until the new management team is up and running). Borrowers and their advisers may consider completing the relevant ESG Fact Sheet when the data is available and prioritising engagement with investors during the interim period.

3. Stakeholder Due Diligence

In order to ensure appropriate, proportionate and relevant ESG-related diligence, it is critical that the right questions are asked by or on behalf of investors from the outset.

a. Management Diligence and Documentary Request Lists

Customary due diligence in the high yield bond market is conducted through topical diligence calls or meetings with company management and internal subject-matter specialists (e.g., environmental, tax, financial). Such calls are partnered with a review of relevant documentary due diligence to identify material information and obtain clear evidence for material assertions disclosed by management.

To ensure material ESG information is disclosed during this process, it is important to ensure that the investment banks arranging the transaction understand the different areas in which ESG can be relevant and frame their questioning accordingly – indeed, many investment banks have already updated their due diligence questionnaires to include ESG questions. Rather than carving out a separate ESG-specific section to questioning, it could be more effective to take a holistic view, incorporating ESG questions into each section of management diligence questionnaires and documentary request lists. Over time, as market practice in this area grows, practitioners may wish to include information in a stand-alone ESG section of the company's ongoing financial reports, or might explore publication of a separate sustainability report.

As noted previously, many investors already require companies to complete diligence questionnaires that increasingly include ESG-related topics. These questionnaires vary in scope and breadth amongst investors. A key way to encourage clarity and consistency in investor ESG diligence, and to ensure a streamlined and efficient process, is to seek to harmonise the approach to diligence. This will support companies in their understanding of the ESG diligence process, and facilitate offering documentation that captures the material ESG-related matters that are important to investors generally. The ESG Fact Sheets and this Guide are designed to support such harmonisation. Without such an approach, there is a risk of inconsistent, selective disclosure of material information to different investors based on their varying questionnaires.

ESG-related questions include the following areas:

- Environment
- Health and safety
- Employment policies
- Corporate governance
- Product quality and supply chain management

- Customer relations
- IT security and data privacy
- Community engagement

Although not a comprehensive list, the above conveys how wide-ranging ESG questions can be, and the importance of integrating ESG data and information into the diligence process, rather than simply bolting on a separate section of questions towards the end of the questionnaire. That being said, in addition to weaving ESG questions throughout the questionnaire, the arranging investment banks may consider using a separate, ESG-specific catch-all section, covering matters such as general ESG strategy, formal commitments and adherence to external frameworks or standards, and monitoring of performance and compliance both historically and going forward.

b. Third-Party Diligence

Although management diligence calls and documentary request lists will be the key drivers in ESG diligence, third parties may also have a role to play. For example, auditor diligence could be valuable regarding corporate governance and the impact of ESG factors on financial statements. However, the value of such engagement is dependent upon the extent to which auditors are willing to discuss and address such topics.

4. Factors to Consider in Developing Diligence Questions

As discussed above, the importance of certain ESG factors will differ depending upon the sector and nature of a company's business, and therefore the scope of diligence to be undertaken will vary accordingly. The ESG Fact Sheets are designed to be a useful starting point in developing due diligence questions – the resource provides key methodologies and metrics at the sector level, supports the materiality analysis, and facilitates greater consistency in disclosure. Companies and investors alike should also consider reviewing the SASB's Materiality Map[36], an interactive tool which sets out the materiality of various ESG factors across different industries. This is a useful tool in determining which areas to focus upon during the diligence process, depending upon the sector[37].

As markets continue to increase their focus on ESG factors, there is likely to be heightened scrutiny on ESG-related policies of issuers in carbon-intensive sectors. Stakeholders will be keen to see evidence of steps being taken in these industries to reduce negative environmental impact and increase long-term sustainability.

Differing geographic factors will also impact ESG considerations of issuers in different regions, and the relevant diligence to be undertaken. Issues such as protecting cultural heritage, biodiversity and indigenous peoples, and proximity to threatened, low-lying, coastal regions will have varying degrees of importance depending upon the geographical area in which an issuer operates, and its interaction with its environment.

Finally, consideration should also be given to focussed on the contemplation or existence of contractual provisions relating to ESG and sustainability; if the underlying instrument contemplates a margin step-up or other pricing enhancement for ESG performance, then this should be addressed upfront in the diligence exercise to ensure milestones or KPIs are appropriate. Chapter 5 on Contractual Considerations goes into more detail on the types of provisions making their way into high yield bonds and leveraged loans.

Although the importance of ESG and relevant key considerations will differ between sectors, there are certain areas applicable to the vast majority of issuers. For example, although environmental factors will not always be directly relevant (even if these still must be disclosed due to investor regulatory requirements), issues such as effective corporate governance, policies relating to employment and ongoing monitoring of ESG processes and evaluations are all of importance to organisations looking to demonstrate the incorporation of ESG in their systems and controls.

ESG-related diligence should ultimately lead to clear, transparent disclosure on points which would be material to an investment decision. Company advisers can support a comprehensive investment analysis, with a clear presentation of a company's ESG profile, that conveys a clear picture of the material ESG factors that could impact an investment decision.

[36] https://www.sasb.org/standards-overview/materiality-map/
[37] Supported by International Sustainability Standards Board (ISSB) as well.

Chapter 4
Drafting Considerations and ESG Roadmap for High Yield Bonds

Introduction

The focus of this chapter is to provide a roadmap for incorporating ESG-related disclosure into offering materials in Rule 144A/Reg S bond offerings. The inclusion of ESG disclosure will be driven by the following factors: (1) regulatory requirements[38]; (2) materiality[39]; and (3) voluntary disclosure of non-material information.

In particular, ESG disclosure will primarily focus on the need to mitigate the risks associated with failing to meet the "reasonable investor" disclosure standard (as described in Chapter 3 of this Guide entitled "Diligence Practices"). Well-articulated and comprehensive disclosure on ESG is essential to secure a company's access to capital. When addressing the increasing demand for ESG information, companies should leverage existing disclosure market practice, incorporating relevant ESG-related information into offering materials where appropriate.

As disclosure relies heavily upon the information obtained during the diligence process, this chapter should be read in conjunction with the previous Chapter 3 "Diligence Practices".

For a discussion on ESG disclosure in loan marketing materials, please see Chapter 5 of this Guide entitled "Contractual Provisions and other Considerations".

1. Relevant Regulatory Considerations

In the context of Rule 144A/Reg S bond offerings, the primary driving force behind offering memorandum disclosure is the requirement under US securities laws to disclose all information a "reasonable investor" would consider "material" to its decision to invest. Regulation S-K and Regulation S-X of the US Securities Act of 1933 outline disclosure requirements for SEC-registered offerings, which, as a result of established market practice, serve as disclosure guidelines in the 144A-for-life marketplace. Similar disclosure requirements apply under securities laws in other jurisdictions, including requirements applicable to prospectuses and listing particulars published in the EEA and the UK. In connection with the due diligence process, underwriters and counsel work together with a company to identify all material information requiring disclosure.

As investors turn their focus to ESG, issues such as sustainability policies, strategies, risks and opportunities are becoming increasingly more relevant to investment decisions, and therefore are more likely to expect disclosure as material factors. In certain cases, investors may even give similar weight to ESG factors as they would to financial information, depending upon their wider investment goals. However, the determination of what information rises to the level of "material" ultimately will be one for management to decide, likely informed by conversations with investors.

High yield bond issuers in Europe will need to have regard in particular to the EU's ESG regulatory regime, including the EU's Sustainable Finance Disclosure Regulation (SFDR) and the proposed Corporate Sustainability Reporting Directive (CSRD)[40]. The SFDR lays down particularly strict rules in relation to financial products that promote environmental or social characteristics, or products that have a sustainable investment as their objective. While the SFDR does not directly apply to high yield debt issuances, it will have an indirect impact. The CSRD, which is expected to directly impact nearly 50,000 entities, will require in-scope companies to annually report in compliance with rigorous new European sustainability reporting standards. The SFDR and the proposed CSRD, along with continued investor demand, has accelerated transactional ESG due diligence and the incorporation of ESG disclosure in the high yield market.

