NORTHERN TRUST
ASSET MANAGEMENT

THE PUSH AND PULL OF ESG REGULATION

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Introduction

Sustainable investing continues to be one of the fastest growing market segments in the asset management industry. According to the Global Sustainable Investment Alliance (GSIA) report, global assets following some form of the environmental, social and governance (ESG) factors have reached $30.7tn at the end of 2018, which represents nearly one-third of the money professionally managed.

The changing landscape of ESG "regulation" is among the main drivers of ESG investing growth. To better understand the issues around this topic, we examine the status of global efforts to pass legislation and implement codes of practice and self-regulation. What do these efforts mean for investors as they consider incorporating ESG criteria into their portfolios? And will these efforts encourage investors to look at ESG when they otherwise might not? Could ESG regulation foster innovation as asset managers adapt to a changing landscape?

In this article, we will examine the various forms, objectives and directions of ESG regulations in the recent years.

The Push and Pull

The constant waltz between financial markets and policymakers on the topic of ESG illustrates the ever-evolving relationship between the two. The fast pace of new financial product development requires adequate regulation. While ESG does not fall into the bucket of a typical regulatory risk, the principle is the same, and ESG needs sufficient regulation to provide clarity and safeguards within the financial industry. The ideal scenario is when regulators act not only to safeguard client assets but also to assist industry change and innovation in order to set the path for a sustainable global financial system.

The development of separate laws, ministerial statements, directives and voluntary codes demonstrates how broadly defined "regulation" and market practice are working in tandem to spread understanding and practice of ESG investing. For a long time, one could not find a set of ESG-specific regulations serving as a guide to monitor investments and enforce financial penalties in case of breaches. What existed was, in fact, a collage of diverse statutory national requirements for certain asset owners; intergovernmental ambitions; private sector initiatives; voluntary codes; and principles. As governments, asset owners and asset managers are becoming increasingly aware of the risks and opportunities related to ESG issues we've seen the emergence of regulations and directives over the past few years, shifting from voluntary to mandatory in countries such as France and/or the EU at large.

One could argue that some of the voluntary industry principles such the United Nations Principles for Responsible Investing (PRI) played a critical role in shifting the framework from aspirational principles and mandatory reporting and disclosures.

Research from the Grantham Research Institute for Climate Change and the Environment indicates that 106 new climate change-related laws and policies have been implemented since the Paris agreement[1]. Some national policies are already in place to reduce emissions, such as switching to electric cars, building low-carbon housing and investing in carbon dioxide removal technology.

The major goal of attracting investments can be achieved via a set of specific objectives. We discuss these objectives and examples of recent ESG regulations below and provide their overview in Exhibit 1.

Fiduciary Duty and Investment Decision

Our definition of sustainable investing acknowledges that the long-term financial success of our clients and shareholders is dependent on a healthy global environment, a stable society and well-functioning, well-governed companies. As such, we view the integration of environmental, social and governance factors in investment analysis as a key part of our responsibility as asset manager. Over the past few years, a large number of reports looked into the relevance of integrating ESG issues as your part fiduciary duty. The 2015 UK Law Commission and the G-20 Financial Stability Board report amongst others, address the importance and relevance of ESG issues in investment management.

The majority of recent legal opinions and regulatory guidelines stress the fact that not assessing ESG risk factors could constitute a violation of fiduciary duty in certain jurisdictions. As such, we have

[1] http://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2018/04/Global-trends-in-climate-change-legislation-and-litigation-2018-snapshot-2.pdf

seen a surge of new regulations established as mandatory under a 'comply or explain' framework.

For example, ESG-related regulatory requirements of **the EU Directive on Institutions for Occupational Retirement Provision, or IORP II**, adopted in December 2016 (in force since January 2019 via delegated acts) require pension funds in the European Union to assess climate change and social risks in their investment decisions. The Commission, in collaboration with ESMA and EIOPA, developed delegated acts to MiFID II, AIFMD, UCITS Directive, Insurance Distribution Directive (IDD), and Solvency II. The final version of the delegated act to MiFID II and IDD ensures that advisors will take into account the sustainable preference of their clients was published in January 2019.

The most advanced developments in this area occurred in the UK over the past few years. In 2016, the UK pension's regulator published the defined contribution (DC) schemes' Code of Practice and six pension guides, which collective are meant to help pension trustees to cope with the discretionary power driving the integration of ESG factors in pension schemes. In January 2019, the regulation on The Occupational Pension Schemes issued by the UK Department for Work and Pensions (DWP) came into force. It requires that trustees of UK occupational pension funds will have to carry out — and document — their "own risk-assessment" of "new or emerging" material ESG risks. Furthermore, trustees must consult with their members and prepare a "statement on members' views," explaining how they take account members' opinions in relation to these matters.

