K&L GATES

PERSPECTIVES IN ESG AND SUSTAINABLE INVESTMENT

ESG and the Sustainable Economy Handbook

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ESG AND SUSTAINABILITY FROM THE INVESTOR'S PERSPECTIVE

HOW INVESTORS APPROACH AND IMPLEMENT ESG AND SUSTAINABILITY GOALS

In this handbook, the term "institutional investor" covers a number of different entities that invest funds, typically in order to support a particular purpose. Institutional investors include pension funds (U.S. public pension funds, ERISA plans, and foreign pension funds) and sovereign wealth funds, as well as non-profit organizations such as universities, private foundations, and public charities. The term also includes large family offices. Institutional investors can be divided into two major groups: those that have fiduciary duties because they are, in effect, investing funds for the benefit of other persons, and those that do not have fiduciary duties.

Institutional investors that are fiduciaries have various approaches to dealing with ESG and sustainability issues. However, they are consistent in viewing ESG and sustainability analysis through the lens of their fiduciary duties to their beneficiaries or the purposes of their institutions.

Some institutional investors view investing according to ESG or sustainability principles as a version of impact investing or socially responsible investing, which they find difficult to justify from a fiduciary standpoint. To the extent that the purpose of these investing methodologies is to achieve societal benefits, that purpose may be inconsistent with the institution's obligation to provide the benefits for which it was formed. In the extreme case, investment returns may be sacrificed for the societal objective. Even if an impact or socially responsible investment does not detract from returns, an investor that actively seeks such investments may be seen as improperly devoting resources in order to do so. Fundamentally, some investors may believe that ESG and sustainable investing involves a purpose other than the purpose for which the institution exists. Put another way, these investors would see themselves under a duty to invest purely for returns.

Other institutional investors see ESG and sustainability factors as key aspects of their investment decisions because these factors provide insight into the economic viability of their investments, especially over the long term. These institutions use ESG and sustainability factors to identify qualities that will enable the investments to increase in value, as well as qualities that may cause deterioration in value. For example, ESG and sustainability analysis has contributed in many cases to divestment from coal and hydrocarbon production, related infrastructure, and marketing companies, while spurring increased exposure to alternative energy investments. ESG and sustainability factors are also often taken into account in infrastructure investments, given the significant environmental and social impacts of these investments and their long-term nature, the success of which requires good governance. Further, ESG and sustainability considerations are seen as important in efforts to avoid acquiring and holding assets that may become stranded assets, especially those that lose significant value as the result of regulatory or environmental changes. In short, these investors may consider ESG and sustainability analysis not to be merely consistent with their fiduciary duties, but in fact to be required by their fiduciary duties.

Institutions that are not fiduciaries are generally understood to have more leeway to consider ESG and sustainability factors in reaching their investment decisions. Some may implement their ESG and sustainability policies in a similar manner of focusing on the potential effects of ESG and sustainability factors on financial returns. However, family offices may have more of a tendency to engage in impact or socially responsible investing, guided by the family's values. And of course, there are funds created especially to effect such investing—in this case, these funds have a fiduciary duty to invest with the required impacts in mind.

Institutions with ESG and sustainability policies, including fiduciaries and non-fiduciaries, may implement these policies both by eliminating certain sectors from their portfolio (e.g., private prisons, firearms, or alcohol) and by proactively investing in certain sectors (e.g., minority-owned businesses). Some fiduciaries will apply ESG and sustainability considerations in ways that they believe will indirectly advance the interests of their beneficiaries (e.g., construction unions favoring investment in real estate, and public pension funds avoiding investments in businesses that privatize public sector jobs).

Institutions that incorporate ESG and sustainability factors into their investment decision-making process do so in a number of different ways. In some cases, institutions have an ESG or sustainability team that reviews all or a specified portion of the institution's investments through an ESG and sustainability lens. This approach may have the benefit of a consistent treatment of these factors across investments. In other cases, ESG and sustainability analysis is an integral part of each investment officer's evaluation of opportunities. Many institutions choose to focus on certain enumerated ESG or sustainability factors in order to keep the evaluation and monitoring manageable. In particular, this approach may guide the institution's shareholder engagement and proxy voting policies for their public investments.

In sum, many institutional investors are still feeling their way as they develop their strategy for dealing with whether and how to incorporate ESG and sustainability issues into their investing decisions. There is a broad spectrum of approaches in this area—from hesitating to consider ESG and sustainability issues at all, to identifying specific factors to pursue or avoid, to embracing the concepts as fundamental to their investment program, to seeking out investments with positive ESG and sustainability impacts.

UNIQUE CONSIDERATIONS OF ERISA INVESTORS AND PLAN FUNDS

U.S. retirement plan sponsors and other fiduciaries of private sector retirement assets that would like to consider ESG and sustainability factors when making investment decisions must consider ERISA, the U.S. federal pension statute. ERISA imposes strict investment duties on fiduciaries responsible for investing private sector pension plan assets, including fiduciaries with responsibility for selecting and monitoring investment options for 401(k) and other individual account retirement plans. The following are among the fiduciary duties imposed by ERISA (collectively, ERISA principles):

- A requirement that ERISA fiduciaries act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to the participants and beneficiaries and defraying reasonable expenses of administering the plan;
- A duty of loyalty, which requires ERISA fiduciaries to act with a single-minded focus in the interest of plan participants and beneficiaries; and
- A duty of prudence, which has been interpreted to prevent an ERISA fiduciary from choosing an investment that is financially less beneficial than an available alternative.

These fiduciary standards are the same regardless of the investment category, and as a result, present challenges for plan sponsors and investment managers that seek to consider ESG and sustainability factors when investing ERISA assets or offering investment options for 401(k) plan participants.