For further discussions on materiality, the US securities law liabilities regime and other applicable regulations, please see Chapters 2 and 3 of this Guide "Regulation and Voluntary Frameworks" and "Diligence Practices".

2. ESG Disclosure in the Offering Memorandum

Offering materials can be a key tool to provide investors with the ESG-related information they require. It would be both efficient and beneficial to stakeholders (including sponsors providing equity that would also require ESG information) to address ESG in a consolidated manner within the offering memorandum and the accompanying roadshow presentation slides, rather than bilaterally through separate investor discussions, as is often currently the case.

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[38] Please see our discussion in Chapters 1 and 2 of this Guide entitled "Why Leveraged Finance Investors Need More Disclosure on ESG Topics" and "Regulatory Considerations for Borrowers".

[39] Please see our discussion in Chapter 3 of this Guide entitled "Diligence Practices – Legal Requirements and – Materiality and Thresholds".

[40] Please see our discussion in Chapter 1 of this Guide entitled "Why Leveraged Finance Investors Need More Disclosure on ESG Topics" and Chapter 2 "Regulatory Considerations for Borrowers".

Following the diligence process outlined in Chapter 3 "Diligence Practices", all material ESG-related issues uncovered should be incorporated into the offering materials in a manner consistent with the approach taken to non-ESG disclosure of a company's business.

Borrowers have the option to weave ESG disclosure throughout offering materials where relevant, ensuring that it ties in with wider business disclosure in a manner that is relevant, proportionate and easy to follow. By incorporating ESG information into each section of the offering memorandum, companies will be able to paint a fuller picture of the risks and opportunities of ESG factors on their business as a whole while conveying a genuine commitment to ESG principles.

Borrowers may also consider including a separate section summarising their ESG policies and highlighting key ESG topics with cross-references to more fulsome disclosure present in other parts of the offering memorandum. Investors are increasingly under significant time pressure when reviewing company disclosure in a high yield bond offering and, as such, this approach may make it easier for them to access the information they require.

This is highlighted in our ESG Investor Survey 2021 as well where investors considered ESG decisions as critical, with 98% of respondents reporting having passed, reduced or sold out of investments due to ESG issues at least once in the last 12 months. Thus it benefits the borrower to make disclosure as clear, comprehensive, and easy to find as possible to facilitate fulsome engagement.

This disclosure roadmap has been prepared for all companies and issuances. It should be noted that market practice for certain ESG offerings (e.g., green bonds, social impact bonds, sustainability-linked bonds) has evolved to include specifically tailored disclosure related to such bonds, namely the description of the ESG framework under which the bonds are being issued and, if applicable, the use and monitoring of proceeds from such issuance. This roadmap does not separately address ESG issuances that require additional or amplified ESG-related disclosure.

The following section provides examples as to how ESG disclosure can be incorporated into a customary Rule 144A/ Reg S offering memorandum.

a. ESG / Sustainability

As discussed above, borrowers may wish to consider including a section highlighting its ESG / sustainability policy and including key data (e.g., a table with Principle Adverse Sustainability Impact (PASI) information or ESG key performance indicators). A description of the borrower's ESG materiality assessment could also be included in this section, along with a summary of its ESG policies with cross-references to other relevant sections of the offering memorandum where these concepts are explored in more detail.

b. Business

The business section of an offering document is the key section in which a company can fully display its ESG strategy and outline the extent to which ESG factors may impact its business. ESG factors could be utilised in this section as a potential draw to encourage investment, with companies voluntarily describing their ESG aims and policies, rather than only including such information due to disclosure requirements stemming from the materiality standards of applicable securities laws.

Commitment to ESG goals and sustainability policies will likely be a competitive strength for a variety of issuers, particularly in so called "brown" industries like coal, mining, oil and gas or nuclear power where there is much public interest in improvement and development in the ESG space. As ESG continues to shape these industries, companies that harness sustainability practices as part of their wider business strategy to reduce costs and improve efficiency and sustainability may wish to advertise their strengths in this area.

Companies can use this section to explain any material ESG-related regulations affecting its business, whether industry-specific or at a national level, and any internal ESG policies it may have. The business section can be used to champion any ESG successes, such as initiatives relating to environmental, health and safety or workforce diversity and inclusion, and explain steps being taken by the company to futureproof its business in respect of changes to the ESG landscape.

Through the business section, companies can also describe the internal procedures and controls that govern their ESG policies, which is important to investors from a risk management perspective.

A robust and comprehensive ESG strategy can also become an important marketing tool. By appropriately capturing ESG-related strengths and strategies in the key business description section, companies can attract the interests of a wider range of investors by evidencing clear commitment to sustainability goals.

c. Risk Factors

Companies and their advisers should ensure that any material ESG-related risks are fully disclosed, particularly regarding their ability to successfully operate in an increasingly sustainability-focused landscape.

The scope of relevant ESG-related risks will vary greatly between sectors and geographies. ESG-related risk factors are likely to include future sector-specific and general regulatory changes, and in particular, the risks companies may face if they fail to adapt to such changes. In particular, industries like construction, oil and gas and manufacturing are likely to face increased scrutiny going forward, as governments and global regulators ramp up their focus on reducing carbon emissions globally.

There are a variety of risks that may apply to issuers across industries in relation to ESG, including but not limited to:

- Reputational risks stemming from failure to adhere to ESG-related industry standards or actively promote sustainable practices;
- Risks of breaches of future regulatory requirements leading to sanctions or financial penalties, as regulators increase focus on ESG;
- Risks of litigation or reputational damage relating to employment, social and governance policies (e.g., anti-discrimination or diversity); and
- Changes in the ESG landscape leading to depreciation in value or a reduction in the useful life of key assets.

All these factors directly link to the creditworthiness of an issuer and outline how a company's ESG profile and the success of an investor's investment are becoming increasingly intertwined.

While ESG-related risks may apply across a company's operations, companies may consider setting out a full section on ESG-related risk factors, in the same manner that risks relating to an issuer's business are usually separated from those relating to the notes themselves. This will assist investors in properly assessing the scope of ESG-related risks to an investment, and their ability to compare issuers across sectors.

Companies and their advisers should bear in mind that, when addressing ESG risks, focus should be placed on "material" risk factors that impact a company and should avoid presenting generic risks.

d. Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

The MD&A section should be viewed as the primary section relating to the impact of ESG on a company's financial position. With its focus on liquidity, capital resources, results of operations and off-balance sheet arrangements, the MD&A is the natural section for disclosure relating to the financial impact of ESG, including ESG KPIs. For more information on ESG KPIs, please see "Data Metrics and Comparing ESG Impact – ESG KPIs" below.

It may be important for issuers to evidence their awareness of, and flexibility to adapt to, potential ESG related industry changes, including fluctuating demand for certain products and services, or unanticipated new regulations. It will also be important for companies to disclose any material negative impact on results or asset valuations due to ESG risks and to explain why these were not proactively managed. Disclosure should be made around any material existing and committed future activities, risk management strategies and decisions regarding new investments and write-downs.

As ESG is currently an area of rapid development, a company may have invested in certain assets that run the risk of becoming "stranded" due to unexpected or premature write-downs following regulatory or social pressures against the use of such assets, due to negative environmental impact. For example, energy intensive industries are facing increasing pressure to transition to more sustainable energy resources and waste management processes. Assets that rely heavily on raw materials or high levels of carbon emissions may therefore rapidly decrease in value.

Companies may wish to explain any ESG-related critical accounting policy estimates or assumptions underpinning their financial statements, and the impact of material ESG issues on historical profit and loss and cash flow statements. An increased focus on ESG factors may drive ongoing liquidity needs, particularly with respect to capital expenditure if a company decides to invest in ESG-related R&D, or new technologies. For example, investments in new clean energy processes may cause a sharp increase in costs for an issuer in the short term, despite having longer-term incentives.

e. Management

In the "Management" section, companies can outline the role of senior management and the board of directors in managing and promoting ESG strategy and overseeing internal compliance with ESG-related policies.

The management section could also be a valuable place for issuers to outline their approach corporate governance. Issuers could explain the composition of their board here and highlight any diversity policies or plans they have in place. Companies may also wish to consider outlining any ESG-linked development strategies or employee or management incentive plans.

