European Leveraged Finance Association

LMA Loan Market Association

Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions

ELFA and LMA joint publication under the ESG Disclosure Initiative

Background on the ELFA's ESG Disclosure Initiative

Environmental, social and governance (ESG) factors have quickly grown to be a critical part of credit analysis in European leveraged finance. Despite the increasing focus on ESG, efforts have been fragmented as the market lacks consensus on the type of ESG disclosure that is necessary.

The European Leveraged Finance Association (ELFA) launched its ESG Disclosure Initiative in June 2019 with a goal to increase ESG disclosure by borrowers and reduce the reliance by investors on individual ESG questionnaires. Together with the Principles for Responsible Investment (PRI), we hosted a series of workshops beginning in September 2020 with sub-investment grade borrowers, credit analysts, and credit rating agencies to foster a dialogue about what ESG information investors would like companies to disclose, to build consensus and support efficiency.

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

The ESG Fact Sheets published in January 2021 are the culmination of the first stage of the ESG Disclosure Initiative. The resources are designed to guide the market to a consistent level of disclosure on a sector-level basis, and the first three sectors covered in the series are debt repurchasers, paper and packaging, and telecoms. A General ESG Fact Sheet is also available to serve as a sector-agnostic tool for the market.

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

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

We intend to publish additional ESG Fact Sheets covering the chemicals, healthcare, industrials, retail/consumer, software/technology, and towers/infrastructure sectors over the coming months, and welcome suggestions from market participants on other industries to include in the initiative. Please send any comments here.

Introduction to this Guide

This Guide for Company Advisers on ESG Disclosure in Leveraged Finance Transactions (the "Guide") reflects the ideas, experience, and input of over a hundred professionals in the European leveraged finance market. Drafted by a group of senior law firm partners and bankers (the "Working Group"), the main points covered in the Guide were discussed during our November workshop and this final version incorporates the valuable feedback received during the event.

The Guide is designed to serve a practical tool for company advisers to use in support of their incorporation of the information contained in the ESG Fact Sheets into company offering materials and ongoing financial reports. In Chapter 1, we describe why there is such an urgent need for increased disclosure on ESG topics from the perspective of credit investors. Chapter 2 outlines the current regulatory landscape and highlights the potential impact of these regulations on borrowers.

Market practice in this area is at a very early stage, and after some deliberation the Working Group decided that the best way to increase adoption of ESG disclosure was to leverage the existing tools and processes already in place. As such, Chapter 3 describes how the ESG Fact Sheets can be incorporated into due diligence procedures and Chapter 4 sets out an ESG roadmap for disclosure in the offering memorandum.

Chapter 5 starts a discussion about how ESG can be reflected in contractual provisions. There is great potential for huge shifts in this area in particular, with ESG-linked margins increasing and, in a recent loan deal, sustainability arrangers joining the roster of banks. We expect this chapter's contents to expand and evolve significantly over the coming years as banks work with their clients to devise creative and innovative ways to leverage investors' increasing focus on ESG and sustainability.

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

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

Akin Gump STRAUSS HAUER & FELD | Hogan Lovells | MORRISON FOERSTER | McGUIREWOODS

CMS Law.Tax | THE DEAL TEAM | 大成 DENTONS | Linklaters | McDermott Will & Emery

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

Introduction

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

As the number of investors focused on ESG topics has increased, so has the number of questionnaires that borrowers receive. According to one bank that the ELFA spoke to, at the beginning of 2019 they would only receive one or two questionnaires from investors on every other deal, but by the end of the year deal teams were receiving more than a dozen on every deal, across both high yield bonds and leveraged loans.

Borrowers and their advisers have questioned the need for these questionnaires. Further, some of the questions are driven by regulatory requirements that management may not be aware of, and as such cause confusion as they appear unrelated to the company's business. There is also substantial overlap in questions, resulting in inefficiencies when deal teams nonetheless are asked to reply to individual questionnaires. Borrowers report to us that they are willing to make ESG disclosures, but that they would like more direction from investors on what, where and when to disclose the information. Understandably, borrowers seek justification for the time spent answering ESG questionnaires from investors. As such, continued engagement with companies and their advisers will help to explain investors' various approaches to ESG integration as well as the drivers behind investors' need for more ESG data. We will continue our work in this area.

In this chapter, we explore the main drivers behind investors' need for more ESG disclosure from borrowers. First, there is mounting evidence that ESG analysis is additive to the investment process. Second, regulatory requirements continue to emerge that oblige asset managers (and borrowers) to disclose how they are managing the financial risks relating to sustainability. Finally, asset managers are reporting ever increasing demand by their end investors to prove that they incorporate ESG considerations into investment products and processes.