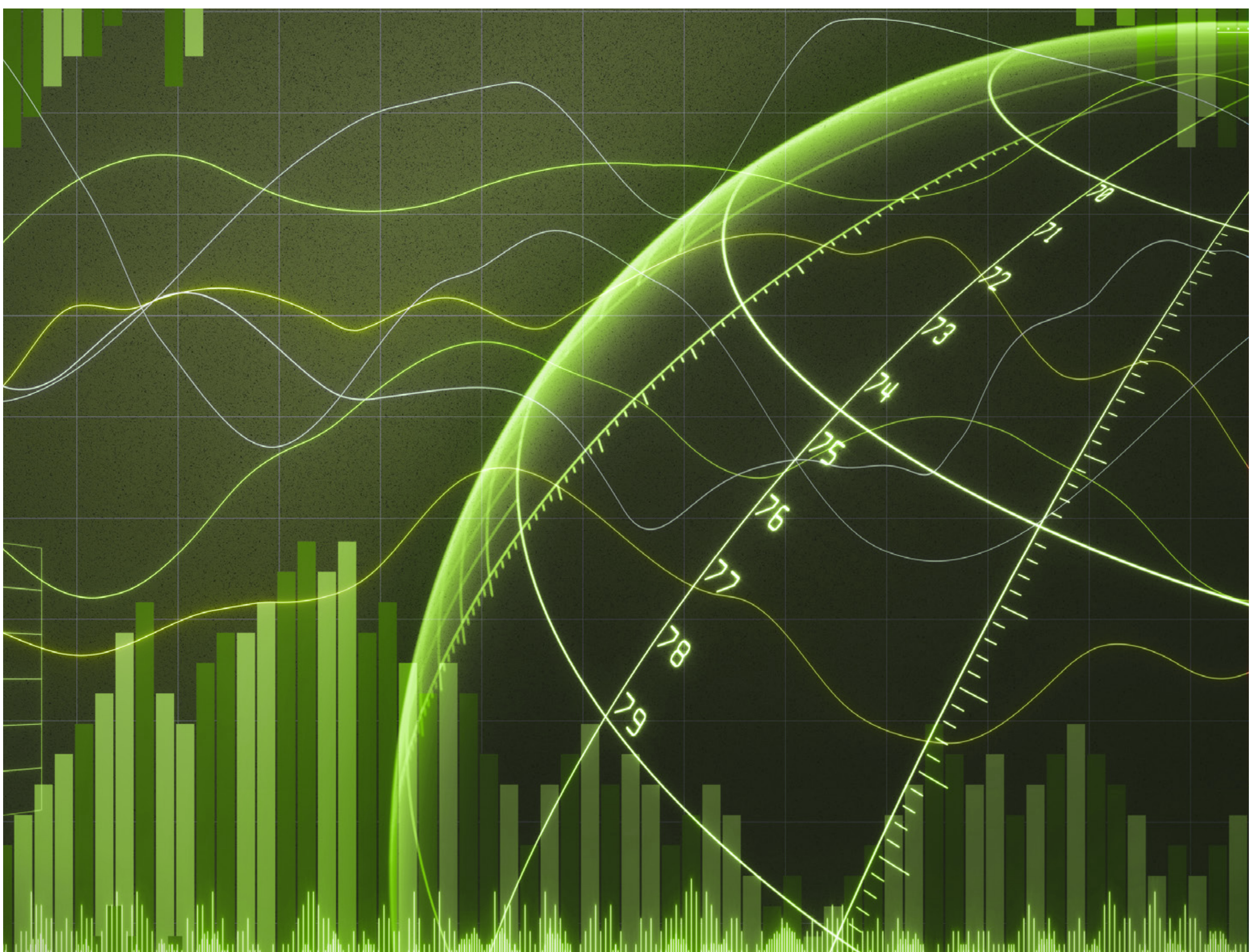
Over the years, the DOL has been asked to consider the application of ERISA's fiduciary rules to ESG and sustainable investing. DOL guidance has not been entirely consistent, and seems to vary based on whether there is a Democratic or Republican administration at the time it is issued. However, a consistent theme runs through the DOL's guidance: when making investment decisions, ERISA fiduciaries must focus solely on the plan's financial risks and returns.

On 30 October 2020, the DOL released its final rule "Financial Factors in Selecting Plan Investments" (the Final Rule). Although the proposed rule aimed to regulate ESG and sustainability investing by employee benefit plans subject to ERISA, in the Final Rule, the DOL rejected the ESG nomenclature as too unclear, removed all ESG terminology, and focused instead on whether a factor is "pecuniary." Broadly speaking, ERISA fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals, and may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives. Instead, a fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors.

One exception under the Final Rule where ERISA fiduciaries can use non-pecuniary factors remains in a tie-breaking scenario (i.e., situations in which the fiduciary is unable to distinguish investment alternatives on the basis of pecuniary factors alone). To consider non-pecuniary factors as tiebreakers, an ERISA fiduciary must document: (1) why pecuniary factors were not sufficient to select the investment, (2) how the selected investment compares to the alternative investments, and (3) how the chosen non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan.

If plan sponsors or retirement plan investment committees appointed by plan sponsors work with a consultant, the plan sponsor will have co-fiduciary responsibility over the plan's investments or fiduciary responsibility to oversee the consultant. In each case, the plan sponsor should consider ERISA principles and the Final Rule before an ESG or sustainability investment option is included in a defined contribution plan investment menu (especially as a default investment option) or causing a defined benefit plan to hire an investment manager who integrates ESG and sustainability factors into the investment process. Plan sponsors should (1) evaluate whether their consultants have sufficient expertise regarding ESG matters, (2) consider whether changes should be made to request for proposals and requests for information used in connection with hiring consultants, and (3) consider whether they have the necessary tools and expertise to evaluate ESG and sustainability matters in addition to more traditional investment matters.

On 10 March 2021, the DOL announced its plan to review the Final Rule, and that it would not enforce the Final Rule pending its review. Additionally, on 20 May 2021, President Biden issued an executive order directing the DOL to "consider publishing, by September 2021, for notice and comment a proposed rule to suspend, revise, or rescind" the Final Rule. In accordance with that directive, the DOL submitted a new proposed rule to the Office of Management and Budget on 6 August 2021, entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights." Therefore, we expect additional guidance and rulemaking in this area. However, any new rulemaking will be limited by the fundamental ERISA principles, and ESG and sustainable investing by plans subject to ERISA will remain an area with broad compliance considerations.



UNIQUE CONSIDERATIONS OF TAX-EXEMPT ORGANIZATIONS

Unsurprisingly, tax-exempt organizations often have a mission that reflects ESG and sustainability principles. For example, Parley for the Oceans is focused on mitigating the environmental impact of ocean plastics, as well as the health impact of consuming seafood that has internalized plastic and social impact on groups that live on coastlines. Emmaus International promotes systemic changes to eliminate human trafficking and forced labor, equalize access to finance, and accomplish environmental justice.

