ESG

Practical steps for TMT businesses

For TMT businesses, ESG (or sustainability) profile has never been more important. With interest in environmental, social and governance (ESG) issues rising from stakeholders including shareholders, customers and employees combined with a surge of new regulations designed to divert capital into more sustainable businesses, TMT businesses have a major opportunity to assess and improve their ESG profile, making their businesses more attractive to stakeholders and more sustainable. Doing so will also assist in mitigating regulatory and litigation risk.

Senior management and legal and compliance teams can play an important role by helping their firms understand the ESG issues that are relevant and material to their business and developing an action plan to implement measures to improve ESG profile. While companies may already be taking action on certain aspects of ESG which are summarised below, a methodical and informed approach will achieve the best results.

This document examines what ESG means for TMT businesses, why it is important and how TMT businesses can improve their ESG profiles.

What is ESG?

ESG refers to three broad pillars of Environment, Social and corporate Governance which are used to assess businesses. The below table shows examples of broad factors that are typically considered when assessing a company's ESG profile[1]. Their relevance and materiality varies from sector to sector.

ESG can be a source of risk: the reputation and financial value of a business can be severely impacted by, for example, a significant and public data (or other compliance) breach. Compliance with new environmental standards can increase the costs of doing business. Poor corporate governance, at its worst, can manifest in serious fraud.

ESG can also be a source of opportunity: providing access to communications and finance in developing countries. Green-tech innovation, using technology which yields benefits to the environment. Anticipating and reacting to changes in consumer trends and laws. Developing the most effective management and work-force though effective diversity and inclusion behaviour and people management. Recruiting and retaining the best talent because people value working for a business with a purpose.

What are Environmental, Social and Governance (ESG) factors?

Environmental	Social	Governance
• Climate change • Greenhouse gas emissions • Resource depletion, including water • Waste and pollution • Deforestation	• Working conditions, including slavery and child labour • Local communities, including indigenous communities • Conflict and humanitarian crises • Health and safety • Employee relations and diversity	• Executive pay • Bribery and corruption • Board diversity and structure • Fair tax strategy

(1) (Table from "EU Parliament: Sustainable finance and disclosures: Bringing clarity to investors")

Why is there so much interest in ESG?

The rise of ESG in recent years has been driven by increased interest both from the wider public on environmental and social issues and from shareholders and investors who not only increasingly want to invest in "good" ESG companies because of their own values, but also see a clear link between ESG factors and financial performance.

This focus on ESG has only increased during the COVID-19 pandemic, as companies have had to focus on these issues to deal with the impact of COVID-19 on their businesses. In particular, companies have concentrated on the "S" and "G" as the public have become more concerned with how companies treat their employees, customers and suppliers both during and after the outbreak.

From 2016 to 2018, global sustainable investments increased by 34% to US $30.7 trillion[2]. This growth has continued, shown by the US $12.2 billion invested in ESG funds in the first four months of 2020 alone (which represented more than double the investment during the same period in the previous year)[3].

In addition, the European Union (EU) has also set in motion an ambitious legislative programme that makes ESG issues a key element of regulation in the financial services sector.

At the core of this, the European Commission's Action Plan on Financing Sustainable Growth sets out key objectives to: (i) re-orient capital flows towards sustainable investments, (ii) manage financial risks stemming from climate change, natural disasters, environmental degradation and social issues, and (iii) foster transparency and long-termism in financial and economic activity.

One of the most immediate regulations flowing from of the Action Plan is the Sustainable Finance Disclosures Regulation (SFDR) which comes into effect in March 2021. While the SFDR has a direct regulatory impact on financial institutions such as asset managers and pension schemes and not on TMT businesses, it will have an indirect impact on most businesses including TMT businesses which are publicly owned or seek to raise private capital.

The SFDR pushes sustainability to the top of the agenda for asset managers and requires them to make important strategic decisions, and then publicly disclose in key areas such as (i) how they take into account sustainability risks when making investments, and (ii) how they consider the adverse sustainability impacts caused by the companies they invest in, along with public periodic reporting of those impacts. "Sustainability risks" are environmental, social or governance events that could cause an adverse impact on the value of the company. This could cover a very broad spectrum of issues such as personal data breaches, management fraud and vulnerability of premises to flooding. Sustainability risks are about financial value.