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

To further this goal, we have worked with the Principles for Responsible Investment (PRI) to create tools to support engagement between sub-investment grade corporate borrowers and investors on ESG matters. By promoting consistent minimum levels of ESG disclosure at the sector level and formalising the inclusion of ESG information in offering documentation and periodic reporting, we believe that engagement on these important topics will become more efficient and effective.

1. ESG Integration is Additive to the Investment Process

The link between financially material ESG considerations and returns is becoming clearer. This has been confirmed by myriad sources, including a comprehensive study carried out in 2015.[1] The study found a positive correlation between ESG and corporate financial performance, and concluded that "the business

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

case for ESG investing is empirically very well founded". In addition, a study from Axioma showed that "in general, increasing exposure to ESG rarely underperforms the market, and often outperforms the market, especially during the last few years".[2]

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

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

In this context, it is important to understand ESG risks through the lens of materiality. The Financial Accounting Standards Board defines materiality as: "Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker"[2], and the Sustainability Accounting Standards Board considers financial material issues as "… those issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors".[4] Companies, together with their advisers, ultimately decide what is financially material and should therefore be disclosed, taking into account legal requirements and the views of their key stakeholders.

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

2. Growing Regulatory Requirements from Governments and Regulators

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

Four key legislative initiatives are of particular relevance to asset managers, some of which are responsible for the increase in investor information requests to borrowers, as this category of ESG information is necessary for them to meet applicable requirements for inclusion in portfolios.[5] Whilst it is a voluntary framework, regulators and policy makers are also reviewing mandatory Taskforce on Climate-related Financial Disclosures (TCFD) reporting for listed companies as well as certain financial institutions. The TCFD is described in more detail in Chapter 2 of this Guide, "Regulatory Considerations for Borrowers".

[2] Thompson J., (2018). 'Companies with strong ESG scores outperform, study finds'. Financial Times, [Accessed: 28 October 2020]
[3] https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176171111614&acceptedDisclaimer=true
[4] https://www.sasb.org/standards-overview/materiality-map/
[5] Some investors will also fall within scope of regulations applicable to corporates, such as the European Non-Financial Reporting Directive (NFRD), described in Chapter 2.

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

Regulation	Summary
Sustainable Finance Disclosure Regulation (SFDR) [6]	**In brief** • New disclosure obligations on how asset managers integrate ESG factors into their risk processes designed to make it easier for end-investors to make informed investment decisions • Disclosure obligations include the publication by a firm of written policies on the integration of sustainability risks in investment decision making process, as well as explicit pre-contractual disclosures. • Although framed as rules about disclosures, there are significant business and policy decisions which firms will need to make in terms of how sustainability impacts on their investment processes. • Relevant to all in-scope asset managers • Passed into law on 9 December 2019 and applicable from 10 March 2021 **Potential investor impacts** • Will have meaningful impact although application is not immediate • While the "comply or explain" logic inherent in some of the key disclosure obligations is helpful, managers will be conscious of reputational risks so will seek to ensure appropriately that they incorporate sustainability risks into their investment policies to avoid the perception of inadequate risk management. • The need to make decisions about how they manage sustainability risks in their investments could lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed. **Potential borrower impacts** • Investors will need company ESG data in order to be able to quantify sustainability risks and evaluate the extent to which they represent investment material risks as well as adverse sustainability risks to society.
Framework (or Taxonomy) Regulation [7]	**In brief** • Creates a new common taxonomy to be used in determining the degree to which an economic activity can be described as being "environmentally sustainable" • Enables asset managers and investors to demonstrate how environmentally sustainable a given investment and/or portfolio is • Applies only to asset managers making available financial products with either an explicit objective of environmentally sustainable investment or which explicitly promote environmental characteristics • All managers will at least need to make a negative disclosure to confirm that all out-of-scope financial products are indeed out of scope. • Passed into law and applicable from late 2021 / early 2022 **Potential investor impacts** • The scrutiny on portfolio taxonomy alignment could potentially amplify investor interest in and demand for such products. • Whilst technically not all managers will need to disclose the alignment of their investments / portfolios to the taxonomy, in practice it is likely that their clients will want to understand how their investment / portfolio stands in terms of alignment with the taxonomy. **Potential borrower impacts** • Investors will need company data on the extent to which their economic activities are within scope of the taxonomy, and if so, the revenue / capex / opex spend in order to determine whether this qualifies as a "significant contribution", as well as to understand whether the business has operated responsibly in terms of not doing significant harm, and ensuring minimum social safeguards.