However, exempt organization investors are generally subject to regulatory requirements about how they deploy funds. In some cases, these requirements act simply as a screen, much like an institutional investor may screen for ESG and sustainability criteria. For example, in the United States, a mission related investment may be made by any exempt organization that wishes to invest its assets in an enterprise designed to have a positive social impact, while also generating a profit or other return on investment. In these cases, an exempt organization investor is likely to seek out evidence that the enterprise will somehow further the organization's specific mission, but otherwise may not differ significantly from a mainstream commercial investor.

In contrast, a U.S. private foundation[1] may wish to qualify an investment as a program-related investment (PRI), as the foundation could then treat the investment similarly to a grant and avoid penalty excise taxes that might otherwise apply to this type of investment. An investment must meet these

criteria to qualify as a PRI: (1) the primary purpose of the investment must be to accomplish one or more of the foundation's exempt purposes; (2) the production of income or appreciation of property may not be a significant purpose (i.e., a for-profit investor would be unlikely to make an investment on the same terms); and (3) influencing legislation or taking part in political campaign activity may not be a purpose. A PRI can take the form of a loan, equity investment, guarantee, or a hybrid investment.

Because a private foundation seeking to make a PRI would invest on less favorable terms than a typical investor, a PRI can provide a source of funding that would be difficult to attract from mainstream investors and can fill gaps where mainstream investors are not willing or able to take the associated risk. A PRI is also likely to add complexity to the negotiation and implementation of the investment, as the foundation likely will require substantial due diligence of legal, financial, and programmatic matters and the PRI rules will dictate certain terms of and processes related to the investment. Furthermore, the foundation is likely to require a side letter or other special agreement to memorialize the charitable purpose of the investment, the ongoing reporting and other requirements needed to comply with the PRI rules, and exit terms in the event that the investment can no longer qualify as a PRI.

From an Australian perspective, income or capital of a tax-exempt person must be made and distributed in accordance with the entity's objects and purposes and can only be made to persons or entities that come within the scope of beneficiaries described in the entity's constituent documents (which may not include the entity's members). When establishing an income tax exempt entity, significant care should be taken in considering the purposes for which the entity is established and the classes of beneficiaries for whom the entity is established. Incorrect identification of these matters at the outset—or failure to properly account for a change in purpose or beneficiaries—can cause significant issues for the operation and administration of these entities.

In Australia, an entity that has charitable purposes (including charitable purposes related to ESG and sustainability criteria) may obtain tax-exempt status by registering with the Australian Charities and Not for Profits Commission (ACNC). Entities registered with the ACNC must have one or more recognized charitable purposes, which could include advancing the natural environment and advancing social or public welfare. Entities that are registered with the ACNC will generally be entitled to various tax concessions, such as income tax-exempt status as well as certain Goods and Services Tax and Fringe Benefits Tax concessions, but also will be subject to ongoing oversight by the ACNC.

In addition to the above, entities with the principal purpose of protecting or enhancing the natural environment or providing information or education about the natural environment are eligible for deductible gift recipient (DGR) status allowing donors to receive an income tax deduction for donations made. Limited categories of organizations providing benevolent relief to sections of the community in recognizable need are also eligible for DGR status.

As to structure, ESG and sustainability-oriented entities can take several forms including, most commonly:

- As a company limited by guarantee, which will be regulated by the Corporations Act and may register with ACNC.
- As a private ancillary fund (PAF), a form of trust that manages gifts and then distributes them to other charitable organizations. PAFs are commonly used as charitable vehicles by high net worth families and institutions and are regulated by both trust law and specific legislative guidelines. PAFs typically have broad charitable purposes and are often registered with the ACNC under any of several charity subtypes.

ESG AND SUSTAINABILITY INVESTMENT FROM THE INVESTMENT SPONSOR'S PERSPECTIVE

FORMING AND MARKETING ESG AND SUSTAINABILITY INVESTMENTS AND FUNDS TO THE PUBLIC

The increase in the popularity of public ESG and sustainability-oriented funds is linked to the integration of ESG and sustainability factors into the mainstream, as well as improvement in performance of these funds. The impact of the climate crisis, underlined by COVID-19, has prompted greater awareness of the vulnerabilities of our planet, revealing the importance of ESG and sustainability investing and spurring record-high flows into ESG and sustainability equity funds in 2020.

To be recognized as an ESG or sustainability fund and to avoid greenwashing, a fund must either have a sustainable investment objective, or be identified as having environmental or social features (i.e., where sustainable investment is not the fund's primary objective but the fund manager makes a binding commitment, usually within pre-contractual documentation, to consider ESG or sustainability characteristics as part of the investment decision-making process).

ESG funds in Europe are most commonly set up as alternative investment funds (AIFs) or Undertakings for the Collective Investment in Transferable Securities (UCITS). In the European Union, marketing requirements for an AIF or a UCITS will, in the absence of the ability to take advantage of the EU passporting regime, depend on local marketing requirements in the country where the fund is being marketed. Meanwhile, managers of non-EU AIFs are only able to access the market through the National Private Placement Regime.

Marketing strategies must avoid greenwashing by ensuring that the objective of any fund is appropriately conveyed. In the European Union, marketing materials must be consistent with the new disclosure requirements under the new EU ESG and sustainability disclosure regime as further described under the section headed "EU Regulation on Sustainability Disclosures."

ESG funds in the United States are commonly established as open-end investment companies registered under the Investment Company Act of 1940, as amended. The Securities and Exchange Commission (SEC) has not yet established rules

regarding what constitutes an ESG strategy, but comments provided by the staff of the SEC to funds that employ ESG strategies in the SEC registration process focus upon enhanced disclosure regarding the adviser's description of ESG and how it is incorporated into the fund's investment objective and strategies. In March 2021, the SEC included climate change and ESG-related risks on its list of examination priorities and announced a new enforcement task force focused on climate change and ESG-related issues. In April 2021, the SEC's Division of Examination issued a risk alert regarding ESG investing. As such, ESG investing is expected to be a continued area of focus by the staff of the SEC in examinations, the review of registration statements, and in upcoming rule proposals.