Additionally, companies may have established specific committees to oversee ESG-related matters and ensure related policies are adhered to in its business or delegated this work to specific individuals. The Management section could be an appropriate place to outline these oversight processes. If the offering relates to a specified ESG issuance (e.g., green bonds), any committee established to monitor the use of proceeds and ensure funds are put towards the agreed eligible projects should be disclosed.

f. Principal Shareholders

This section provides an opportunity to market any relevant sustainable practices by the company's shareholders, or any tangible support offered by shareholders for ESG-related development. Where relevant, the offering could outline actions taken by shareholders to promote ESG, and any specific sustainability targets impacting their relationship with the company.

g. Related Party Transactions

Any material arrangements between the company and its affiliates with an ESG nexus should be captured in this section. For example, the issuer may have established a relationship with an affiliate that plays an ESG consultancy role, or may be considering working more closely with other branches of its wider corporate group which focus on improving sustainability.

h. Financial Statements

Financial statements can be a useful area to outline a company's ESG strategy and the quantitative impact on its financial position. Supply and demand may fluctuate due to changes in policies, technology and market dynamics relating to ESG matters, which may in turn impact the valuation of a company's assets and liabilities. Investments in new processes or materials, which promote sustainability, may also increase initial upfront costs to a business. These factors will all be captured through the company's financial statements.

Investors may find value in comparing recent statements, in order to analyse ESG-related changes to financial performance. While reviewing financial statements can be useful to obtain concrete data, any increases or decreases in costs, revenues or asset valuations should be discussed with management and the reasons for such changes properly disclosed in the MD&A section, as discussed above.

3. ESG Data Metrics and Comparability

As more companies provide disclosure on ESG topics, it will become more important for investors to be able to compare and contrast the ESG profile of different issuers. Consistent data metrics should therefore be applied where possible to ensure valuable comparisons can be made going forward.

a. Data Metrics

The process of gathering most ESG-related disclosure points will involve discussions with management, as discussed elsewhere in this Guide, and the accompanying disclosure may be qualitative in nature.

Some data will be quantitative, however. For example, the following metrics could be used to describe the ESG profile of a business:

- Numerical approach: Analysis of, for example, carbon footprint information, employee injury rates, gender pay gap data, the number of actions taken or hours committed towards certain goals, composition of board, number of products targeting specific ESG goals, and number of health and safety-related accidents.
- Percentages: Issuers may be able to evidence a set percentage of carbon reduction or change in waste management over the last financial year, or report on the percentage of revenue earned from controversial products such as military weapons, tobacco, gambling, coal and nuclear power, etc.
- Ratios: Investors could set out ESG-related ratios, such as the ratio of clean energy used compared to traditional energy sources, or male to female representation in the workforce or on the board of directors.

Some of this information may also be relevant to include in relation to the company's supply chains, to the extent it is available.

b. ESG KPIs

General and sector specific KPIs are a key tool for investors in measuring and comparing ESG factors. The adoption by companies of widely recognised, comparable and easily understood ESG KPIs will allow investors to readily assess the genuine impact of ESG factors on a business.

A number of public and private institutions have opined on the identification and reporting of ESG KPIs. For example, the European Commission's Guidelines on reporting climate-related information set out six key principles for effective ESG reporting.[41] KPIs should be: (i) material; (ii) fair; balanced and understandable; (iii) comprehensive but concise; (iv) strategic and forward-looking; (v) stakeholder orientated; and (vi) consistent and coherent. The Guidelines recommend using KPIs that are easily comparable between peers and setting them out alongside disclosures which support and provide background for their use.

Additionally, the GRI Sustainability Reporting Standards, issued by the Global Reporting Initiative in May 2020, also highlight the importance of accuracy, reliability, clarity and ease of comparability in ESG reporting, and note that disclosure should be stakeholder focused.[42]

Harmonisation and widespread adoption of global and sector specific KPIs will assist issuers in improving their ESG reporting and will be critical to ensuring that meaningful ESG disclosure gains traction in the market. Participants in our ESG workshops reported looking increasingly to TCFD, SASB and GRI for ESG diligence and disclosure guidance, including with respect to KPIs.

Several initiatives are under development to support greater consistency in ESG disclosure – some of these are outlined in Chapter 2 of this Guide "Regulatory Considerations for Borrowers".

We continue to focus on a range of ESG KPIs during our discussions with management in our sector-focused workshops so that we can incorporate their input into the ESG Fact Sheets.

Many stakeholders with an interest in ESG have already identified a number of relevant KPIs, many of which overlap. In choosing KPIs for an issuer, it will be important to consider its industry and the size of the organisation, as these will impact its ability to properly measure ESG-related performance indicators and provide genuine value in reporting.

In addition to the ESG Fact Sheets, some key resources for issuers looking to develop ESG-specific KPIs include the ICMA's Handbook of Harmonised Impact Reporting, ICMA KPI Registry[43], the European Federation of Financial Analyst Societies' KPIs for ESG, SASB Standards, GRI Standards and the TCFD recommendations on climate-related disclosures. Market precedents from both investment grade and leveraged finance markets can also provide valuable insight into the types of KPIs already used by issuers, although these will vary from sector to sector.

4. Other Methods of ESG Disclosure

In addition to ESG disclosure in offering documents, companies can provide further evidence of their ESG strategy, goals and KPIs, via website publications. These can include standalone ESG, or sustainability, reports that are based on one or more of the voluntary global ESG disclosure frameworks (e.g., TCFD, The Value Reporting Foundation). Additionally, in connection with ESG bond offerings, companies tend to publish ESG financing frameworks on their websites that summarise ESG strategies and policies along with alignment with applicable ESG bond principles, such as ICMA's Sustainability-Linked Bond Principles. These frameworks are usually verified by a third-party ESG agency. Given liability concerns, these external ESG disclosures tend not to be disclosed or incorporated by reference into an offering document, although they may be summarised in part. If this approach is used, care should still be paid to ensure that this external information is not material information that should have been included in the offering document.

Where relevant, companies can engage rating agencies, or obtain independent opinions or internationally recognised certifications, to clearly convey their active engagement with ESG issues and commitment to genuine improvement.

There are a number of ways in which issuers can add value to their offering materials through third party sources. It should be noted that, in the current market, the third-party reporting options described in this section are mainly used in connection with ESG offerings (e.g., green bonds or sustainability-linked bonds) rather than in respect of standard bond offerings. Such ESG offerings may specifically require certain forms of independent verification or certification of the bonds as compliant with specified ESG standards, meaning third party reports are more commonly used. While many recognised bodies in the high yield bond market encourage the issuance of ESG-linked bonds, at present these bonds form a small part of the wider market, and their use varies between sectors. This roadmap does not separately address these ESG issuances that require additional third-party reporting.

Although many of these approaches will be more relevant to issuers of ESG bond offerings, all of the following resources may benefit companies with an interest in promoting and disclosing ESG principles:

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[41] European Commission's Guidelines on reporting climate-related information (2019)
[42] https://www.globalreporting.org/standards/
[43] https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/

a. Globally Recognised ISO Standards

Issuers can obtain certifications from the ISO on areas such as environmental management, IT security, health and safety, and product quality, which can be directly included in the offering memorandum. ISO certifications act as robust evidence of compliance with globally recognised ESG standards for investors. While many of the other third-party resources in this section are mainly used for ESG offerings, ESG-related ISO certifications are often obtained by a variety of companies, regardless of the type of issuance, as part of their overall business strategy.

b. Certification

Bonds which meet certain criteria can be certified by the Climate Bonds Initiative (CBI) as conforming to the Climate Bonds Standard. These standards seek to ensure consistency with the UN Sustainable Development Goals and the goals of the Paris Climate Agreement. While certification is a prerequisite to the issuance of a green bond, it could add value for all issuers with an ESG focus by demonstrating compliance with best practice standards and real commitment to environmental sustainability. To ensure continuing adherence to the Climate Bonds Standard, the issuer is reviewed 12 months after the initial offering in a further, identical certification process.

c. Independent Verification

Verification of the ESG impact of a bond by an approved independent agency can be a valuable way to demonstrate credibility to investors looking to adopt an ESG investment strategy. It can act as a form of assurance to investors that their funds will be used to directly finance green or social projects, and that the issuer is not “greenwashing” the bond to gain access to a broader pool of investors without genuine commitment to ESG.