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

[7] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

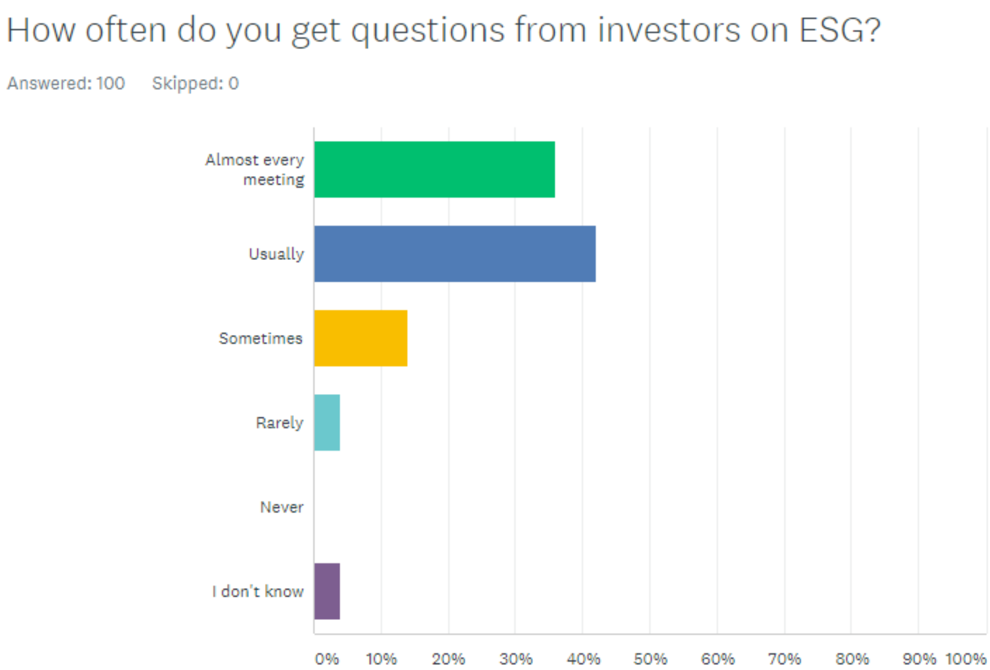
Regulation	Summary
Suitability Delegated Regulation[8]	**In brief** • This would amend the MiFID 2 Delegate Regulation to clarify that ESG considerations and preferences should be taken into account in the investment and advisory process as part of an investment firm's duties towards its clients when performing the 'suitability' assessment for portfolio management and investment advices. • Yet to be passed into law. Public Consultation expired 6 July 2020, under consideration by the Council of the EU and the European Parliament **Potential investor impacts** • Potentially amplifies investor interest in and demand for products that integrate ESG factors, leading asset managers to increase availability of such products. However, the drafting makes clear that the rules apply "where relevant", whilst acknowledging that a client might not have explicit ESG preferences. **Potential borrower impacts** • The absence of ESG disclosure by borrowers could be perceived as indicative of weak ESG practices, reducing the likelihood that debt of these companies will be included in such products.
Integration of sustainability into a firm's systems and controls	**In brief** • Additional Level 2 delegated acts would make amendments to the existing Level 2 measures under the UCITS Directive[9] and AIFMD [10]and MiFID 2[11] respectively, to ensure that sustainability risks and sustainability factors are integrated within a manager's organisational, operating and risk management processes. • Yet to be passed into law. Public Consultation expired 6 July 2020, under consideration by the Council of the EU and the European Parliament **Potential investor impacts** • The explicit references to sustainability risk will inevitably lead to greater scrutiny by firms and investors of such risks, particularly given the obligations placed on senior management. • The need to make decisions on how they manage sustainability risks in their investments could lead some asset managers to adopt investment restrictions on certain borrowers based on the ESG profile of their economic activities and how well these are being managed. **Potential borrower impacts** • Investors will need company ESG data in order to be able to quantify sustainability risks and evaluate the extent to which they represent investment material risks.