Further, in October 2020, the DOL finalized a rule aimed to regulate ESG investing by employee benefit plans subject to the ERISA. This rule prohibits plan fiduciaries from sacrificing investment return or taking on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals. Accordingly, if a fund integrates ESG factors into the investment process for non-financial reasons or discloses that investment performance may be adversely impacted because of the portfolio manager's consideration of ESG factors, an ERISA fiduciary, such as a consultant or a plan's retirement plan investment committee, may not be able to recommend or offer the investment product to defined contribution plan participants or cause a defined benefit plan to invest in the investment product. This would likely have had a resulting impact upon product design and disclosure. In March 2021, the DOL announced it will not enforce the Final Rule or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with the Final Rule.

In May 2021, President Biden issued an executive order that directs the DOL to review the rule and gave the agency until September 2021 to "consider publishing…for notice and comment a proposed rule to suspend, revise or rescind" the rule. In accordance with that directive, the DOL submitted a new proposed rule for OMB review on 6 August 2021.

FORMING AND MARKETING ESG- AND SUSTAINABILITY-FOCUSED PRIVATE FUNDS

As with many other types of investment products, there is no formal definition of what ESG or sustainability means in the context of a private fund. While a discrete segment of private funds has pursued investment strategies flavored by ESG and sustainability considerations for many years, stakeholder interest in ESG and sustainability matters has increased markedly in recent years. This is particularly the case with institutional investors increasing interest in incorporating material ESG and sustainability factors into their investment processes in spite of regulatory uncertainty.

ESG and sustainability manifests in numerous ways, including an affirmative environmental-, social-, or governance-focused investment strategy, public disclosures, investor demands, portfolio company reporting, and active involvement with the management of a fund's portfolio companies. When marketing a private fund as an ESG or sustainability fund, managers should disclose what aspects of ESG and sustainability they harness in the management of their fund. For example, clearly defining the ESG or sustainability metrics incorporated into investment decisions, such as revenues from clean energy, women or minority ownership, or governance characteristics, is important for investors' understanding of a fund's strategy and its limitations on their investments; synergistically, it may also help managers balance returns with their stated ESG and sustainability criteria.

In making investment decisions, managers need access to the data and information on target investments necessary to make a determination that an investment falls within the fund's investment strategy. For publicly traded securities, managers often license this data from ESG data providers for a fee, or perform their own fundamental analysis of issuers' ESG and sustainability criteria. The latter approach is resource-intensive, but allows a manager to zero in on a tailored ESG and sustainability focus and engage with management directly. For private markets investments, managers are generally limited to internal research and analysis and management reporting from portfolio companies.

Fund managers may also seek to influence the ESG practices of companies in which they invest, taking activist positions in publicly traded issuers or using control positions in private companies to drive management's ESG and sustainability initiatives. To the extent possible, managers should disclose their proxy voting and management policies to potential private fund investors.

In addition to a private fund's disclosed positions on ESG and sustainability matters, investors may seek comfort in the form of side letter representations or otherwise that a manager will invest in accordance with the investor's adopted ESG and sustainability policies, or published ESG and sustainability principles such as the Principles for Responsible Investment. Managers should avoid making any representations that would materially affect the private fund's disclosed strategy.

Finally, private fund managers should document the policies and procedures they follow in pursuing their ESG and sustainability strategies to avoid the appearance of greenwashing the private fund, or marketing a fund as ESG and sustainability focused to take advantage of investor interest while (mostly) eschewing investment decisions based on ESG and sustainability factors. Greenwashing is a particular concern of investors and the SEC, who contemporary evidence shows are increasingly likely to demand to review a manager's policies and procedures in connection with ESG and sustainability marketed funds.

STANDARDIZATION AND REGULATION OF ESG INVESTING AND COMMUNICATING COMPLIANCE WITH ESG AND SUSTAINABILITY CRITERIA

PASSIVE AND ACTIVE ESG INVESTMENT STYLES — REGULATORY IMPLICATIONS

ESG investing frequently is used as an umbrella term intended to capture a wide spectrum of potentially disparate activities, including both passive and active ESG and sustainability investment styles. As the term pertains to institutional asset managers, a passive approach to ESG investing typically involves purchasing minority positions after assessing the effect of certain sustainability factors. This may be done through integration (increasing or reducing the overall exposure of a particular ESG or sustainability factor in a portfolio), screens (applying filters to an investment universe or based on particular ESG or sustainability characteristics), or themes (selecting investments based on their exposure to specific ESG or sustainability themes). An active approach to ESG investing, by contrast, typically refers to investments that seek to influence the activities of companies with the intention of promoting behaviors that the manager perceives to create ESG or sustainability benefits. This influence is often exercised through discussing ESG and sustainability issues with company management individually or in collaboration with other investors, or through proposing shareholder resolutions that pertain to specific ESG and sustainability issues.

In determining whether to incorporate passive or active investment ESG and sustainability elements into their investment strategies, managers should be mindful that this choice could have regulatory

implications. Although managers pursuing passive strategies generally are subject to fewer restrictions, asset managers are fiduciaries that should disclose to clients all material information pertaining to the strategy. For managers making investment decisions based on sustainability factors, for example, managers should consider how each factor is implemented, and the relative weights of each factor. Similarly, for managers screening out certain types of companies, are there specific types of companies or more general themes that are excluded entirely, or is the determination made based on a review of factors, where no single factor is determinative? Does the manager rely on third-party data sources to determine whether a company has exposure to a preferred or restricted activity? In addition to carefully considering the active and passive ESG and sustainability elements of its investment process, a manager should ensure that it describes this process to investors in a meaningful way, and maintains documentation that evidences that the manager is, in fact, adhering to its stated process.

Depending on the jurisdiction of a company, managers that acquire large positions in a company could also be faced with ownership threshold filings (e.g., upon owning or controlling 5% or more of a particular company). These filings can sometimes be more onerous if a manager seeks to influence or exercise control of a company.

GLOBAL ESG AND SUSTAINABILITY STANDARDS AND REGULATIONS

ESG and sustainability criteria affect many actors in the business community, from the investors who elect to use an ESG or sustainable investment model to the operators of a business.

As interest in ESG and sustainability as a way of measuring an investment as increased, it has become more important to many stakeholders to standardize the measurement of ESG and sustainability criteria, whether through voluntary guidelines and rubrics or through government mandate. So too has it become more important to government actors to regulate how adherence to ESG standards or activities with sustainability indicia are communicated to investors.