The UK Financial Conduct Authority (FCA) is also consulting on additional ESG duties for Independent Governance Committees (IGC) of contract-based workplace pensions. The consultation closes on 15 July 2019 and rules will be drafted in late 2019.

In the Nordic region, the Swedish government introduced investment rules in 2019 requiring the buffer funds (AP funds) to integrate "responsible investments and responsible ownership".

In the **U.S.**, the recent developments have been mixed. The Department of Labor (DOL) guidance on ERISA schemes in 2015 designed that retirement plans can include ESG factors as part of their investment decision making process. However, the guidance from April 2018, further reinforced by the presidential executive order of April 2019, suggested that the possibility for sponsors to include sustainable investments should be balanced with economic benefits.

Stewardship of Investments

We believe appropriate management of environmental, social and corporate governance factors can create long-term shareholder value for Northern Trust as an investment management firm as well as a publicly traded company. Being an active owner on behalf of shareholders should help companies produce sustainable value.

The emergence of national codes calling shareholders to become active owners via engagement and proxy voting has been in place for many years, starting with the UK Stewardship Code in 2010. Stewardship codes are voluntary regulations setting best practice standards. However, having started as a set of targets, they have gradually progressed to become common practice for most investors across Europe and Asia and Africa.

Stewardship codes now exist in Hong Kong, Japan, Denmark, Italy, The Netherlands, Australia, South Korea, Brazil, Thailand, Taiwan, Malaysia, Kenya and South Africa. Other forms of investor-led best practice initiatives exist in a number of other countries, as well as US, Canada and Singapore. The International Corporate Governance Network's (ICGN) Global Stewardship Principles (2016) and **The European Fund and Asset Management Association** (EFAMA) Stewardship Principles (2011, updated in 2019) also call for strong investor stewardship.

Over time, the need to set best practice standards has evolved even further. The FCA has proposed draft amendments to the **UK Stewardship Code** setting even more rigorous requirements for stewardship and reporting. They are focusing on how stewardship activities deliver outcomes against objectives, specifically on material ESG issues and are widening the scope of stewardship responsibilities to other asset classes beyond equity.

At the European level, the **EU Shareholder Rights Directive II (SRD II)** has come into force in June 2019, with the main focus of further protection of investor rights through investment stewardship. It imposes the obligation for registered holders of shares traded in markets inside the European Economic Area to publish engagement and proxy voting policies and disclose how their published engagement policies have been implemented. This will increasingly hold institutional investors and managers to account for their long-term investment strategies in addition to stewardship activities.

In the U.S., the SEC also requires funds to disclose their votes on shareholder resolutions and their voting policies, but there have been no substantial developments in this.

Stewardship for Financial Products and Innovation

The development new ESG regulations and industry standards is the seedbed for innovation in ESG. The shaping of the ESG regulatory framework not only fosters greater ESG integration in investment portfolios but also addresses some of key the challenges around ESG and SRI semantics and nomenclature. Asset owners and policymakers feed on each other's advancements and provide perpetual motion that drives the ESG market forward. The acceptance of voluntary codes and principles testifies that the investment community is becoming more receptive to following aspirational norms and code of conducts but, more importantly, to disclose ESG activities. The regulatory framework as it relates to ESG matters is constantly evolving. Nuances between national and regional requirements can prove challenging when asset owners are developing or implementing ESG policies. Could ESG regulation be the conduit for industry innovations?

To illustrate a potential virtual circle, let's look at the evolution of the EU taxonomy and related rules. In June 2019 the TEG proposed, along with the EU Taxonomy of sustainable activities, a EU **Green Bond Standard**. The stated objective was to clarify the classification of green bonds, to ultimately foster the growth of green bonds´ funds and ETFs. Whilst the standard is voluntary, borrowers have to comply with the European Union guidelines, and therefore, to publish a specific green-bond framework disclosures and report on the use of proceeds.

In addition, the Commission is looking to use the existing EU Ecolabel Regulation to create a voluntary EU-wide labelling and certification schemes for financial products.

Another example is the TEG report on the voluntary **low-carbon benchmarks** aiming at creating "harmonized, reliable tool to pursue low-carbon investment strategies".

Such far-reaching and universally applying regulatory developments are likely to have broader ramifications outside the borders of the EU, with global investors free to use the taxonomy and green bond standard to inform their strategies. There may be ISO standards, too. The question remains, however, whether making index rules compulsory might have a negative impact on competition and innovation in the rapidly developing area of green indexes.