Independent verification is also a pre-certification requirement of the CBI. Before a bond can be certified as “green”, the agency must review and confirm the issuer’s compliance with certain ESG factors and verify that the bond proceeds will only be used towards certain eligible “green” projects.

Verifiers will assist issuers in developing an ESG framework that will suit their business and align with recognised market practice. Verification agencies are approved on the basis of their experience and compliance with the ISAE 3000 Assurance Framework (a globally recognised standard for sustainability audits). All of the Big Four accounting firms are currently able to act as independent ESG verifiers.

d. ESG Ratings

Issuers can engage ESG ratings organisations, such as MSCI or Sustainalytics, to measure their performance against specific ESG metrics and provide an ESG rating. Similar to a credit rating, an ESG rating can act as a tool for investors to analyse and compare different issuers. However, critics suggest there are currently insufficient levels of standardisation between different ESG rating agencies, who apply varying methodologies and metrics, making comparisons difficult. It should be noted that the EU has proposed the establishment of a registry of approved third-party ESG ratings organisations in connection with its European Green Bond Standard that would be supervised by the European Securities Market Authority. This registry would provide for a centralised accreditation regime for such third parties, requiring them to have “adequate qualifications, professional experience, and independence…to ensure adequate investor protection.”[44]

Despite these concerns, if used appropriately, an ESG rating can be a valuable tool for issuers to prove their high standards of compliance with standards of environmental sustainability and good corporate governance.

e. ESG Factors in Credit Ratings

Credit rating agencies are increasingly including ESG factors in their analysis of the financial status of corporate borrowers. Moody’s, Fitch and S&P have all signed the UN PRI’s statement on ESG, signalling commitment to their role in developing the focus on ESG in the global financial system.

As with ESG ratings, there have been some concerns of limited consistency between methods of analysis applied by these agencies, and a lack of consolidation in this area. In addition, credit rating agencies recognise that there are often factors that will be more immediate and material to a credit score, such as liquidity concerns.

If ESG is not material in light of such credit risk, it is unlikely to be included in the credit analysis. Nonetheless, this has potential to be an area for both growth and harmonisation going forward. Credit rating agencies are keen to improve their ESG-related products due to a growing investor demand for more extensive commentary on ESG issues and readily usable comparison tools.

Indeed, the PRI’s ESG in Credit Risk and Ratings Initiative aims to enhance the transparent and systematic integration of ESG factors in credit risk analysis. The PRI is facilitating a dialogue between credit ratings agencies (CRAs) and investors to cultivate a common language, discuss ESG risks to creditworthiness and bridge disconnects. More information on the initiative is available here.

[44] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0391

Chapter 5
Contractual Provisions in Leveraged Loans

Introduction

There are an increasing number of examples of contractual provisions in European leveraged financing arrangements focussing on borrowers' ESG performance.

1. Growth Across Leveraged Finance Asset Classes

Adoption of ESG provisions in Europe has been significant, and this seismic shift in approach to ESG has been driven by a number of factors, including the range of different existing and emerging regulatory requirements that are now impacting all levels of the market, which are described in Chapter 1 and Chapter 2 of this Guide.

Incorporation of ESG provisions in high yield bonds has also been on the rise, having first appeared in the bond market in September 2019, pioneered by Enel, an investment grade rated Italian provider of electricity and gas.

While ESG provisions are discussed for many European leveraged loans, they do not always make it into the final documentation for private company mid-market credit fund loans, where a debate between borrowers and lenders can fall down on the question whether if all ESG metrics are missed, should the loan become more expensive than it would have been absent ESG metrics.

Furthermore, for top tier loans with a US$ tranche being syndicated into the US, ESG margin ratchets continue to remain relatively uncommon in the US institutional market.[45]

2. Distinguishing Amongst Products

When we consider ESG contractual provisions within the European leveraged markets, it is important to distinguish two products which exist more generally outside of the leveraged space. First, so-called "use of proceeds" instruments, the key feature of which is that the proceeds of the financing are earmarked for "green" or "social" projects/activities (or a combination of both); and second, "sustainability-linked" instruments, which incentivise the borrower's achievement of ambitious, predetermined sustainability performance targets. It is the latter product which has made its way into the European leveraged finance markets.

3. Considerations for Contracting Parties

We consider the nature of contractual provisions below, but it is important to recognise that in assessing the form of any ESG-specific contractual provision, a range of factors may be considered, including whether the provision should be general or sector-specific, or qualitative versus quantitative. In addition, there are a number of other challenges to creating uniformity across the market, including a lack of consistency in reporting (which ELFA's ESG Disclosure Initiative aims to address), differences and difficulties in measurement of sustainability-linked outputs, and an absence of relevant KPIs.

In addition, given that any contractual provision will be closely linked to on-going diligence processes, greater consistency in diligence practices is also a prerequisite to supporting uniformity in contractual provisions. It is also necessary to consider "materiality" – which is discussed at length in Chapter 3 – when assessing the appropriate contractual standard. To this end, whilst it has been possible to identify trends which have emerged in the leveraged markets, the detailed drafting of the various contractual provisions themselves have very much been led by the underlying diligence materials and/or statistics available for a particular borrower or issuer.

Understandably, contractual disclosures and covenants that align to ESG metrics will strengthen the overall ESG message and reinforce the commitment of both the investor and the borrower. To this end, in drafting any new contractual provision, it is important that it is ambitious and readily accepted by the market, and does not inadvertently result in default hair triggers. At the same time, and in light of market concerns over greenwashing, a delicate balance must be maintained to ensure that any contractual provisions are meaningful for both investors and the underlying borrower or issuer.

4. Summary of Emerging Practices

Below is a high-level summary some of the ESG contractual provisions that have emerged in the European leveraged markets:

- the setting of KPIs, focussing on a range of criteria covering either the E, the S and/or the G;
- a margin reduction (and, in some cases, a quid-pro-quo increase) tied to the performance and compliance with reporting (or not, as the case may be) of such pre-determined SPTs;

[45] This is however set to change with the SEC proposal: https://www.sec.gov/news/press-release/2022-92

- verification and reporting in respect of performance against SPTs for each of the KPIs, which for loans aligned to the Sustainability-Linked Loan Principles and bonds aligned with the Sustainability-Linked Bond Principles require third party verification; and
- on-going reporting obligations and/or undertakings, including in relation to compliance with ESG laws, policies and procedures.

Our Insights report, The Emergence of ESG Provisions in Leveraged Finance Transactions, provides a detailed exploration of the different permutations of ESG-linked margin ratchets and sustainability-linked high yield bonds.

5. Identifying and Assessing Relevant ESG Metrics

Having said all of the above, there is the task of identifying and assessing the relevant ESG metrics, and for companies that have them, the Environmental and Social Risk Management (ESRM) teams will be the most appropriate initial source of guidance.

Institutional ESRM teams typically sit within the risk function of the institutional ecosystem, and as such all recommendations from those teams are usually deemed as “must-haves” for the institution to which they relate. This does limit drafting standardised terms on a pure commercial basis to some degree as the market has not yet reached a stage where ESRM considerations are uniform.

A sustainability coordinator may also assist the parties in negotiating the relevant KPIs and SPTs, although it should be noted that this is typically a non-reliance role and so individual lenders will still be responsible for ensuring that they are satisfied with the KPIs and SPTs selected.

Going forward, and as ESG metrics become more prevalent in the European leveraged loan and high yield bond markets, we anticipate that covenant protections may be elaborated further, and we may begin to see a degree of standardisation.

Chapter 6
ESG in Private Debt Market

Introduction

The heightened focus on ESG factors across the general debt and equity markets has been well publicised. Whilst there has been less written on the private debt market, which may be seen by some as opaque, this does not mean that this market is taking its sustainability responsibilities any less seriously. Private debt funds have recognised the importance placed on sustainability by their LPs and borrowers and are increasingly following the direction of travel set across other asset classes.