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

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

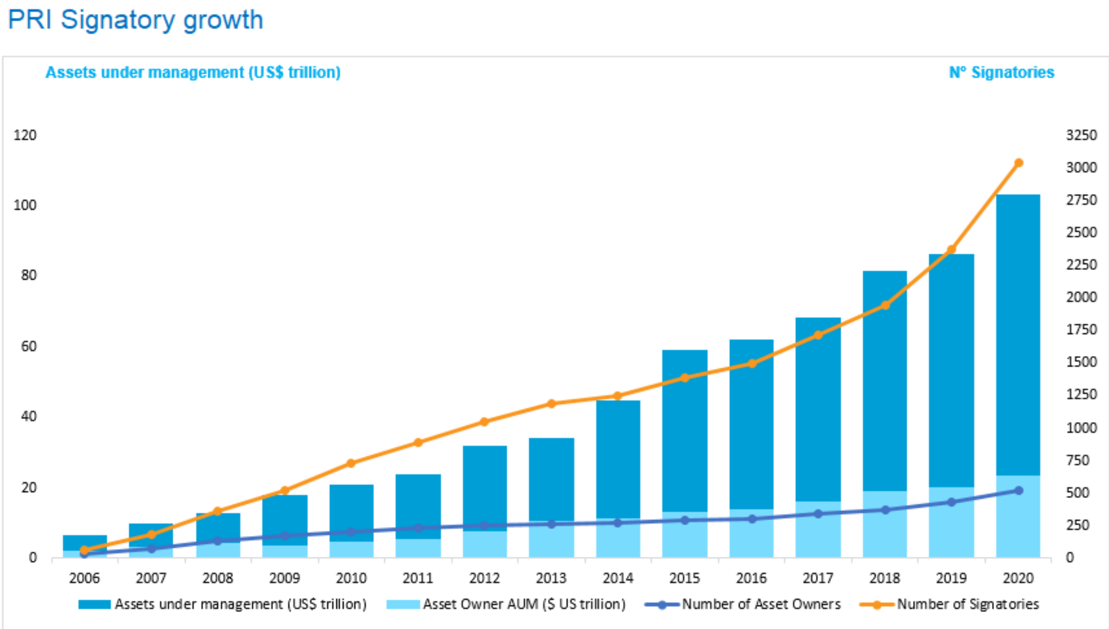
As their end clients increasingly seek more granular detail on ESG topics, like a portfolio's overall carbon footprint, investors will need to receive this data from companies. According to our ESG Investor Survey conducted in November 2019, through which 100 investors submitted their views on ESG investing, almost 90% reported fielding questions from their end-investors on ESG "usually" or "at almost every meeting".

[8]MiFID2: draft delegated directive, to amend the MiFID Commission Delegated Directive ((EU) 2017/593) as regards the integration of sustainability factors and preferences into the product governance obligations.
[9]UCITS: draft delegated directive, to amend the UCITS Commission Directive (2010/43/EU) as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS).
[10]AIFMD: draft delegated regulation, to amend the AIFMD Delegated Regulation ((EU) 231/2013) as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers.
[11]MiFID2: draft delegated regulation, to amend the MiFID Commission Delegated Regulation ((EU) 2017/565) as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.



Further, to the extent that companies provide this information, investors can screen-in those with comprehensive disclosure as they will be equipped to conduct holistic fundamental and non-fundamental work. In addition, as investors increasingly seek to "green-up" their portfolios, they will look to invest in companies that provide the relevant disclosure necessary to further this objective.

The rising growth and popularity of ESG investing is well illustrated by the increasing number of signatories to the PRI, established in 2005 and supported by the United Nations. To date, over 3,000 investment organisations, representing over US$103 trillion, have signed up to the PRI.



Source: PRI, April 2020

According to Morningstar data, investors continued to pour in capital in sustainable funds during 2020, as Q2 saw record fund inflows, despite the ongoing pandemic[12]. Assets in European sustainable funds rose a remarkable 20% in Q2 to €774 billion, compared with an increase of just 11% for the overall European fund universe. This data suggests that the COVID-19 crisis has further reinforced the importance of building sustainable and resilient business models.

[12] https://www.morningstar.co.uk/uk/news/204525/sustainable-fund-flows-hit-record-in-q2.aspx

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

Investors broadly agree that the best place for ESG data disclosure is in company offering materials, including as part of dedicated ESG slides in the roadshow presentation. In the first instance, this is viewed as a more effective approach than management answering multiple unique investor questionnaires.