NOTABLE VOLUNTARY STANDARDS AND GUIDELINES

Investor-Level

The Principles for Responsible Investment (PRI) were created in 2006 by a group of institutional investors supported by the United Nations. The PRI are a set of six broad guidelines that signatories pledge to incorporate into their investment processes. The PRI themselves are not investment criteria, nor are they auditable standards. However, investors that become signatories to PRI are required to report annually a variety of information about how ESG and sustainability are incorporated into their investment processes. Information is broken out by asset class when a threshold amount of assets under management is invested in one of a number of asset class categories provided by PRI, including infrastructure, commodities, forestry, farmland, listed equity, and private equity.

The new PRI reporting tool, which applies to the 2021 and future reporting periods, incorporates two stages of reporting: the "core," which is focused on the investment process and is quantitative, and "plus," which incorporates information about outcomes and is qualitative. PRI personnel evaluate the annual reports and provide assessments to signatories, which then evaluate any recommended changes to their ESG and sustainable investment frameworks. A portion of the core reporting responses are made available to the public.

The United Nations Sustainable Development Goals (SDG) are a set of 17 goals for sustainable development ranging from eliminating hunger and creating clean water and effective sanitation, to reducing inequalities and promoting gender equality and responsible consumption. The SDG can be incorporated into an ESG or sustainability investment policy or plan, including by signatories to PRI. However, the SDG is not part of PRI and, like PRI, the SDG is not itself an auditable standard. Rather, the SDG inform ESG investment policies and practices.

Business-Level

How businesses voluntarily track and report on their ESG activities and metrics is quickly evolving. While several standards and guidelines are currently available, there is variation about what constitutes ESG-related information, as well as how best to gather relevant data, evaluate it, and describe it in voluntary reporting to investors and members of the public. We expect this area to continue to change, particularly as more governmental organizations roll out mandatory reporting regimes and other regulatory requirements. In the meantime, a few major standards are available to gauge ESG-related performance of a company.

The Sustainability Accounting Standards Board (SASB) is a U.S. nongovernmental organization that has created standards for 77 industries to test key criteria identified as important to ESG-focused investment strategies. Companies may use the standard for their industry to score their performance and create reporting to investors. The company may engage a third-party auditor to verify the scoring. As such, the SASB standards allow for some comparison of companies, at least within industries.

The International Integrated Reporting Council (IIRC) is an English nongovernmental organization that has created principles-based guidelines (the <IR> Framework) for integrated reporting that takes into account a wide variety of matters that impact the creation, preservation, and erosion of value in a business. The <IR> Frameworks looks to the organization's activities, as well as relationships with its stakeholders, external environment, and dependency on resources.

In November 2020, the SASB and the IIRC announced their intention to merge to become the Value Reporting Foundation. This decision has been heralded as a key step toward simplifying voluntary corporate ESG reporting.

The Global Reporting Initiative (GRI) is a Dutch nongovernmental organization that has created industry-agnostic general and topic-specific standards around ESG-related matters. A company that uses the GRI standard evaluates its operations under three general standards as well as any number of additional standards concerning specific areas such as tax, emissions, forced or compulsory labor, and procurement practices. Reporting concerning these standards is auditable, which therefore permits some comparison of companies using GRI standards.

The Task Force on Climate-Related Disclosures (TCFD) was created by the Financial Stability Board. In 2017, it published several recommendations and suggested disclosures guidelines for financial reporting concerning risks specifically related to climate. Like the SDG and PRI, the TCFD recommendations are guidelines rather than auditable standards.

In September 2020, the SASB, the IIRC, and the GRI, together with the Climate Disclosure Standards Board (CDSB) and the CDP (formerly the Carbon Disclosure Project), both of which are climate-focused standards organizations, announced their intent to work together to streamline sustainability-related reporting and combine it with more comprehensive frameworks such as that created by the IIRC.

At roughly the same time, the International Business Council (IBC) of the World Economic Forum, working with the "Big 4" accounting firms, announced that it has created a new draft set of standards referred to as the Stakeholder Capitalism Metrics (SCM). The SCM is oriented toward the SDG and based on existing standards, including those published by the SASB, the CDSB, the GRI, and the IIRC. Like the joint effort between the SASB, the IIRC, the GRI, the CDSB, and the CDP, the primary goal of the SCM is to create a more generally applicable ESG and sustainability standard with standard financial statement disclosures based on application of the SCM to a business and its practices.

Activity and Product-Level Standards

There are also many industry-specific standards setting organizations, some of which address a full range of ESG and sustainability criteria. For example, in 2020, Leading Harvest published its first standard, which incorporates ESG criteria. The forestry industry has two major standards organizations, both of which account for criteria in all ESG categories: the Sustainable Forestry Initiative and Forest Stewardship Council. The Global Organic Textile Standard is used to evaluate environmental and social factors in the textile supply chain.

However, industry-specific ESG standards tend to be focused on producer practices or product attributes. As such, they may be utilized to evaluate certain or more comprehensive ESG practices of portfolio investments, but some translation may be required to properly account for them in the context of an investment process.

NOTABLE REGULATIONS

While the ESG standards and guidelines above are voluntary, government regulation is generally mandatory. In the ESG and sustainability context, this type of regulation is typically oriented toward investor protection or education, often by means of disclosure requirements. However, there are also examples of regulation prohibiting the use of certain ESG and sustainability factors at all when evaluating investments, for example, recent guidance concerning the use of ESG criteria by pension plans governed by the ERISA, discussed above. There are also some examples of regulation requiring that certain ESG and sustainability requirements be met (e.g., California's requirement that corporate boards include at least a specified number of women). So, too, are there countries that have implemented the Kyoto Protocol or the Paris Agreement that have created laws in furtherance of the goals stated in these environmentally focused international agreements.

Nonetheless, although investors that create and implement ESG and sustainability policies focus on compliance with applicable laws through the governance prong of ESG, they often also seek to evaluate performance under a broader range of factors underlying the sustainable economy, beyond legal requirements. Thus, if applicable law about what a business must or must not do is the baseline, evaluating ESG and sustainability criteria may be thought of as evaluating whether an investment will create additionality in respect of those ESG and sustainability criteria.

Therefore, when we discuss regulation in the context of investing based on ESG and sustainability factors, we usually mean either:

1. What a regulator (a) requires an investor to communicate, or (b) permits an investor to communicate, in each case to a given audience (e.g., what an investment manager may say to potential investors or a business entity may say to its customers); or
2. What a regulator will permit an investor to consider when evaluating a potential investment.