Over the course of the last 18 months, ESG aspects of private debt have grown exponentially and now feature in the majority of deals in the middle market, the main market for private debt deployment. The fundamental reason behind this is that it has become more important for investors to build ESG factors into their investment thesis because of the general desire for financing to flow to businesses that are more sustainable, and due to the increasing expectation by LPs that private debt funds qualify at least as Article 8 funds.

1. ESG Diligence and Disclosure

a. Diligence

Asset managers and their LPs are coming under increasing pressure from their governing bodies to invest in companies with an ESG focus and are also increasingly expected by their LPs to qualify as Article 8 funds. According to our ESG in Private Debt Survey 2021 which was conducted in Q4 2021 and collated the views on ESG investing from 32 investors representing 23 organisations, LP information requests are becoming more ESG focused, with 87% reporting that LPs have asked about ESG with nearly 68% fielding such questions at every or almost every other meeting and another 19% usually do.

Consequently, this has fed into their due diligence processes where an increasing number of private debt investors are looking at ESG metrics as a fundamental aspect of their investment thesis. Due to the observation of a positive correlation between companies with heightened ESG focus and financial performance, private debt fund managers are spending an increasing amount of time on ESG at the due diligence stage.

Accessing the information of private companies is one of the issues that private debt funds are actively seeking to navigate. Whilst publicly listed companies are required to produce certain disclosures and data to the market, private markets do not have these general disclosure requirements and so investors have to do their own due diligence. Compressed deal timetables can make meaningful due diligence on ESG harder but as the importance of ESG has grown so has the sophistication from credit funds in terms of ascertaining relevant information they require at the diligence stage.

Further, the lack of quantitative data and third-party databases requires that diligence comes out of direct interaction with companies. As a result, the quality of the data that is provided ranges from comprehensive to non-existent. Therefore, what is clearly needed is more education of companies, ideally through their advisors, to establish what investors need in an ideal world. The establishment of processes within the company to gather data will take some time.

Whilst each fund's approach will vary, funds should dedicate time to ESG during their investment committee stage. There will be different levels of due diligence depending on the focus on ESG and the borrower's degree of ESG sophistication. This ranges from basic screening of investments against high-risk activities to identifying any issues relevant to the investment and having those considerations at the forefront of investment decisions. Due diligence will include utilising sponsor ESG due diligence reports, holding interviews with stakeholders and following sector guidance to outline key ESG factors relevant to the investment together with dialogue with management.

b. Disclosure

The fundamental goal of disclosure requirements is to encourage investment firms to be more transparent with the information that they gain through their ongoing diligence of assets and the risks that come with such investments when trying to align them with their investment theses. This allows investors to price their investments with information available to them and to make an informed decision based on the risk allocation given to certain ESG factors. A big challenge in the private debt space is the lack of public information and so, as mentioned above, investors conduct their own diligence.

The EU has been a driving force behind promoting responsible investment. The main EU legislation is the SFDR which applied from 10 March 2021 and which imposes mandatory disclosure obligations on investment managers, the main goal of which is to improve transparency around sustainable investments and prevent greenwashing. SFDR is described in more detail in Chapter 1 of this Guide, "Why Leveraged Finance Investors Need More Disclosure on ESG Topics".

Given the lack of public information on sustainable investing, SFDR looks to create a level playing field for financial institutions on transparency in relation to sustainability risks and the information available with respect to financial products. It applies to all financial market participants that pursue the objective of sustainable investment (such as asset managers, institutional investors, insurance companies, and pension funds). The Taxonomy Regulation also creates additional disclosure requirements and is the EU's principal mechanism to address greenwashing by setting out criteria for determining if an activity is environmentally sustainable.

In addition, the UK started setting its own strategy for addressing ESG considerations in capital markets. In 2020, it set out an ambitious five-year roadmap, the main goal of which was to make available information on the climate impact of companies across the financial industry. The intention is to provide investors with the information to correctly price climate risk into their investment decisions. The FCA has also published a consultation paper setting out a disclosure regime for asset managers. These regulations and developments are discussed in more detail in Chapter 1 and Chapter 2 of this Guide. Hence, obtaining satisfactory ESG information in order to satisfy these regulatory requirements will be a key challenge for private debt funds in the short term until borrowers have caught up with the ESG journey.

2. ESG Contractual Provisions

a. ESG Margin Ratchets

The incorporation of ESG-related provisions into private debt loan documents has generally followed what has been seen in the syndicated term loan and high yield bond markets. It is designed to incentivise companies to improve the performance of certain areas of the business. These are often judged against criteria that may be set in advance or at the time of closing or developed post-closing. It is important to note that the relevant deal should not be labelled as a sustainability-linked loans (SLL) until such time as the relevant metrics have been set, scrutinised and approved.

There are many incentives for companies and their sponsors to pursue an ESG strategy, such as a desire to support business that is sustainably conscious or to align their funds with upcoming regulations. Through margin ratchets (or other incentives) borrowers that hit certain SPTs may secure a reduction in their margin (or other benefit). A tiered approach can be implemented which allows for companies to hit multiple SPTs over the life of the financing, the result of which may be cumulative potential margin reductions (or other incentives).

In most cases, where applicable, the margin ratchet is only applied to the term facilities, an approach that differs to the syndicated TLB market where the RCF is increasingly also subject to the ratchet. For the time being most loans remain silent as to what, if anything, needs to be done with such interest savings.

Ideally KPIs and SPTs will be set prior to origination but, where this is not possible, the ESG criteria may be agreed post-origination. Agreeing on what the KPIs is sometimes the hardest part of the process. Given increasingly truncated deal timetables, it may be necessary to include terms that allow for the lender(s) and borrower to work together post-closing of the transaction to establish the KPIs that form the basis of the ratchet within a timeframe agreed in the SFA. We would however like to highlight that such deals should not be referred to as SLLs until such time as the relevant metrics have been set, scrutinised and approved.

Term sheets can be quite general and simply include the concept of the ratchet or other incentive. It is certainly the case that some sectors are more developed in terms of KPI/SPT selection, such as industrials and consumer, but the concept as a whole appears to be sector agnostic and has appeared across the board.

A robust approach to validating these metrics is needed to mitigate greenwashing concerns. The Sustainability-Linked Loan Principles (SLLP) require independent and external verification of the borrower's performance level against each SPT for each KPI, and it is suggested that the SLLP requirements should be applied equally across all loan markets, including the private debt market.

One school of thought is that for the ratchet to have real teeth and act as a true incentive for borrowers to improve on ESG and make an actual difference in the reaching of global goals, it needs to be a two-way ratchet. In this case, where the agreed metrics are not met, an increase in pricing would kick in. Equally in some transactions there may be an uplift in the margin for failure to deliver the relevant ESG reporting documentation. That said, some private debt funds may be willing to offer one-way economic incentives as a driver for companies to make substantive change.

In terms of timing for reporting, the market is generally working off a 12 month look back. If the relevant confirmations can be given for the previous 12-month period (either based from closing or as per financial year) then any positive (or negative) effects on the margin will usually become effective for the next 12 months.

b. Reporting

Many investors are taking a proactive approach and including other reporting requirements in the documentation, such as an obligation to complete ESG questionnaires on an annual basis. Often this requires a form or questionnaire to be completed by the borrower prior to close.

An alternate approach is for the borrower to provide lenders with a questionnaire/report that is already required to provide to its own owners and investors. In such cases, lenders will want to ensure that all key reporting requirements from their perspective are included.

Given the lack of conformity as to reporting requirements and the contents of such reports, there is less standardisation in terms of reporting requirements. However, as both borrowers and lenders continue to focus on ESG we expect a greater alignment of interests and more standardisation to develop.

3. Ongoing Monitoring of ESG

It is vital to monitor investments and continue to identify areas of risk. No matter how much due diligence is done before an investment is consummated, the position is likely to evolve throughout the life of the investment. It is for that reason that investors have ESG metrics that they will constantly monitor. There will then be action points to mitigate any risk that develop.

Active dialogue between the lender and management of the company is essential. This enables both parties to put in place policies and initiatives to mitigate ESG risks. Some private debt investors will feel the need to directly engage with management to understand their business practices.