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

- **Investor confidence:** Leveraging off an existing, established process and that all parties are familiar with and trust will provide investors with confidence that the ESG information has undergone an adequate level of due diligence
- **Timely information:** Investors would have access to the information when they need it, with data refreshed during the new deal process, which is a typical trigger for investor ESG requests. The current timing of investor requests is challenging for banks to manage, and market participants report that it would be better for this process to be frontloaded so that ESG information can be incorporated into the due diligence process
- **Mechanism for updates:** Periodic reporting cycles provide a mechanism for the information to be refreshed
- **Market consensus:** Reaching consensus on the scope of a core set of ESG disclosure topics and associated metrics by way of our ESG Fact Sheets provides the market with a minimum basis for ESG disclosure, facilitating a level of standardisation within the industry
- **Consistency amongst borrowers:** Disclosure in offering materials and periodic reports provides a common reference point for ESG disclosure and creates a level playing field for all borrowers in the market. It also provides a foundation to build additional proactive, public ESG communication such as on a corporate website and/or stand-alone ESG reporting
- **Avoiding selective disclosure:** If companies are reporting directly to investors without seeking advice from counsel, there is a risk they may inadvertently disclose material information to some investors, but not others, potentially giving rise to liability

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

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

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

By providing the market with a foundation for a minimum level of sector-focused information, we believe that the quality of engagement between investors and borrowers on ESG topics will improve significantly. Indeed, we hope that the dialogue will move beyond basic facts to more business-relevant ESG subject matter, positioning borrowers to better engage with investors and reap the opportunities that a more progressive ESG approach can bring.

Chapter 2

Regulatory Considerations for Borrowers

Introduction

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

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

1. Taskforce on Climate-related Financial Disclosures (TCFD)

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

The Recommendations: In June 2017, the TCFD released its recommendations for consistent, climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers and other stakeholders. The recommendations are based around four thematic areas that represent core elements of how organisations are organised: governance, strategy, risk management, and metrics and targets. These recommendations are supported by specific disclosures that organisations should include in financial filings or other reports in order to provide decision-useful information to investors and others. The recommendations can be found at: https://www.fsb-tcfd.org/.

Support: The TCFD recommendations have been strongly supported and endorsed by a wide range of national and international regulators and policymakers, and form the basis of many national and international initiatives emerging in this space. As of June 2019, more than 780 organisations had expressed their support for the TCFD's recommendations.

2. European Non-Financial Reporting Directive (Directive 2014/95/EU)

Background: The Non-Financial Reporting Directive (NFRD) came into effect in 2018 and requires large Public Interest Entities with more than 500 employees to include a non-financial statement as part of their annual public reporting obligations. In its Communication on the European Green Deal, the European Commission committed to review the NFRD as part of the strategy to strengthen the foundations for sustainable investment, launching a public consultation in February 2020. The Commission expects to adopt a proposal regarding the NFRD in the first quarter of 2021.

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

3. The EU Taxonomy Regulation[13]

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

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

The six environmental objectives defined in the Taxonomy are:
1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use and protection of water and marine resources
4. Transition to a circular economy
5. Pollution prevention and control
6. Protection and restoration of biodiversity and ecosystems

The European Commission will develop delegated acts containing technical screening criteria to further specify elements of the Taxonomy Regulation. The technical screening criteria for activities substantially contributing to climate change mitigation and climate change adaptation were intended to be established by the end of 2020, (now expected in the first quarter 2021), for application by the end of 2021. The technical screening criteria for the remaining four environmental objectives are intended to be established by the end of 2021 and to apply by the end of 2022.

The Taxonomy Regulation has also introduced new disclosure requirements for financial market participants offering financial products in Europe and for companies subject to disclosure requirements under the NFRD.

Application: The Taxonomy will apply to individual Member States, companies and firms within the scope of the NFRD and financial market participants. Financial market participants will be required to complete the first round of disclosures covering activities that substantially contribute to climate change mitigation and/or adaptation by 31 December 2021. Companies will be required to disclose in the course of 2022. By 1 June 2021, the European Commission is expected to adopt a delegated act specifying how the corporate disclosure obligations should be applied in practice.

4. Principles for Responsible Investment (PRI)[14]

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

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

[13] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities
[14] https://www.unpri.org/download?ac=10948

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

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

Support: To date, over 3,000 investment organisations, representing over US$103 trillion, have signed up to the PRI.

