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DerivSource Podcast Transcript

Environmental, Social and Governance (ESG): Spotlight on Legal

Julia Schieffer: Hello and welcome to this DerivSource podcast. I'm Julia Schieffer, the founder and editor of derivsource.com. Welcome to part one of our four-part series on ESG or environmental, social and governance investing.

No matter where you look this year, the focus really seems to be on the environment and sustainability and generally just being more socially conscious. In fact, one of DerivSource's most popular articles so far in 2019 has been a feature article looking specifically at ESG.

To explore this trend further, we have put together this four-part podcast series to explore how ESG is evolving in capital markets from the perspectives of law, futures trading, asset management and data.

In this podcast, I am joined by two legal experts who shed light on ESG from a legal perspective. We have Michael Green, Counsel at Latham and Watkins and Paul Davies, Partner at Latham and Watkins. Welcome to the podcast.

Michael Green: Good morning.

Paul Davies: Good morning.

Julia Schieffer: So let's begin with some introductions. Paul, with you first, can you tell us a little bit about yourself?

Paul Davies: Thank you. So my name is Paul Davies. I'm a partner at Latham & Watkins and I am head of the European and Asia Environmental, Land and Resources practice, and I have been practicing in the environmental, social and governance space now for approximately 20 years.

Julia Schieffer: And Michael would you like to introduce yourself?

Michael Green: My name is Michael Green. I've worked with Paul for longer than I can care to remember but I'm also working in the London office of Latham & Watkins and have been practising on ESG issues for 15 years.

Julia Schieffer: So, let's start with the basics. Can you tell me a little about what ESG is? And starting with you Paul.

Paul Davies: ESG stands for a range of factors in the environment, social and governance areas by which an investor will evaluate themselves or the firms they invest in in order to review performance in those areas. ESG is a term that has strong connections with the financial services and investment community. However, and this is very important, there are many other terms which are being used to describe this area. These include sustainability, resilience, business integrity and to some extent CSR.

In our view there is no right answer. In terms of the categories of issues falling under ESG, people often refer to the UN PRI which has identified 40 categories and these breakdown the E, the S and the G. On the environment side, it might be about how a business reacts to climate change, the waste it produces or old fashioned issues such as whether or not it has contamination problems. On the social side it's about how it treats staff, customers and other stakeholders and on the governance side, it's looking at how transparent a businesses and how compliant the business is with underlying laws and the wider best practice within industry to ensure they are acting ethically.

Julia Schieffer: And talking about the legal and regulatory side of things. To what extent is ESG different by legal and regulatory developments or voluntary and non-legal?

Michael Green: This is something that lawyers get very worked up about, but actually both the legal and non-legal aspects are very important. Let me first deal with the non-legal drivers. There are two particular non-legal drivers that we would highlight. The first is what I will call investor pressure. So if you take a step back, you have future pensioners and therefore pension funds, who no longer want just a return on their investment. As well as getting a return, they also want to know their money is being invested in companies that perform ethically, don't harm the environment and are socially beneficial. In addition, there's an increasing view that investments in companies that are strong ESG performers generate better longer-term returns. For example, studies indicate that ESG compatible deals outperform ESG incompatible deals by an average of 21% on a five-year cumulative return basis.

So looking at the customer's ESG demands, these are being pushed on to pension funds. They in turn push ESG obligations onto the investments, and then this leads to the trickle-down effect. Those investments impose ESG obligations on their suppliers, and gradually ESG requirements are being imposed throughout the supply chain. Some funds will also choose to signal their approach to ESG by adopting formal standards. Paul has spoken about the UN Principles of Responsible Investment, which is probably one of the best known.

But the second aspect we would flag is the changing perception of ESG risks, particularly amongst consumers. In some instances, this is a gradual change in consumer attitude over a period of time, so consumer views and attitudes have changed towards climate change, knowledge and awareness of climate change has increased, and there was a greater sensitivity to events such as flooding or extreme climate events. These events have real implications for businesses, whether it's the ability to move goods and supplies in and around areas impacted by flooding, whether it's the long-term change in consumer markets due to migration resulting from the effects of climate change or whether it's simply a manufacturer's ability to access water and at what price.

But in other areas the consumer response has been far more instantaneous. The rapid response to the Blue Planet II program was very significant with respect to plastics and in particular single-use plastics. Consumers very quickly adopted a negative view of plastics and this resulted in companies seeing their whole market change. Companies‘ investors therefore have to be alert to these non-legal ESG risks.

But turning to the legal risks, are some instances where legal can be transformative in the ESG space. In the UK, we would highlight the UK Modern Slavery Act as having a material impact in terms of consumer and company awareness on modern slavery. While there is still a long way to go, the very fact that many companies are obliged to report on modern slavery has changed the perception of the issue. There are other areas where legal is more responsive, so I highlighted the Blue Planet II and plastics and the EU proposals on single use plastics and also in the UK as being responses to those quick changes.

The big factor that ties both the legal and non-legal developments together is reputational risk. We've talked about reputation and reputational risk for a long time. If you step back two, three, four years and people could find themselves involved in significant events that wouldn't necessarily affect the bottom line; but that's changed. Negative reputational value is now far stronger. Where sudden crisis management issues arise, people have to consider what impact will this have on my sales? From a legal perspective: do I have compliance issues, or do I face the threat of litigation? Either directly as a result of an event that caused the crisis or from investors because inaccurate disclosures have resulted in a material decrease in my share price. What is also going to be the response of shareholders, investors, stakeholders? So will that pension fund reinvest in me next time I do a fundraise? Will my shares continue to be attractive to asset managers? Or will banks continue to provide me with competitive terms for borrowing?