The changing landscape of regulations on climate risks and client demand has led us to develop the Northern Trust Quality Low Carbon strategy applying a framework which demonstrates how ESG matters can be integrated with company financial data to seek a climate-aware portfolio with alpha generation potential. The portfolio construction process starts by limiting the universe with a custom suite of screens, developed by Northern Trust more than a decade ago. From there, we utilize financial data to identify sustainable companies that are “high-quality” (efficient management, profitable, with strong cash flow and conservative balance sheets) as well as emissions data to create the final portfolio. With this methodology, we are able to construct a portfolio in a manner that will help meet investor’s financial and environmental goals.

Realizing the drastic difference in the current and potential carbon output between the emerging and developed economies, we felt developing a strategy focused on emerging markets would allow clients to exercise a larger impact in reducing the carbon footprint of their overall portfolio. With the quality of emissions data improving and the sophistication of quantitative techniques, we were in a strong position to combine our core competency of factor investing with a climate change lens.

Disclosure

This topic is at the heart of shift in ESG regulations. Investors and regulators are demanding greater transparency on how investment policies and decisions to integrate ESG considerations are combined to drive investment returns and adherence to norms and regulations.

France became the first country to introduce mandatory reporting for all types of investors on how climate change considerations are incorporated in their investment and risk-management processes. Article 173 of the French Energy Law in August 2015 (effective since January 2016) required investors to disclose how they address climate change-related risks, split into “physical” and “transition” risks, and to assess and report on their contribution to France’s energy transition and international efforts to cap global warming.

A few other countries such as Denmark, Sweden and Italy have also introduced disclosure requirements, different for different types of investment organizations. In Sweden, for example, fund industry guidelines on marketing and information were updated at the request of the regulator in December 2018 to encompass ESG factors. Several countries (Germany, Netherlands, Belgium, Spain, and the UK) regulate ESG disclosures in pension schemes. In the Netherlands, for example, pension plans are required to disclose in their annual report whether or not ESG factors are incorporated and, if so, how.

In the US, very important developments occurred recently at the state level. The bill, signed in California in September 2018, requires public sector pension schemes CalPERS and CalSTRS to publicly report every three years on the climate-related financial risks of their public market portfolios. The California insurance regulator requires insurers to disclose their fossil fuel-related holdings.

In Canada, the provincial government in Ontario since 2016 is requiring pensions to disclose in their statements of investment policies and procedures whether ESG factors are considered and, if so, how.

These changes have been accompanied by substantial advancements in the area of **voluntary disclosure standards for reporting sustainability information**. The two major initiatives are the following:

TCFD

The Task Force on Climate-related Financial Disclosure (TCFD) was created in December 2015 under the auspices of the Financial Stability Board (FSB) and released its recommendations in June 2017. This is a voluntary disclosure framework for companies focusing on four specific topics: Governance, Strategy, Risk Management, and Metrics and Targets. It additionally offers a set of industry-specific guidance. The framework encompasses both risks and opportunities related to transition to lower-carbon economy and physical risks of climate change.

TCFD recommendations have played an important role in driving climate related transparency, particularly in high-carbon sectors. Based on continued efforts of Task Force members and others, as of June 2019, TCFD had over 800 supporters. TCFD framework has become the industry standard for reporting climate risks and strategic implications, and there have been important legislative initiatives linked to it (see below).

Also, PRI has decided that the TCFD strategy and governance indicators, introduced in signatories' assessments in 2019, are to become mandatory for PRI signatories to report on from 2020.

SASB

Sustainability Accounting Standards Board (SASB) spent 6 years on work and consultations before it published its final Standards in November 2018. They lay out short sets of disclosure KPIs for 77 industries across ten sectors. The selection principle of these industry-specific sustainability accounting standards is financial materiality, which has been defined via the SASB 5-Factor Test. The Test looked at the areas where the biggest evidence of financial impacts have been seen, also where the regulatory initiatives or changes in market behaviors or industry best practices can be seen or expected, and where the existing opportunities for innovation lay.

Initially designed to drive sustainability reporting by US companies, SASB standards have become truly international. At least 69 leading companies globally were using the SASB standards for reporting as of May 2019. Many other industry standards get updated alongside the SASB work, such as the Sustainable Development Key Performance Indicators (SD-KPIs), welcomed by the German Environment Ministry. Northern Trust has played an active role at various stages of SASB work via participation in its working groups.