The margin ratchet and accompanying ESG metrics go directly to ongoing ESG monitoring. It is a way of incentivising the company to continue monitoring ESG and improve best practice. This is also why some private debt lenders include the provision of an ESG questionnaire in the information undertakings as part of their investment committee sign off.

4. The Challenges

Whilst ESG has become the increasingly popular topic across all asset classes, there are still challenges to overcome, some of which are unique to the private debt space:

- Private markets v. public markets: publicly listed companies are required to produce certain disclosures and data. Private markets do not have such general disclosure requirements and so investors have to do their own diligence. Combined with compressed diligence timetables, this makes it very difficult to gather relevant information.
- ESG metrics: setting ambitious metrics for a company to get the benefit of the margin ratchet and incentivise to drive change remains a challenge. The risk of rewarding borrowers for ordinary course activities is a key concern.
- Multiple ESG issues v. single ESG issue: The number of KPIs, and consequently the number of sustainability/ESG issues to be covered by these, will need to be determined on a case-by-case basis having regard to the nature of the borrower, the sector the borrower operates within and the transaction structure. In many instances, multiple KPIs will be appropriate, but there may also be cases where it is appropriate to concentrate on improvement in relation to one material KPI where this is fundamental to the borrower’s sustainability performance. Either way, a clear rationale should be established for the number of KPIs which are to be used.

Conclusion

ESG in the private debt market is a revolutionary change. It adds a dimension to the investment decision that has not been seen previously and that is permeating in the due diligence process and filtering down through the investment decision and, ultimately the debt documentation. There remain challenges to overcome, but in general private debt market participants are focused on improving on the ESG agenda. Sustainable investing is responsible investing and that is becoming increasingly evident in the private debt market.

Chapter 7
Guide to ESG Litigation

The increased volume of ESG-related financings presents unique opportunities for the market, but also comes with increased legal risk. This is particularly true for bonds and loans marketed to investors or lenders with ESG features (whether described as "sustainability-linked," "social," "green" or otherwise), such as pricing ratchets that are tied to SPTs and/or marketed as having the "use of proceeds" committed to finance ESG-related projects.

ESG litigation risks have increased over the past twelve months in the face of well-funded and aggressive NGOs, whose efforts are becoming more coordinated and sophisticated and in light of the significant increase in the laws governing ESG-related disclosures and activities. In the EU, NGOs have brought cases seeking to void German and European legislation, as well as taking actions against private actors, such as the fossil fuel industry or financial industry. In the US, NGOs have similarly targeted both federal and state governments and private industry. NGOs are using existing regulatory frameworks to scrutinise the financial industry, and the next wave of litigation targets is expected to include not only corporate issuers but also capital providers (including lenders and bondholders) and companies that purportedly contribute to greenhouse gas emissions (GHG).

1. ESG Risk: Potential Disclosure-Based and Contract-Based Claims

a. Disclosure Based Claims – Investor and NGO Risks

Public ESG disclosures and commitments, including those in relation to climate change, can be a source of litigation risk. Inaccurate or unsubstantiated statements, or commitments made without a reasonable expectation of achieving them, may lead to lawsuits brought by NGOs, investors, counterparties, or regulatory authorities alleging greenwashing or misleading, deceptive or false advertising.

ESG performance-linked debt may be susceptible to litigation risk relating to the choice of KPIs and the levels at which SPTs are set. Issuers/borrowers, underwriters, lenders and arrangers of loans and bonds that are described as "sustainability-linked" may, for example, be subject to risk of liability if the SPT levels are set in line with the current or projected core business performance of the borrower or issuer. Put another way, if the SPTs utilise metrics that do not provide "additionality" – i.e., the metrics will be achieved without any change in the borrower's business practices or the business trajectory – the financing may be more susceptible to a challenge that it is not truly sustainable. This also goes back to the level of ambition discussed in previous chapters.

Similarly, disputes may arise when the offering or transaction documents state that debt proceeds are allocated to green projects that are later criticised for not being "green" or "green enough." Although there has been increasing market pushback regarding the flexibility of use-of-proceeds green financing – allowing issuers to use the actual debt proceeds for refinancing or other purposes while allocating an equivalent amount to green projects – issuers may be susceptible to claims that the issuer misled investors by using proceeds to finance non-green or not-green-enough projects.

It should be noted that the Green Loan Principles require the proceeds of the green loan to be credited to a dedicated account or otherwise tracked by the borrower in an appropriate manner, so as to maintain transparency and promote the integrity of the product. As such, they do not offer flexibility in terms of use-of-proceeds as all proceeds must be used to finance or refinance Green Projects.

Consider a scenario in which a green debt issuer finances a high carbon project with green bond proceeds while committing an equivalent amount to eligible green projects. The absence of general standards as to what constitutes a "green" project, along with decentralised self-certification, may increase the likelihood of disputes. Additionally, green bonds with shorter duration periods may also be criticised for not being impactful.

By way of example of disputes related to "green" financing, a consortium of NGOs filed a complaint with the US Securities and Exchange Commission (SEC) against the Japan International Cooperation Agency (JICA) for alleged greenwashing of its US-based bond issuance. In its prospectus, JICA stated that it would not allocate any proceeds from the sale of the bonds to finance coal-based activities. But the complainants alleged that JICA used the proceeds to continue to fund ongoing coal power projects in Bangladesh, as well as fund new coal power projects.

The disclosure of the total amount of annual ESG-related financings by investment banks and capital providers may increase these risks. As more financial institutions aggregate ESG-linked financings to demonstrate their commitment to ESG goals to the public (e.g., "$300 million in sustainable financing in 2021"), increased scrutiny of transactions or debt portfolios could create enterprise-level disclosure risk.

b. Contract Based Claims – Counterparty Risks

Disputes may also arise when ESG metrics, targets, or assessments are not clearly and consistently described in disclosure documentation or the definitive debt documents. Data gaps can hamper a counterparty's ability to assess the sustainability or "greenness" of debt and could lead to disputes. In the absence of closer coordination among

borrowers, lenders, and other parties, reporting on ESG KPIs may not accurately communicate how a company determines the process of fitting specific projects within its KPIs. Further, in light of self-adopted standards that vary across companies, disputes can arise regarding whether the borrower has met its KPIs, given the prevalence of self-reporting.

An additional layer of reporting by an external reviewer or auditor can be implemented to minimise the chance of such disputes. Reliance on external reviewers and auditors, with appropriate knowledge of the industry and complexities of the specific KPIs, can also mitigate some of the risks associated with KPI selection across different industry sectors. However, it is important to carefully select and review external reviewers and auditors, as well as what they measure and how. Although ESG benchmarks and ratings have proliferated in the last year or so, they have also been criticised as being based on subjective inclinations rather than objective financial assessments. Transaction documentation should clearly delineate each party's rights and obligations concerning ongoing assessment of performance against KPIs and also provide for various contingencies including the possibilities that benchmarks may materially change or even be discontinued.

2. ESG Risk: Jurisdictional Considerations

In recent years, there has been a significant increase in the laws governing ESG-related disclosures and activities. In order to mitigate against litigation risk and regulatory enforcement, it is important to understand the existing legal environment, even as it continues to develop.

a. Jurisdictional Considerations – The European Union

Companies and financial market players are now increasingly required to comply with new ESG-related reporting and disclosure obligations.

The EU Taxonomy's corporate disclosure requirements, for example, create a risk of future liability. Private claimants and NGOs could use these disclosure requirements to highlight potential ESG shortcomings and bring claims against the disclosing entity more easily. Indeed, a number of complaints have been upheld by advertising authorities across Europe, and NGOs are bringing new complaints against companies in light of these recent regulatory developments. These standards appear poised to be upheld against lenders as well.

In its Sustainable Finance Roadmap 2022-2024, the European Securities and Markets Authority (ESMA) addressed the importance of developing a convergent supervisory approach to sustainable finance. ESMA is concerned that the growing investor demand for ESG financial products, coupled with inconsistent interpretation of ESG rules, creates room for greenwashing, and has emphasised its intention to coordinate with national EU regulators to address greenwashing practices over the next two years.

b. Jurisdictional Considerations – France

In France, the French Climate and Resilience Law of 22 August 2021 has reinforced obligations in connection with environmental claims, and has banned the use in advertising of any wording indicating that a product, service, or activity is carbon-neutral or has no negative impact on the climate or the environment, unless substantiated by reference to recognised norms and standards under French, European or international law.