The concept of "adverse sustainability impacts" is the harm that the company causes to environmental, social and employee matters, respect for human rights, corruption and anti-bribery matters. This could cover issues such as companies which use child labour, cause environmental pollution or are involved in corruption. Adverse sustainability impacts are broadly about moral or ethical values.

TMT businesses therefore need to understand that their investors will increasingly be assessing them both for resilience to sustainability risks and for their adverse impact on sustainability factors.

(2) (2018 Global Sustainable Investment Review, Global Sustainable Investment Alliance, March 2019)
(3) https://www.lexology.com/library/detail.aspx?g=6542aabf-5bd7-4241-8c97-cf6a15ec9982 [see comment below about linking to another law firm's article]

Why is ESG important to TMT businesses?

ESG matters to a broad range of stakeholders.

Many investors already explicitly take into account a company's exposure to sustainability risks when evaluating whether to become (or remain) a shareholder.

The advent of the SFDR means that a growing proportion of investors will also pay attention to the adverse sustainability impacts of companies as part of the investment decision.

ESG ratings are now widely available and used by investors as part of their investment decisions in a similar way to credit ratings.

Customers, both business and retail, pay increasing attention to sustainability risk exposure and to the adverse sustainability impacts of companies they buy from.

There is evidence to suggest that employees are increasingly attracted to businesses which perform well from a sustainability perspective, and that employees perform better and are more productive within companies with strong sustainability practices.

It is therefore imperative for TMT businesses to understand how ESG factors feed into their ESG profile, and which factors carry the most weight.

While the TMT sector appears to have begun to embrace ESG[4], the growing regulation and guidance on the topic means it is ever more important for companies in the sector to take practical steps to take account of ESG in their business practices and policies.

Which areas of ESG matter to TMT?

The importance of different ESG factors varies enormously across industries.

For example, for sectors which naturally have a relatively low environmental impact (e.g. office based professional services) even a relatively significant reduction in carbon emissions may only have a limited impact on the overall ESG profile of a business. This contrasts with highly pollutive industries (e.g. cement production) where it may be possible to materially improve a business's ESG profile by reducing its carbon emissions.

To give another example, for a cement manufacturer the difference between having the best possible and very poor privacy and data security practices is likely to have a negligible impact on its overall ESG profile because of the limited volume of personal data processed by it.

When looking at ESG risk ratings for "communications services" from a leading ratings agency, considerable weight is given to corporate governance, closely followed by privacy and data security, and then human capital development, with only around 5% weighting given to environmental factors such as carbon emissions.

(4) https://www.ft.com/content/adee5360-2265-11ea-b8a1-584213ee7b2b

Practical steps for TMT businesses to improve their ESG profile

There is no uniform approach to assessing ESG profile and even among different ESG ratings agencies the scores for a given company may vary considerably depending on what they are trying to rate (e.g. ESG risk, ESG adverse impact on sustainability or a combination of these and potentially other approaches).

Further, third party ESG ratings are not the only way businesses are assessed, some stakeholders collecting their own raw data or relying on ESG data published by companies themselves.