Greenwashing

"Greenwashing" is an umbrella term for activities that involve encouraging investment in products based on misleading information regarding their sustainability. Greenwashing activities range from marketing tactics that awe investors into making false assumptions, to the deliberate misselling, mislabeling, or misrepresenting of financial products.[2]

The growing market for conscientious investment has resulted in heightened demand for sustainable investment products and a consequential rise in complaints of greenwashing[3]—as increasingly aware investors grow cynical of marketing information. In response to these concerns, and mounting urgency to address the climate crisis, it is important that sustainably minded investors are able to make informed decisions on investing "green."

In February 2020, the chair of the European Securities and Markets Authority (ESMA) highlighted three key areas in combatting greenwashing: improving the quality of ESG and sustainability disclosures, tightening the regulation of ESG ratings, and ensuring high supervision standards for green bonds.

The work of the Technical Expert Group (TEG) on Sustainable Finance, a group appointed by the European Commission (EU Commission) to look at the overarching taxonomy of sustainable finance,[4] has honed in on greenwashing in the context of minimal technical standards and methodologies for sustainability benchmarks—particularly in the context of low carbon indices.[5] The TEG is looking to ensure financial investment can contribute to the necessary rate of change regarding climate change emission issues, with concern that marginal emissions reductions in emissions-intensive sectors will be insufficient for addressing urgent climate concerns.[6] The TEG is keen to ensure that benchmarking standards under the new European Benchmark Regulation are sufficiently precise to prevent all low-carbon indices being promoted as equally environmentally relevant, thus ensuring conscientious investors are directed towards products with the greatest capacity to drive change.

It is this goal, of sufficient clarity as to what constitutes genuine sustainable investment, which is at the heart of initiatives to reduce greenwashing and facilitate capital flow to investments with the greatest sustainability.

Europe

The EU Regulation on Sustainability Disclosures

Disclosure standards are at the heart of all regulatory action focused on ESG and sustainability matters, given their value in keeping investors informed. As part of the EU Commission's sustainable finance reforms, a number of new disclosure standards have been introduced in order to integrate ESG and sustainability concerns into the current financial services monitoring and regulation.

The EU Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU) (SFDR) entered into force on 29 December 2019, and is a key part of the European Union's push to channel more money into sustainable projects.[7] SFDR is intended to clamp down on greenwashing, by requiring financial market participants and advisers to provide the necessary information to enable investors to identify and compare so-called "sustainable investments."

Sustainable investment is an investment in an economic activity that contributes to the furtherance of a given environmental or social objective, while doing no harm to other objectives and being carried out by a company maintaining good governance.[8]

To ensure transparency, SFDR requires financial market participants and advisers (described collectively for the purpose of this section as asset managers) to disclose, on their website, up-to-date sustainability risk policies and information regarding sustainability risks resulting from their investment products,[9] as well as relevant details of remuneration policies,[10] and entity level sustainability risk policies.[11] These entities will also be required to disclose details of their ongoing engagement with sustainability factors to potential investors on a pre-contractual basis.[12]

SFDR will also introduce periodic reporting obligations for asset managers mandating disclosures relating to the sustainability indicators of their financial products (with appropriate comparison to any relevant benchmarks).[13] The reporting standards will be greater for large asset managers (those with 500 or more employees),[14] and the format of reporting will be dependent upon the nature of the market participant entity and subject to pending regulatory technical standards.[15]

At the entity level, asset managers must publish and maintain disclosures relating to principal adverse sustainability impacts of their investment decisions or advice, how sustainability risks are integrated into their investment decision-making processes, and their remuneration policies.

At the product level, for products with environmental or social characteristics, asset managers must disclose how these characteristics are met, and whether any index designated as a benchmark is consistent with these characteristics. For products with a broader ESG investment objective, asset

managers must disclose how a designated index aligns with the investment objective, or alternatively how the objective will be attained. Meanwhile, all asset managers (including for products without ESG or sustainability objectives or environmental and social characteristics) must assess the likely impact of sustainability risks on product returns, and consider the principal adverse impacts of its investment decisions on sustainability factors at product level.

Earlier this year, the EU Commission consulted on proposed amendments to the UCITS Directive, the Alternative Investment Fund Managers Directive, the Markets in Financial Instruments Directive (MiFID II), the Directive on Insurance and Reinsurance, and the Insurance Distribution Directive in line with the same objectives. In summary, the proposed amendments seek to integrate the active consideration of sustainability risk into existing due diligence processes, remuneration policies, and the like. Also, specifically in the context of MiFID II, the changes will require that investment firms enquire as to, and take account of, client sustainability preferences in their investing.

At the end of 2020, the Brexit transition period came to an end, meaning, the operative provisions regarding disclosure in the SFDR will not be automatically applicable within the United Kingdom. At the time of writing, the extent of the divergence between any potential UK regime post-transition and the EU regime under SFDR remains unclear.

Asia

The integration of ESG and sustainability criteria into investment processes has lagged in Asia compared to the United States and Europe for a number of reasons, including limited understanding of its benefits and a relative lack of commercial motivation.[16] A number of Asia Pacific governments and regulators are taking the lead as a part of their sustainable development or green economic growth agendas and taking active initiatives to increase the awareness of ESG and ESG disclosure and reporting in order to reduce exposure to climate change risks and broader environmental and social impacts as well as increase the attractiveness and quality of green and ESG investments and investor confidence in the region.