Under this law, greenwashing claims can also constitute deceptive commercial practices that are criminal offences. These claims are regulated by the French Consumer Code, which now includes environmental claims regarding products or services, regardless of whether these claims are made to consumers or businesses. Similarly, deceptive environmental claims relating to financial services may also qualify for potential criminal sanctions. Therefore, any company making "green" claims in its communications, advertisements or ESG disclosures will want to ensure that it can justify and substantiate those claims for example by reference to robust scientific evidence.

In addition, the 2019 French Duty of Vigilance Law, which inspired the 2022 EU Proposal for a Corporate Sustainability Reporting Directive, has become the subject of increasing ESG disputes, including climate change litigation. Under this law, large French companies are required to prepare and publish a so-called "vigilance plan" intended to address the risks of serious impact on the environment, as well as violations of human rights and fundamental freedoms. The plan must consider not only the company's own activities, but also the activities of the companies it controls and those of its usual subcontractors and suppliers.

c. Jurisdictional Considerations – Germany

The most important recent ESG-related development in Germany is the adoption of the German Act on Corporate Due Diligence Obligations in Supply Chains (LkSG). The LkSG requires certain companies and enterprises to respect the environment and human rights by implementing defined due diligence obligations. These include the establishment of a risk management system to identify, prevent or minimise the risks of human rights violations and damage to the environment caused by the company's business activities. The LkSG may open the door to increased ESG-related litigation in Germany.

d. Jurisdictional Considerations – The Netherlands

In the Netherlands, the ESG landscape has been largely influenced by "climate change focused" civil litigation. In 2019, the Dutch Supreme Court ruled in favor of the Dutch NGO Urgenda obliging the Dutch government to reduce its greenhouse gas emissions by at least 25% compared to 1990 levels. Inspired by that success, and building on the arguments which found favor with the courts in those proceedings, NGOs have been increasingly active in pursuing judicial routes against private companies in the Netherlands.

Most notably, the District Court of the Hague ordered on 26 May 2021, in favor of Friends of the Earth Netherlands, that Shell has to reduce or cause to be reduced their global annual volume of all relevant CO2 emissions into the atmosphere by at least net 45% by the end of 2030 (relative to 2019 levels). Shell has since appealed the Court's judgment, and the hearing on appeal is expected to take place in 2023 or early 2024. Fueled by this victory, Friends of the Earth Netherlands has since demanded climate plans from 29 other large Dutch corporates, and has further threatened Shell's CEO and other executives, referencing their potential personal liability for climate damage.

Another notable development, has been the rise in successful greenwashing claims in front of the Dutch Advertising Code Committee in the Netherlands. One NGO, that received a favorable decision at the Dutch Advertising Code Committee, has now filed a writ of summons against KLM, in which they ask the court to order KLM to cease their "CO2 neutral" flying compensation scheme and related advertisement. Next to this development in civil litigation, the Netherlands Authority for Consumers and Markets (the Dutch Regulatory body responsible for supervising and enforcing anti-greenwashing rules) has announced that it has initiated investigations into sustainability claims.

e. Jurisdictional Considerations – The United Kingdom

In the UK, company directors have a codified obligation to consider environmental impact: pursuant to section 172 of the Companies Act 2006, directors must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, having regard to a number of non-exhaustive factors including the impact of the company's operations on the community and the environment. Section 172 of the Companies Act 2006 has already been recently used to bring actions against directors for failure to implement a Paris Agreement compliant climate strategy or to create a credible plan for the divestment from fossil fuel investments. Similar legal actions can be expected in the future.

f. Jurisdictional Considerations – The United States

More stringent standing and injury requirements in the US make it more difficult for NGOs to bring claims as plaintiffs than in some parts of Europe. Therefore, while ESG and climate change lawsuits are proliferating in the US, most are still at jurisdictional or preliminary stages. To bring a claim under existing US securities law against companies, banks and other offering participants, a plaintiff must show that the allegedly false statement or omission was material and specific. If the claim is for an affirmative misstatement, a plaintiff generally needs to show it was aware of a company's statement and engaged in the relevant transaction in reliance on that specific misrepresentation. On the other hand, if a statement is deemed vague or aspirational, US courts will typically find that it cannot have been material to a reasonable investor, and is thus not actionable under US law. Although US courts have previously deemed statements about corporate ethics, culture and integrity to be "puffery" or "aspirational," it is possible ESG-related statements could be deemed material as investors increasingly rely on such statements.[46]

Earlier this year, the SEC proposed climate-related disclosure rules. If enacted as proposed, these rules would apply to companies with reporting obligations under the US Securities Exchange Act of 1934 and would require US public companies, including foreign private issuers, to disclose certain climate-related information and GHG emission metrics. Required climate-related disclosures include the following: climate-related risks and their actual or likely material impacts on the company's business, strategy, and outlook; the company's governance of climate-related risks and relevant risk management processes; the company's Scope 1, Scope 2 and, in some cases, Scope 3 GHG emissions, which for certain companies with respect to certain emissions, would be subject to Scope 1 and Scope 2 assurance; certain climate-related financial statement metrics and related disclosures; and information about climate-related targets and goals, and the company's transition plan, if any. These disclosures will be filed with the SEC, which could create an increased risk of potential liability under US securities laws.

[46] See In re Vale S.A. Sec. Litig., No. 19-CV-526-RJD-SJB, 2020 WL 2610979 (E.D.N.Y. May 20, 2020) (denying motion to dismiss securities fraud claims based on Vale's commitment to sustainability: when "statements are "made repeatedly in an effort to reassure the investing public" about matters particularly important to the company and investors, those statements may become material to investors.").

3. ESG Risks: Focus on Asset Managers

In recent years, some asset managers have been accused of trying to satisfy the growing demands of investors by overstating the sustainability profile and characteristics of their funds, their ESG implementation strategy or the integration of their ESG processes. Regulators in both the EU and the US have expressed concern about "greenwashing" and are likely to expect asset managers to be able to substantiate any ESG claims.

In the EU, SFDR was intended to avoid the greenwashing of financial products and financial advice in the financial services sector by imposing an obligation to provide more substantiated sustainability related information to allow investors to make informed investment decisions in line with their sustainability objectives. As discussed in Chapter 1 of this Guide, it imposes significant additional disclosure obligations on entities within its scope, such as investment managers and investment firms providing investment advice. It applies not only to the EU AIFMs, EU UCITS managers and EU investment firms managing individual portfolios but also to non-EU AIFMs managing or marketing AIFs in the EU as well as non-EU delegates of the EU AIFMs.

In the US, in May 2022, the SEC proposed amendments to (i) the "Names Rule" (Rule 35d-1) under the US Investment Company Act of 1940 (the "1940 Act") and (ii) rules and forms under both the Investment Advisers Act of 1940 and the 1940 Act to expand the Names Rule to any fund name whose terms suggest a focus on investments that have particular characteristics, and to require registered investment advisers, exempt reporting advisers, registered investment companies, and BDCs, that consider ESG factors in making investment decisions to provide additional information and disclosures regarding their ESG investment practices and considerations. These proposed rules follow an April 2021 Risk Alert identifying a series of factors that investment advisers and funds should consider in implementing policies and procedures that accord with their ESG-related disclosures.[47] Most recently, the SEC's Climate and ESG Task Force announced that it had settled charges with an investment adviser for misstatements and omissions concerning ESG considerations in making investment decisions for certain mutual funds that it managed.

In addition, asset managers must be mindful of the impact and potential conflicts relating to state efforts to legislate against ESG-guided behavior by financial institutions. For example, Texas passed laws last year that required financial institutions to certify that they are not boycotting energy companies as a pre-condition to entering into major contracts with the state, or receiving investments from the state pension funds. The laws define boycott as "without an ordinary business purpose, refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to . . . limit commercial relations with a company" because it is in the fossil fuel business. Earlier this year, the SEC's Fort Worth regional office opened a preliminary investigation targeting financial institutions that made those certifications to Texas, comparing the certifications against the companies' climate disclosures. And, in August 2022, the Texas comptroller's office identified 10 financial companies it has accused of "boycotting" energy companies, and ordered state pension funds to divest from holdings in those companies. West Virginia, Kentucky, Oklahoma, and Tennessee have since passed anti-boycott measures and other states have similar measures pending. On the other hand, Maine passed a statute that required its pension funds to divest from fossil fuels by January 2026 and other states have similar measures pending. In the year ahead, many asset managers will need to navigate these statutes, while balancing their own disclosures on climate change, as well as the likely SEC climate change disclosure rules.