5. ESG Investor Associations, Standards and Codes

Investment managers and investors have committed to a range of voluntary associations and networks in the field of ESG, corporate governance, climate change, and related issues. Below is a non-exhaustive list of some key international examples in each of these fields.[15]

Responsible and sustainable investment[16]	**(SBP) Corporate governance, accounting and disclosure**
• UN Global Compact (UNGC) • EuroSIF, UKSIF, USSIF, SIF Japan, ASrIA, RIA Canada, RIA Australasia, etc. • Global Sustainable Investment Alliance (GSIA) • The Equator Principles • International Capital Market Association (ICMA) Green Bond Principles (GBP) and Social Bond Principles	• International Corporate Governance Network (ICGN) • Global Reporting Initiative (GRI); • Global Sustainability Standards Board (GSSB) • Sustainability Accounting Standards Board (SASB) • The FSB Task Force on Climate-related Financial Disclosures (TCFD)
Green and climate change investment Associations	**Initiatives**
• Institutional Investors Group on Climate Change (IIGCC) • Investor Group on Climate Change (IGCC) • Asia Investor Group on Climate Change (AIGCC) • GIC global platform • Ceres	• Carbon Disclosure Project (CDP) • Asset Owners Disclosure Project (AODP) • Montreal Carbon Pledge • Portfolio Decarbonization Coalition • Action 100+
Impact investing	
• Global Impact Investing Network (GIIN)	

[15] Inderst, G. and Stewart, F., (2018). Incorporating Environmental, Social and Governance (ESG) Factors into Fixed Income Investment. World Bank Group Publication.

[16] Following the releases of this chart in a World Bank Group publication, the following additional association standards have been produced: Asia-Pacific Loan Market Association (APLMA), Loan Market Association (LMA) and Loan Syndications and Trading Association's (LSTA) Green Loan Principles (GLP) and Sustainability-Linked Loan Principles (SLLP); ICMA Sustainability-Linked Bond Principles (SLBP) and Climate Transition Finance Handbook; and AFME Recommended ESG Disclosure and Diligence Practices for the European High Yield Market.

Chapter 3

Diligence Practices

Introduction

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

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

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

Thus, bond investors do not directly participate in the diligence process and, as a result, do not have access to the documentary and oral diligence conducted by investment banks. Therefore, the challenge for companies seeking to address investors' increasing focus on ESG is to translate ESG diligence into readily accessible disclosure.

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

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

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

1. Legal Requirements

ESG diligence for leveraged finance transactions will be driven by two key factors, which are explored in the first two chapters of this Guide. First, investors are increasingly focused on a company's ESG risks, policies and disclosure when making investment decisions.[17] Second, there is a growing number of regulations addressing ESG policies and disclosure requirements.[18]

Of course, companies falling under the scope of regulations giving rise to an ESG disclosure framework will be obliged to comply with applicable requirements, and diligence will be crafted accordingly. In some cases, such regulations will dovetail with investor expectations and internal compliance requirements. In circumstance where there is a gap between regulatory requirements and investor expectations, companies may find that they have to address a more robust investor-based ESG disclosure standard when carrying out ESG diligence.

The importance of non-financial disclosure is reflected in global reporting frameworks (including the International Integrated Reporting Framework, Global Reporting Initiative and Sustainability Accounting Standards). In the UK, the Taskforce for Climate Related Financial Disclosure (TCFD) has published recommendations for disclosing clear, comparable and consistent information about the risks and opportunities presented by climate change. In the EU, the European Commission is currently reviewing the Non-Financial Reporting Directive (NFRD), with a view to improving disclosure of climate and environmental data by companies, to better inform investors about the sustainability of their investments, while giving effect to changes required by the new Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation. For a detailed discussion of the key legal and regulatory points impacting ESG diligence and reporting by borrowers, see Chapters 1 and 2 of this Guide entitled "Why Leveraged Finance Investors Need More Disclosure on ESG Topics" and "Regulatory Considerations for Borrowers".

2. Materiality and Thresholds

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

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

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

It is a well-recognised principle in Rule 144A/Reg S high yield bond offerings that companies have a duty to disclose all information a "reasonable investor" would consider material to its decision whether or not to invest in a business. This is the founding bedrock of securities laws in many jurisdictions including the US, the European Union, the United Kingdom, Hong Kong and Singapore. This principle requires a company to ensure that disclosure made to investors does not contain an untrue statement of a material fact, or omit to state a material fact necessary in order to ensure such disclosure is not misleading. In many jurisdictions, these principles are also reflected in on-going disclosure obligations placed on issuers of public debt, where such obligations are typically linked to the price-sensitivity of information relating to the issuer and its business, as it affects that public debt.

[17] Please see our discussion in Chapter 1 of this Guide entitled "Why Leveraged Finance Investors Need More Disclosure on ESG Topics".