Hong Kong (SAR)

The Hong Kong Exchanges and Clearing Limited (HKEx), the regulator of listed companies in Hong Kong, first introduced a voluntary ESG reporting guide in 2013 (ESG Guide). The Hong Kong Listing Rules were amended in 2015 to mandate issuers to report on ESG matters on an annual basis. The ESG Guide was updated in 2016 with reporting obligations on a "comply and explain basis" for meeting environmental key performance indicators. Other disclosures were not mandated but recommended.[17] Since 1 July 2020, certain ESG disclosures have now become mandatory, with other disclosures elevated from being a recommended disclosure to being required on a "comply and explain" basis.[18] The revised ESG Guide requires issuers to disclose their ESG governance by including a statement from the board containing a disclosure of oversight on ESG issues, its ESG management approach and strategy, and how the board reviews progress made against ESG-related goals and targets. The revised ESG Guide also introduced two new key performance indicators in relation to emissions for scopes 1 and 2 greenhouse gas emissions, a description of emissions targets, and steps taken by the listed company to achieve them respectively. Additionally, the guide introduced a new obligation to disclose significant climate-related issues which have impacted or may impact the listed company, and actions taken to manage them. The ESG Guide essentially aligns with the TCFD recommendations, but ESG reporting under the ESG Guide is broader in scope, covering wider environmental and social areas, and is not focused only on material risk and opportunities posed by climate change. The HKEx launched e-training and guidance material for ESG reporting on 6 March 2020.[19]

In April 2019, the Hong Kong Securities and Futures Commission (SFC) issued the "Circular to management companies of SFC-authorized unit trusts and mutual funds - Green or ESG funds"[20] (Circular). Prior to the issue of the Circular, the SFC had found that the quality of disclosure by funds with investment focuses on climate, green, environmental, or sustainable development varied widely. A principal aim of the Circular was to mandate enhanced disclosure requirements for SFC authorized green or ESG funds. Under the Circular, the SFC requires a fund to demonstrate its green or ESG-related investment focus, apply globally recognized green or ESG criteria or principles, and comply with minimum disclosure requirements to enable investors to make an informed judgment of the investment in the green or ESG fund. The manager of the green or ESG fund is also required to regularly monitor and evaluate the underlying investments to ensure the green or ESG fund continues to meet the stated green or ESG investment objective and requirements of the Circular. The SFC maintains a list of green and ESG funds authorized in accordance with the requirements.[21]

In May 2019, the Hong Kong Monetary Authority (HKMA) announced a three-phased approach to promote green and sustainable banking with the objectives of building climate resilience within the banking system and of raising banks' awareness of climate change.[22] This approach involves (1) developing a common framework to assess the greenness baseline of individual banks, along with providing technical support to banks; (2) engaging the industry and other relevant stakeholders in consultation with respect to the supervisory expectations or requirements in this area; and (3) implementing, monitoring, and evaluating banks' progress toward identified goals. In May 2020, the HKMA and the SFC joined hands for the first time for a common cause in establishing the Green and Sustainable Finance Cross-Agency Steering Group,[23] which aims to coordinate the management of climate and environmental risks to the financial sector, accelerate the growth of green and sustainable finance in Hong Kong, and support the government's climate strategies.[24]

Singapore

In February 2021, Singapore unveiled the Singapore Green Plan 2030, a "whole-of-nation movement to advance Singapore's national agenda on sustainable development" (the Green Plan).[25] The Green Plan lays out climate change targets for the next 10 years, strengthening Paris Agreement commitments and positioning the country to achieve long-term net zero emission aspirations as soon as viable. One of the Green Plan's key targets is for Singapore to be a leading center for green finance in Asia and globally, facilitating Asia's transition to a low-carbon and sustainable future. To further this objective, the Monetary Authority of Singapore (MAS) has released guidelines on environmental risk management for financial institutions and the Green Finance Industry Taskforce, an industry-led initiative convened by the MAS, has issued a consultation paper on the Singapore taxonomy, a white paper for green finance solutions and a framework for green trade finance and working capital. In addition, the Green and Sustainability-Linked Loan Grant Scheme, launched by the MAS on 24 November 2020, is intended to enhance the accessibility of green financing for corporates by defraying the expenses of independent service providers to validate corporate green and sustainability credentials. These efforts are supported by the Singapore Green Finance Centre, which was launched on 13 October 2020 by the Imperial College Business School and Lee Kong Chian School of Business at Singapore Management University. Supported by the MAS and nine founding partners from the financial services industry, this is Singapore's first research institute dedicated to green finance research and talent development.

In June 2016, the Singapore Exchange (SGX) made it mandatory for all listed companies to submit annual reports, on a "comply or explain" basis, about their ESG and sustainability practices. Under Listing Rule 711B, this sustainability report must provide information about five primary components: (1) material ESG factors; (2) policies, practices, and performance; (3) targets; (4) sustainability reporting framework; and (5) board statement.[26] If the issuer cannot provide a satisfactory report on any of the enumerated components, the issuer must disclose its failure to make such a report and explain its deviations from the reporting standards and its reasons for such deviations. Also in 2016, the SGX announced the launch of SGX Sustainability Indices, a suite of equity indices comprised of SGX-listed companies that are considered clear frontrunners in ESG and sustainability standards when compared to their peers, which companies must meet minimum liquidity requirements to qualify for inclusion.[27] More recently, in the Singapore Budget 2021, the Singapore government announced approximately US$14 billion in green bonds (in equivalent Singapore dollars) adding to the US$3.5 billion in green bonds issued in Singapore in 2020, carrying the label of 'ASEAN Green Bond' or otherwise aligned with the Association of Southeast Asian Nations (ASEAN) Green Bond Standards.[28]

China

In China, the concept of ESG investment has gradually emerged alongside the development of the concept of "green finance." This concept of green finance initially gained traction in 2016 with the creation and implementation of the Guidelines for Establishing the Green Financial System, which were jointly issued by the People's Bank of China and other ministries. These guidelines sought to "encourage long-term capital such as pension funds and insurance capital to implement green investment and encourage investors to publish green investment responsibility reports." Subsequently, in the fall of 2018, a series of incentives and supporting measures were introduced, creating a more favorable policy environment for ESG investment. These measures include: (1) revision by the China Securities Regulatory Commission of the Code of Corporate Governance for Listed Companies and subsequent establishment of an ESG disclosure framework; (2) development and publishing by the Shanghai Stock Exchange of the Principles for Sustainable Exchanges, which proposes guidelines for disclosure of ESG matters for its member exchanges; and (3) release by the Asset Management Association of China of the Guidelines for Green Investment (for trial implementation) to guide and standardize the green investment activities of securities investment funds.[29] As a result of such groundwork, a variety of sustainable and ESG-related index products covering both stocks and bond assets have emerged, providing rich investment options in the market. However, despite such progress, there continues to be a consensus view that the average scope and quality of ESG disclosures reported by Chinese Securities Index 300 companies lags behind constituents of other major global equity indices in Australia, Hong Kong, Japan, Korea, and the United States.[30] Few mainland Chinese companies have streamlined or automated data collection procedures in place, so their manual workaround processes are time-consuming and can lead to poor quality data output.