[47] The Division of Examinations' Review of ESG Investing (April 09, 2021): https://www.sec.gov/files/esg-risk-alert.pdf

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

About the LMA:
The LMA is the trade body for the European, Middle Eastern and African syndicated loan markets. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 800 organisations across EMEA, including the European Commission, and consists of banks, non-bank investors, borrowers, law firms, rating agencies and service providers. lma.eu.com

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Appendix:

Key changes to the Guide

- Guide updated to reflect changes in the ESG investment landscape and regulatory developments during 2021 -2022.
- Post publication, in 2021 ELFA conducted two surveys for ESG (namely the ESG Investor Survey 2021 and the ESG in Private Debt 2021). The Guide contains data from both of these surveys.
- New Chapter 6 – ESG in Private debt Market
- New Chapter 7 – Guide to ESG Litigation

Chapter 1: Why Leveraged Finance investors need more disclosure on ESG Topics

Key update: Provision of an additional table that summarises UK investment related regulation.

Specific updates on SFDR:

- SFDR establishes firm- and product-level ESG disclosure requirements and it de facto creates a process for classifying ESG funds
- Relevant to all in-scope asset managers and to all financial products made available by an in-scope asset management firm; whether or not the product has an express ESG focus (although some aspects will be relevant only when a financial product has a specific ESG focus)
- Additional disclosures will be needed where a financial product:
  - Promotes environmental or social characteristics (i.e., Article 8 product); or
  - Has sustainable investment or a reduction in carbon emissions as an objective (i.e., Article 9 product)
- The European Supervisory Authorities (ESAs) have developed regulatory technical standards (Level 2 RTS) to give more detail on: (i) what information the various disclosures should contain and (ii) how this should be presented. Following a series of changes, the application date of the Level 2 RTS has now been delayed until 1 January 2023
- Meaningful impact although application of certain disclosure obligations (i.e., Level 2 RTS) is not immediate

Specific updates to Taxonomy Regulation:

- Establishes a classification system to be used in determining the degree to which an economic activity can be described as being "environmentally sustainable"
- Passed into law and applicable from January 2022
- The Framework Regulation establishes a phased application of disclosure requirements. Asset managers at an entity level will be required to report their underlying investments eligibility to the taxonomy as a % of total AUM starting Jan 1, 2022

Specific updates to Suitability Delegated Regulation:

- Passed into law on 2 August 2021 and applicable from 2 August 2022

Specific updates to integration of sustainability into a firm's systems and controls:

- Passed into law on 2 August 2021. The measures made under AIFMD and the UCITS Directive will apply from 1 August 2022 while the measure made under MiFID 2 will apply from 22 November 2022

Chapter 2: Regulatory considerations for borrowers

Key update: Post publication of the Guide, the International Sustainability Standards Board (ISSB) was established. We have updated this chapter to highlight their work on developing a global baseline for sustainability reporting. We also updated the chapter to reflect the Corporate Sustainability Reporting Directive (CSRD) that was adopted by the European commission shortly after publication.

Specific updates on TCFD:

- As of January 2022, the number of TCFD supporters surpassed 3,000 organisations from 92 countries with a combined market capitalisation $27.2 trillion.

Specific updates on Taxonomy Regulation:

- On 9 December 2021, a delegated act supplementing the Taxonomy Regulation and establishing the technical screening criteria for climate change mitigation and climate change adaptation objectives was published in the Official Journal and has applied since 1 January 2022. A draft second delegated act for the remaining objectives is expected to be published in 2022.
- The Taxonomy Regulation has also introduced new disclosure requirements for financial market participants offering financial products in Europe and for companies subject to disclosure requirements under the NFRD. On 10 December 2021, a delegated act supplementing Article 8 of the Taxonomy Regulation was published in the Official Journal has applied since 1 January 2022 (the Delegated Act). The Delegated Act specifies the content, methodology and presentation of information to be disclosed by financial and non-financial undertakings concerning environmentally sustainable economic activities.
- On 2 February 2022, the European Commission approved in principle a Complementary Climate Delegated Act including, under strict conditions, specific nuclear and gas energy activities in the list of economic activities covered by the Taxonomy. The Complementary Delegated Act was formally adopted in all EU official languages on 9 March 2022 and transmitted to the co-legislators for their scrutiny on 10 March 2022.
- On Application: Under the Delegated Act, in-scope non-financial undertakings will be required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2023. In-scope financial undertakings will be required to disclose Taxonomy-eligibility from 1 January 2022 and Taxonomy-alignment from 1 January 2024.

Chapter 3: Diligence Practices

No material changes.

Chapter 4: Drafting Considerations and ESG Roadmap

Key update: This chapter was updated to take into account the CSRD regulation.

Specific updates on relevant regulatory considerations:

- The CSRD, which is expected to directly impact nearly 50,000 entities, will require in-scope companies to annually report in compliance with rigorous new European sustainability reporting standards. The SFDR and the proposed CSRD, along with continued investor demand, has accelerated transactional ESG due diligence and the incorporation of ESG disclosure in the high yield market.

Specific updates on ESG disclosure in Offering Memorandum

- Borrowers have the option to weave ESG disclosure throughout offering materials where relevant, ensuring that it ties in with wider business disclosure in a manner that is relevant, proportionate and easy to follow. By incorporating ESG information into each section of the offering memorandum, companies will be able to paint a fuller picture of the risks and opportunities of ESG factors on their business as a whole while conveying a genuine commitment to ESG principles.
- Borrowers may also consider including a separate section summarising their ESG policies and highlighting key ESG topics with cross-references to more fulsome disclosure present in other parts of the offering memorandum. Investors are increasingly under significant time pressure when reviewing company disclosure in a high yield bond offering and, as such, this approach may make it easier for them to access the information they require.
- Borrowers may wish to consider including a section highlighting their ESG / sustainability policy and including key data (e.g., a table with Principle Adverse Sustainability Impact (PASI) information or ESG key performance indicators). A description of the borrower's ESG materiality assessment could also be included in this section, along with a summary of its ESG policies with cross-references to other relevant sections of the offering memorandum where these concepts are explored in more detail.

Specific updates on other methods of ESG disclosure

- In addition to ESG disclosure in offering documents, companies can provide further evidence of their ESG strategy, goals and KPIs, via website publications. These can include standalone ESG, or sustainability, reports that are based on one or more of the voluntary global ESG disclosure frameworks (e.g., TCFD, The Value Reporting Foundation). Additionally, in connection with ESG bond offerings, companies tend to publish ESG financing frameworks on their websites that summarize ESG strategies and policies along with alignment with applicable ESG bond principles, such as ICMA's Sustainability-Linked Bond Principles.

Specific updates on ESG ratings:

- It should be noted that the EU has proposed the establishment of a registry of approved third-party ESG ratings organisations in connection with its European Green Bond Standard that would be supervised by the European Securities Market Authority. This registry would provide for a centralized accreditation regime for such third parties, requiring them to have "adequate qualifications, professional experience, and independence…to ensure adequate investor protection."

Chapter 5: Contractual Provisions

Key update: The chapter has been updated to reflect developments in ESG contractual provisions in the European leveraged market and highlights new provisions that emerged during 2021 – 2022.

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Banks
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BBVA
BNP Paribas
Crédit Agricole CIB
Credit Suisse
Deutsche Bank
Goldman Sachs
ING Bank
J.P. Morgan
NatWest Markets
Société Générale

Companies
Arrow Global
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Encore Capital
Ethypharm
Fedrigoni
Grupo MásMóvil
Intrum
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Sappi
TalkTalk
TDC
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Scope Ratings
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ESG Data Vendors
9fin
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