[18] Please see our discussion in Chapter 2 of this Guide entitled "Regulatory Considerations for Borrowers".

As a general rule, materiality of ESG-related factors should be reviewed consistently with the methods used by companies in determining whether other information relating to their business more generally is "material". Such an approach has been endorsed by certain market stakeholders, including SASB, which identifies financially material issues as "the issues that are reasonably likely to impact the financial condition or operating performance of a company and therefore are most important to investors."[19]

It should be noted, however, that other institutions and stakeholders focused on ESG have adopted contrasting materiality principles compared to the traditional position on materiality. For example, the EU's NFRD adopts a "double materiality" principle for matters relating to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters that requires companies to disclose information "to the extent necessary for an understanding of the development, performance, position and impact of [the company's] activities"[20]. Thus, a company is required to assess and disclose financial materiality (e.g., how climate change impacts a company's financial position) as well as environmental and social materiality (e.g., how a company impacts the climate).

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

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

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

b. Qualitative or Quantitative?

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

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

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

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

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

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

c. Future Impact

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

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

d. Impact on Reputation

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

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

e. Differences Between Sectors, Company Size and Location

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

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

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

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

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

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

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

3. Stakeholder Due Diligence

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

a. Management Diligence and Documentary Request Lists

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

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

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

It is likely that ESG-related questioning will arise in the following areas:

- Environment
- Health and safety
- Employment policies
- Corporate governance
- Product quality and supply chain management
- Customer relations
- IT security and data privacy
- Community engagement

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

b. Third-Party Diligence

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

4. Factors to Consider in Developing Diligence Questions

As discussed above, the importance of certain ESG factors will differ depending upon the sector and nature of a company's business, and therefore the scope of diligence to be undertaken will vary accordingly. The ESG Fact Sheets are designed to be a useful starting point in developing due diligence questions. Companies and investors alike should also consider reviewing the SASB's Materiality Map[21], an interactive tool which sets out the materiality of various ESG factors across different industries. This is a useful tool in determining which areas to focus upon during the diligence process, depending upon the sector.

As markets continue to increase their focus on ESG factors, there is likely to be heightened scrutiny on ESG-related policies of issuers in certain "brown" industry sectors, such as those known for high carbon emissions and other climate-related risks. Stakeholders will be keen to see evidence of steps being taken in these industries to reduce negative environmental impact and increase long-term sustainability.

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

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

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

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

Chapter 4

Drafting Considerations and ESG Roadmap

Introduction

The focus of this chapter is to provide a roadmap for incorporation of ESG-related disclosure into offering materials in Rule 144A/Reg S bond offerings. The inclusion of ESG disclosure will be driven by the following factors: (1) regulatory requirements[22]; (2) materiality[23]; and (3) voluntary disclosure of non-material information. In particular, ESG disclosure will primarily focus on the need to mitigate the risks associated with failing to meet the "reasonable investor" disclosure standard (as described in Chapter 3 of this Guide entitled "Diligence Practices"). A well-articulated and comprehensively disclosed approach to ESG might also create opportunities to widen a company's access to capital. When addressing the increasing demand for ESG information, companies should leverage existing disclosure market practice, incorporating relevant ESG-related information into offering materials where appropriate.

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

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

1. Relevant Regulatory Considerations

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

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

High yield bond issues in Europe will need to have regard in particular to the EU's Sustainable Finance Disclosure Regulation (SFDR)[24], which lays down particularly strict rules in relation to financial products that promote environmental or social characteristics, or products that have a sustainable investment as their objective. While the SFDR does not directly apply to high yield debt issuances, it may have an indirect impact. As a rising tide lifts all boats, the SFDR, along with continued investor demand, will no doubt accelerate the incorporation of ESG disclosure in the high yield market.

For further discussions on materiality, the US securities law liabilities regime and other applicable regulations, please see Chapters 2 and 3 of this Guide "Regulatory Considerations for Borrowers" and "Diligence Practices – Legal Requirements and – Materiality and Thresholds".

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

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

[24] Please see our discussion in Chapter 1 of this Guide entitled "Why Leveraged Finance Investors Need More Disclosure on ESG Topics".