Julia Schieffer: And how has ESG changed the way that lawyers like yourself work?

Paul Davies: The question we are always asked now is actually what does ESG mean for lawyers? Yes, we do the traditional environmental work, but there's an increasing focus on these social issues. They're tremendously important, as are the governance issues. One particular area that we're seeing a lot of activity around at the moment is the relationship between parents and subsidiaries and how groups are structured. There are three cases that have been to the Court of Appeal or the Supreme Court and that focus on the duty of care that parent companies may owe to employees of their overseas subsidiaries or to third parties. This will be a very important area of focus, particularly for large multinational enterprises and especially for those operating in the natural resources sector.

More broadly, ESG is something where we think that lawyers and consultants have an incredibly important role to play. Where we think we can really make the difference is as lawyers and consultants working together. And over the years, lawyers and consultants have worked together to develop new due diligence products. We think these are going to be increasingly important, bringing together both the technical and the legal solutions, to bring together a joined up solution. Traditionally we were very focused on a target, but now that's fundamentally changed. We are looking not only at the target, but we're looking at the broader supply chain. In delivering these products, we need to do this efficiently and we need to adopt this much wider approach.

Julia Schieffer: Can you talk to me a little bit about some of the tools - or new tools - and ways of working that are needed in order to address these matters?

Michael Green: Paul has spoken about the breadth of ESG and in order for us to address these broader issues, technology is crucial. We've seen that in the corporate legal space, our corporate colleagues are working with AI technology that can scan data rooms, technology such as Kira. The use of AI will allow us to capture some of the newer issues, particularly around social and governance. It's going to be really fundamental. For example, in the context of transactions, we have compressed timescales, tightly controlled flows of information and increased fee pressure to do more for less.

It's hard enough to look at the target itself, as Paul said. But when you broaden that out so that we're looking at both the horizon scanning and assessing the potential long-term changes in the sector for the target and also assessing supply chain issues, including second, third and fourth-tier suppliers, we can only do this efficiently through the deployment of technology. But the other aspect to consider here is that the voluntary standards and drivers we've spoken about, mean that companies and investors are generating significant amounts of data to meet those obligations.

From the legal side, one significant feature of ESG regulation is the approach to require companies to make information publicly available. We've seen this in disclosures on greenhouse gases, in the nonfinancial reporting obligations and in the Modern Slavery Act requirements. This leads to even more data. The challenge is therefore how to deal with this data and how to make comparables with sector and peer performance. Companies and lawyers will try to gain a technological edge around obtaining and analyzing this data so that we can consider if the results are good, bad or ugly, or something they want to shout about in a positive fashion. These technological developments and tools will allow us to quickly start to identify the outliers and then how to address those outliers.

Julia Schieffer: And sticking with the tools and that conversation a little bit longer. Paul, how are the new tools and data obtained and developed?

Paul Davies: As Michael mentioned earlier, we think there needs to be greater collaboration between lawyers, clients, and other advisors with an interest in ESG issues. For example, transactional environmental due diligence has changed little since its emergence into the mainstream. Therefore, a major overhaul of environmental due diligence is required, in our view, to address both conventional compliance and legacy liabilities, as well as sustainability performance and future proofing. This should include incorporating ESG into investment analysis and decision making processes through early phase ESG screening of investments.

Technology and innovation, therefore, are primary means of changing how we undertake due diligence. There are a number of databases and indices that provide useful ESG information, but none that specifically assist in the context of transactions. And this has led to our involvement in Risk Horizon, developed by Anthesis, in conjunction with Latham and Watkins. It is a purpose made tool for use in the due diligence process. Its further development will continue through the use of advanced risk analysis and through the incorporation of AI.

What do these tools rely on? Well, the power of big data. Limited information is required to enable investors to model ESG risk so that they can be subsequently evaluated during more detailed environmental due diligence and social and governance. However, and this is very important, the use of data and new technology is currently best deployed at an early stage risk screening. It is not, and I repeat, not a substitute for more detailed site specific and organization specific diligence.

Julia Schieffer: So final question here, and we're having a separate podcast focused specifically on ESG and data, but I want to get your view on if you think ESG data and tools can be used to influence the overall direction of ESG.

Michael Green: The short answer from my perspective is yes. We've discussed that ESG is a truly cross disciplinary and cross sector issue and we see all the stakeholders, advisors, shareholders, employees, consumers and others playing a key role in shaping the future of organizations.

But all those stakeholders are going to want data and analysis of data in order to come to judgments. Whether that's a decision around making investments around brand loyalty or choice of employer. The same will apply for lawyers who are counselling their clients. So assuming the data is good and the tools are effective, then with appropriate incentives this should encourage sustainable development.

Paul Davies: I would agree with Michael. I think this is absolutely key to the future and the way stakeholders look at investment decisions. Sustainable development is key to ensuring the sustainability of companies' future operations. We are at a crossroads and it is important that everyone embraces the opportunities in the ESG space.

Julia Schieffer: Great. I think that's an excellent point to end on. Thank you both Paul and Michael for joining us in this podcast.

Paul Davies: Thank you very much indeed. We valued the opportunity and we look forward to others engaging with ESG in the same way that we are passionate about it. Thank you.

Julia Schieffer: Thank you for listening to this DerivSource podcast. We hope you found it informative and useful. You can find related resources on our show notes page on derivsource.com and please consider subscribing on iTunes. Join us soon for our next episode in this ESG series. Thank you for listening. Join us next time.