An important development on the European regulatory agenda is that in the course of the European Commission's work on the **EU Action Plan**, in June 2019 the European Commission **presented the new non-binding guidelines for companies on how to report climate-related information**. They align with the TCFD recommendations, the concept of materiality and a proposed EU taxonomy on sustainable activities – as they encourage companies to provide turnover data broken down according to the taxonomy's classification.

Conclusions

In this ever-evolving regulatory framework, we believe investors should align their investments with ESG norms and regulations applicable to their jurisdictions. They also should consider the implications of exclusionary/norms-based strategies in portfolio constructions. Adhering to voluntary codes serves a greater purpose in supporting sustainable economies and societies and encourages investors to look at ESG when they otherwise might not. But the main challenge is translating ESG policies and guidelines in multi-asset-classes investment portfolios without triggering additional risks, such as sector mis-weights, tracking error, volatility, et cetera. The changing shape of ESG "regulation" is among the main drivers of growth of ESG investing. Globally, more codes and conventions are being developed to help asset owners integrate ESG criteria into their investment portfolios. For asset manager such as Northern Trust, Sustainability is in our DNA – from operations to investing and ESG regulations constitute a catalyst to drive innovation. Our flexible approach combines investor values with 30 years of sustainable investing expertise and innovation. Sustainability is central to all investment areas and we believe companies' long term financial performance is connected to their Environmental, Social and Governance (ESG) performance.

	Mandatory	Mandatory 'comply or explain'	Market Expectation (quasi-regulation)
Investment restrictions or limitations	Global and European sanctions lists Prohibitions of investments in controversial weapons identified in the International Convention on Cluster Munitions and the Anti-Personnel Mine Ban Convention: Belgium, Ireland, Italy, Liechtenstein, Luxembourg, Netherlands, Spain and Switzerland Ireland's Fossil Fuel Divestment Bill (2018)		Netherlands – AFM Exclusion list Norway – Ethical Guidelines Sweden - Ethical Council list
Investment analysis integration / decision governance	European Commission's proposal to integrate sustainability factors into Mifid II product governance rules (2019)	UK: Department for Work and Pensions (DWP)'s regulation on The Occupational Pension Schemes (2019) Sweden: Investment Rules for government buffer funds (2019) U.S. Department of Labor (DOL) guidance on ERISA schemes (2015 and 2018) Netherlands: Covenant on Socially Responsible Investment for pension funds; Covenant for international responsible investment in the insurance sector (2018) China Asset Management Association and China Securities Regulatory Commission: Green Investment Guidelines (2018, also address information disclosure) Italy insurance supervisor's (IVASS) regulation for insurance companies to consider E and S issues International Organisation of Pension Supervisors' (IOPS) guidelines on the integration of ESG factors by pension funds (consultation 2019)	Principles for Responsible Investment (PRI, 2006) UK Pension Regulator's (TPR) Code of Practice and pension guides for DC and DB investors (2019) UK's Prudential Regulation Authority's (PRA) expectations on management of climate risks by banks and insurers
Stewardship: Engagement and Proxy Voting		EU Shareholder Rights Directive II (2019)	UK Stewardship Code (2010, update in 2019) Stewardship Codes of Hong Kong, Japan, Denmark, Italy, The Netherlands, Australia, South Korea, Brazil, Thailand, Taiwan, Malaysia, Kenya and South Africa ICGN's Global Stewardship Principles (2016); EFAMA Stewardship Principles (2011, updated 2019)

	Mandatory	Mandatory 'comply or explain'	Market Expectation (quasi-regulation)
Disclosure	Article 173 of France's law on "energy transition for green growth"; an implementing decree setting out the requirements in greater detail (2016). Denmark and Italy: similar regulations. Germany, Netherlands, Spain, and UK: regulation on disclosures in pension schemes. E.g., UK DWP's Regulation on The Occupational Pension Schemes (2019) Californian bill on public sector pension schemes' disclosure on the climate-related financial risks (2018) California Insurance Commission's regulation on insurers' disclosure of fossil fuel holdings Ontario's Investment Guidance Note on ESG disclosure by pension funds; Ontario's Pension & Benefit Act (2016)	EU's existing Non-Financial Reporting Directive (NFRD, 2016); Guidelines on non-financial reporting (2017); Supplement on reporting climate-related information (2019) EU Regulation on Sustainability-related Disclosures in the Financial Services Sector (2019)	The Swedish Investment Fund Association's Marketing and Information guidelines.
Standards and incentives			EU Green Bond Standard EU Benchmark Regulation (incorporating standards for low carbon indexes and disclosure rules for all ESG indexes)

Note: EU Directives are implemented via delegated acts. We are not including all of them here.

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