Australia

There are three main investment areas in Australia in which ESG factors are considered.

Superannuation Funds

Australia's compulsory retirement savings systems place a large pool of assets (approximately US$2.1 trillion as at the end of the June 2020 quarter) in the hands of Australian superannuation funds. Superannuation funds are, for the most part, regulated by the Australian Prudential Regulatory Authority (APRA), which provides guidance to superannuation funds in the form of its prudential standards. APRA standards require superannuation funds to consider the risk and the likely return from investments, diversification, liquidity, valuation, and other relevant factors. An entity may also take into account additional ESG factors to allow them to offer an "ethical" investment option; however, this area has not been well developed in Australia to date. APRA has indicated that it may make changes to its approach to managing the financial risks of various ESG factors, but these changes have not yet been implemented.

Superannuation funds are estimated to hold approximately 60% of the local stock exchange within 20 years. While superannuation funds have not traditionally played the role of an activist shareholder, they are increasingly imposing minimum governance expectations on the companies in which they invest. Further, the vast majority of superannuation funds have made commitments towards some form of responsible investing.

Fund Managers

The requirements for fund managers are much less prescriptive. The regulatory body for the funds management industry, the Australian Securities and Investments Commission (ASIC), acts primarily as a conduct regulator. For the most part, ESG issues in this context arise simply as a matter of disclosure. ASIC requires managers to give clients a Product Disclosure Statement (PDS). In this PDS, the manager must disclose the extent to which labor standards or environmental, social, or ethical considerations are taken into account in selecting, retaining, or realizing an investment. ASIC has published Regulatory Guide 65 to provide guidance in this area. A PDS must state whether labor standards or environmental, social, or ethical considerations are taken into account in selecting, retaining, and realizing an investment and, if so, how and to what extent they are taken into account. The PDS must set forth information sufficient to allow the reader to understand those standards or considerations employed. At a minimum, a client should be given general information about what issues the manager takes into account in making investment decisions.

Listed Company Disclosures

While the regulatory landscape for institutional investors is somewhat permissive, listed companies are required to make fairly extensive disclosures to enable investors who wish to do so to make ethically motivated investment decisions. The Australian Stock Exchange (ASX) Corporate Governance Council develops recommendations to be adopted by ASX listed entities. One of these recommendations requires a listed entity to disclose whether it has any material exposure to economic, environmental, and social sustainability risks and, if it does, how it manages or intends to manage those risks. Further, ASIC expects companies in affected industries to make specific disclosures in relation to climate change risks.

ENDNOTES AND ADDITIONAL RESOURCES

ENDNOTES

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[11] Art. 4 SFDR.

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GLOSSARY

Acronym	Description
ACNC	Australian Charities and Not for Profits Commission
AIFMD	Alternative Investment Fund Managers Directive
APRA	Australian Prudential Regulatory Authority
ASEAN	Association of Southeast Asian Nations
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
CDP	Carbon Disclosure Project
CDSB	Climate Disclosure Standards Board
DGR	Deductible Gift Recipient
DOL	U.S. Department of Labor
ERISA	Employee Retirement Income Security Act of 1974
ESMA	European Securities and Markets Authority
GRI	Global Reporting Initiative, a Dutch nonngovernmental organization
HKEx	Hong Kong Exchanges and Clearing Limited
HKMA	Hong Kong Monetary Authority
IBC	International Business Council
IIRC	International Integrated Reporting Council
<IR> Framework	International Integrated Reporting Framework
MAS	Monetary Authority of Singapore
MiFID II	Markets in Financial Instruments Directive
PAF	Private Ancillary Fund
PDS	Product Disclosure Statement
PRI	Program-Related Investment (may also refer to the Principles for Responsible Investment)
SASB	Sustainability Accounting Standards Board
SCM	Stakeholder Capitalism Metrics
SEC	United States Securities and Exchange Commission
SFC	Hong Kong Securities and Futures Commission
SFDR	European Union Sustainable Finance Disclosure Regulation (Regulation 2019/2088/EU)
SGX	Singapore Exchange
TCFD	Task Force on Climate-Related Disclosures
TEG	Technical Expert Group on Sustainable Finance
UCITS	Undertakings for the Collective Investment in Transferable Securities

EDITORS AND AUTHORS

EDITOR

Elisabeth Yandell McNeil
Partner
+1.206.370.7824
elisabeth.mcneil@klgates.com

AUTHORS

Rebecca Bolton
Special Counsel
+61.3.9640.4285
rebecca.bolton@klgates.com

Cordelia Glenn Grabiak
Partner
+1.412.355.6701
cordelia.glenn@klgates.com

Ndenisarya Bregasi
Partner, Practice Area Leader
+1.202.778.9021
ndenisarya.bregasi@klgates.com

Kenneth Holston
Partner
+1.617.261.3154
kenneth.holston@klgates.com

Jon-Luc Dupuy
Partner
+1.617.261.3146
jon-luc.dupuy@klgates.com

Daniel Knight
Partner
+61.3.9640.4324
daniel.knight@klgates.com

EDITORS AND AUTHORS

AUTHORS

Hilger von Livonius

Partner

+49.(0)89.321.215.330

hilger.livonius@klgates.com

Margaret Niles

Partner

+1.206.370.8358

margaret.niles@klgates.com

Pablo J. Man

Partner

+1.617.951.9209

pablo.man@klgates.com

Clair Pagnano

Partner

+1.617.261.3246

clair.pagnano@klgates.com

Michelle Moran

Partner

+44.(0)20.7360.8255

michelle.moran@klgates.com

Scott Peterman

Partner

+852.2230.3598

scott.peterman@klgates.com

AUTHORS

Charles Purcell

Partner

+1.206.370.8369

charles.purcell@klgates.com

Christopher Tung

Partner

+852.2230.3511

christopher.tung@klgates.com

Marius Toime*

Partner

+65.6507.8117

marius.toime@klgates.com

Kristina Zanotti

Partner

+1.202.778.9171

kristina.zanotti@klgates.com

*Marius Toime is located in our Singapore office and affiliated with K&L Gates Straits Law.

K&L Gates is a fully integrated global law firm with lawyers and policy professionals located across five continents. For more information about K&L Gates or its locations, practices, and registrations, visit klgates.com.

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