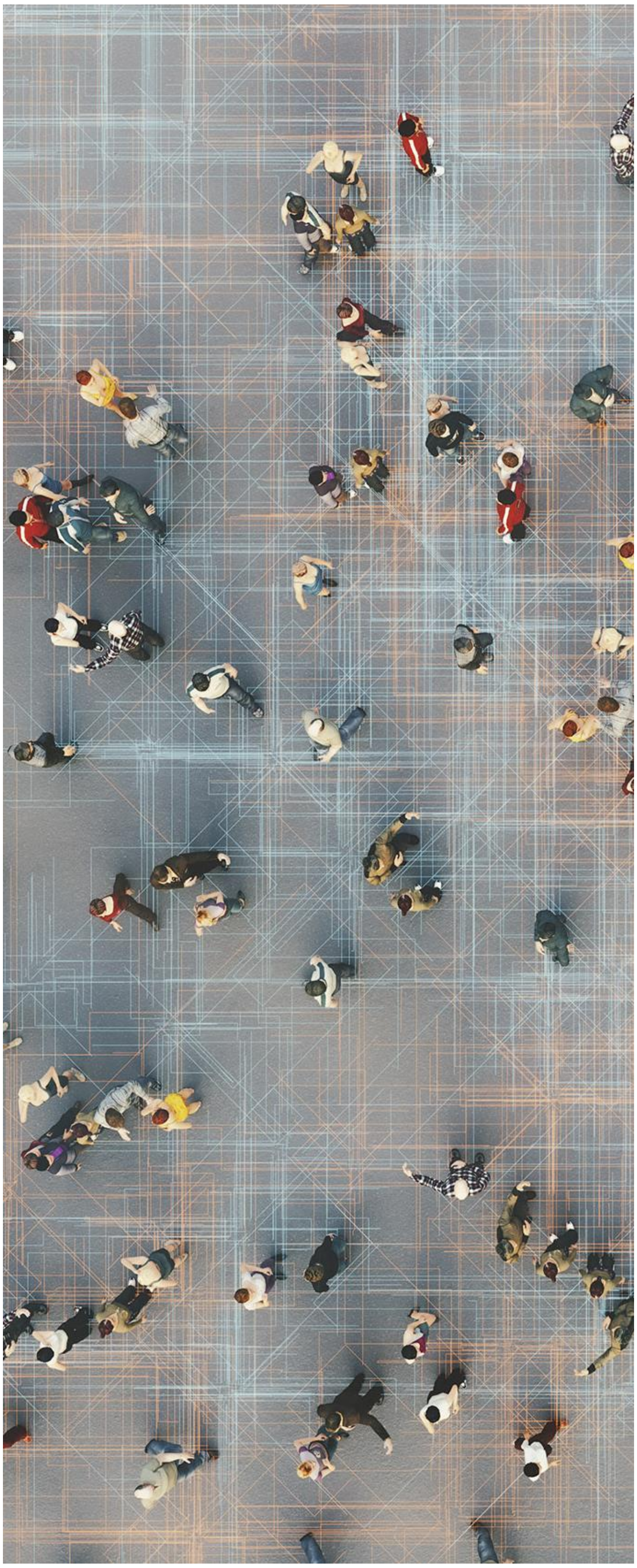
To this end, the draft regulatory technical standards to the SFDR published in Q2 2020 contained 32 mandatory fields in respect of which asset managers would be required to collect and report data on companies in which they invest, including fields such as carbon emissions (broken down by scope 1, 2 and 3), energy consumption intensity, gender pay gap and excess CEO pay ratio and also binary fields such as whether or not the company has a deforestation policy. While these measures are currently being reconsidered as the regulatory technical standards are still being reworked, TMT businesses may wish to inform themselves about the information their investors may demand for them.

Other regulations such as the Framework Regulation (Taxonomy) will provide specific standards that economic activities must meet if they are to be considered “environmentally sustainable”. For example, draft texts prescribe specific energy efficiency levels for data processing to be considered “environmentally sustainable”.

For further information see our finance ESG notes for clients here.

TMT businesses may still wish to research any third party ESG ratings and seek to understand which ESG factors are given most weight and how they are scored across these factors.

Although a uniform approach for assessing or addressing ESG factors does not yet exist, below are a range of practical steps for TMT businesses to consider in respect of ESG. Companies should take care to not only address ESG factors but also communicate how they are addressing them where relevant.



Practical steps for TMT businesses to consider in respect of ESG

Environmental

i. Consider and report on climate related risks.

- Companies should consider the impact of climate change on their business and have a way of identifying and addressing this impact. They should also report on climate related issues in accordance with appropriate guidance and regulation.
- For example, the UK government is expecting listed companies to disclose in line with the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFDs) recommendations by 2022 and the UK regulator is consulting on proposals that would require listed companies to make climate-related disclosures consistent with the TCFD's recommendations or explain why not. The Investment Association also expects all listed companies to include information on how climate change impacts their business, and how this impact is addressed, in their annual reports.

ii. Develop "greener" products.

- Companies should review their supply chain (both their subsidiaries and third parties) and products for environmental sustainability.
- Companies should consider publishing an ESG policy (for example a human rights policy statement in accordance with the United Nations Guiding Principles on Business and Human Rights).
- Companies will increasingly also wish to include information about their ESG performance and commitments in corporate documentation, including information to shareholders and investors.
- Companies should also monitor developments made by the EU's Sustainable Finance Action Plan on an "EU green classification system", as this will serve as a basis for any UK related standards and requirements for environmentally sustainable products.

iii. Report on energy and carbon use.

- Quoted companies, large private companies and limited liability partnerships should disclose details of their emissions, energy consumption and energy efficiency in an energy and carbon report under new energy and carbon reporting regulations.

simmons + simmons

Social

i. Assess supply chain ESG performance.

- The rise in ESG-related technology and innovation will make it easier to scrutinise a company's supply chain's compliance with ESG-related requirements. Companies should therefore ensure that:
    - They have regarded to the requirements of both soft and hard law obligations (e.g. the United Nations Guiding Principles on Business and Human Rights and the UK's Modern Slavery Act) – this may involve taking positive action (e.g. conducting human rights due diligence); and
    - appropriate due diligence has been conducted to assess the supply chain's ESG performance and there are contractual provisions in place to allow termination and audit/inspection/receipt of information from various levels of the supply chain.

ii. Review and maintain robust data protection and privacy practices.

- Companies should have robust data protection policies and procedures to protect personal data and maintain privacy.
- This should help prevent the likelihood of unauthorised data use and of personal data breaches, which have in recent years lead to companies incurring significant fines from regulators, suffering reputational damage and being subject to related class actions.

iii. Ensure transparency around executive pay and benefits.

- Companies should be clear about executive pay and pension contributions and how this compares to that of the company's workforce generally.
- Companies should consider how the pension contributions of all executive directors compare to the level of contributions received by the majority of the workforce by the end of 2022 and, where necessary, make related changes.

iv. Review workforce diversity.

- To comply with internal and external diversity targets (and in response to the importance placed on diversity following the Black Lives Matter movement), companies should keep their workforce diversity under review and take action where needed.
- Listed companies should also assess the level of diversity on their board, in particular where there are targets to be met. UK FTSE 350 companies, for example, were expected to have achieved targets of 33% of board positions to be held by women; and 33% of women on their executive committees and direct reports to executive committees by 2020; and to have increased the number of women in the role of chair, senior independent director and executive positions on the board by 2020. In 2021, each FTSE 100 Board is expected to have at least one non-white director by 2021.

v. Report on bribery, corruption and modern slavery.

- Companies should ensure they have conducted the appropriate due diligence and have suitable audit/inspection rights in relation to their service providers as they are liable for the bribery and corruption of such service providers under applicable anti-bribery laws.
- Companies that are large enough to be subject to the anti-modern slavery laws should make annual modern slavery statements setting out the steps taken to abolish slavery and human trafficking in their business and supply chains.
- Companies should also monitor the EU's consultation on a legislative proposal for mandatory human rights due diligence, which is proposed to be adopted in 2021.

vi. Increase communication and engagement with workforce.

- Companies should be clear and active in their engagement with their workforce, particularly during and in the aftermath of the COVID-19 pandemic as direct or face-to-face communication with employees is difficult within this period.
- By way of example, in the UK, incorporated companies with more than 250 UK employees must include a summary in their directors' report setting out how they have engaged with employees.
- Listed companies are expected to engage with their workforce through a designated non-executive director; a formal workforce advisory panel; and/or a director appointed from the workforce; or alternative arrangements.

Governance

i. Take account of directors' responsibility in relation to ESG.

- Directors have duties under corporate law to act in the best interest of the company and to promote the success of the company for the benefit of its members as a whole. This includes ESG factors such as considering the interests of employees, relationships with customers and suppliers and the impact of the company's operations on the community and the environment. Certain large companies and financial services companies must also report annually on how directors had regard to those factors.

ii. Consider shareholder and stakeholder engagement on ESG matters.

- Companies should be aware that institutional investors and asset managers will increasingly be engaging with the companies they invest in on ESG issues.
- For instance, under the Shareholder Rights Directive II institutional investors have had to develop engagement and voting policies and must annually disclose those policies, which includes reporting on how to evaluate investee companies on their social and environmental impact.

iii. Review and keep track of ESG related activities, disclosures and statements.

- To prevent the likelihood of "greenwashing" (as described above) and to ensure compliance with ESG, companies should keep an accurate record of any ESG related activities, disclosures and statements.

As well as the above, companies should monitor any developments in the creation of a set of centralised ESG criteria. For example, the World Economic Forum, in collaboration with the Big Four accounting firms, is currently working to develop unified ESG metrics and disclosures.

We have published related client insights on ESG: 10 considerations for UK directors and Top 10 things asset managers need to know about the EU ESG Initiative. See also our Sustainable Financing and ESG Investment feature.

(5) https://www.weforum.org/press/2020/01/measuring-stakeholder-capitalism-world-s-largest-companies-support-developing-core-set-of-universal-esg-disclosures/

simmons-simmons.com.