2. ESG Disclosure in the Offering Memorandum

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

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

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

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

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

a. Business

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

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

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

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

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

b. Risk Factors

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

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

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

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

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

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

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

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

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

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

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

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

d. Management

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

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

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

e. Principle Shareholders

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

f. Related Party Transactions

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

g. Financial Statements

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

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

3. ESG Data Metrics and Comparability

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

a. Data Metrics

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

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

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

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

b. ESG KPIs

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

A number of public and private institutions have opined on the identification and reporting of ESG KPIs. For example, the European Commission's Guidelines on reporting climate-related information set out six key principles for effective ESG reporting.[25] KPIs should be: (i) material; (ii), fair; balanced and understandable; (iii) comprehensive but concise; (iv) strategic and forward-looking; (v) stakeholder orientated; and (vi) consistent and coherent. The Guidelines recommend using KPIs that are easily comparable between peers, and setting them out alongside disclosures which support and provide background for their use.

Additionally, the GRI Sustainability Reporting Standards, issued by the Global Reporting Initiative in May 2020, also highlight the importance of accuracy, reliability, clarity and ease of comparability in ESG reporting, and note that disclosure should be stakeholder focused.[26]

Harmonisation and widespread adoption of global and sector-specific KPIs will assist issuers in improving their ESG reporting, and will be critical to ensuring that meaningful ESG disclosure gains traction in the market. Participants in our ESG workshops reported looking increasingly to TCFD, SASB and GRI for ESG diligence and disclosure guidance, including with respect to KPIs. We continue to focus on a range of ESG KPIs during our discussions with management in our sector-focused workshops so that we can incorporate their input into the ESG Fact Sheets.

[25] European Commission's Guidelines on reporting climate-related information (2019)
[26] https://www.globalreporting.org/standards/

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

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

4. Other Methods of ESG Disclosure

In addition to ESG disclosure in offering documents, companies can provide further evidence of their ESG strategy and goals through separate ESG-specific reports published at the time of issuance, usually accredited or verified by a third-party independent agency. Given liability concerns, such forms of ESG disclosure are likely to be published on a company's website and not disclosed or incorporated by reference into an offering document. If this approach is used, care will be needed to ensure that information published in this way is not considered, perhaps in hindsight, to be material information that should have been included in the offering document.

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

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

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

a. Globally Recognised ISO Standards

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

b. Certification

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

c. Independent Verification

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

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

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

d. ESG Ratings

Issuers can engage ESG ratings organisations, such as MSCI or Sustainalytics, to measure their performance against specific ESG metrics and provide an ESG rating. Similar to a credit rating, an ESG rating can act as a tool for investors to analyse and compare different issuers. However, critics suggest there are currently insufficient levels of standardisation between different ESG rating agencies, who apply varying methodologies and metrics, making comparisons difficult.

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

e. ESG Factors in Credit Ratings

Credit rating agencies are increasingly including ESG factors in their analysis of the financial status of corporate borrowers. Moody's, Fitch and S&P have all signed the UN PRI's statement on ESG, signalling commitment to their role in developing the focus on ESG in the global financial system. As with ESG ratings, there have been some concerns of limited consistency between methods of analysis applied by these agencies, and a lack of consolidation in this area. In addition, credit rating agencies recognise that there are often factors that will be more immediate and material to a credit score, such as liquidity concerns. If ESG is not material in light of such credit risk, it is unlikely to be included in the credit analysis. Nonetheless, this has potential to be an area for both growth and harmonisation going forward. Credit rating agencies are keen to improve their ESG-related products due to a growing investor demand for more extensive commentary on ESG issues and readily usable comparison tools.

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

Chapter 5

Contractual Provisions and other Considerations

Other than on a bespoke basis, there are limited examples of ESG-specific contractual provisions in European credit agreements, whether by way of representation, information undertaking or covenants. Most examples seen to date have been pricing-related provisions incentivising borrowers to improve ESG performance on pre-agreed metrics.

As described in this Guide, there are a number of different existing and emerging regulatory requirements, and for companies that have them, the Environmental and Social Risk Management (ESRM) teams will be the most appropriate initial source of guidance to identify and assess ESG factors. Institutional ESRM teams sit within the risk function of the institutional ecosystem, and as such all recommendations from such teams are deemed as "must-haves" for the institution to which they relate. This does limit drafting standardised terms on a pure commercial basis to some degree as the market has not yet reached a stage where ESRM considerations are uniform.

In assessing the form of an ESG-specific contractual provision, a range of factors may be considered, including whether the provision should be general or sector-specific, or qualitative versus quantitative.

There are a number of other challenges to creating uniformity across the market, including a lack of consistency in reporting (which the ESG Disclosure Initiative aims to address), differences in measurement of sustainability-linked outputs, and an absence of relevant KPIs. In addition, given that any contractual provision will be closely linked to on-going diligence processes, greater consistency in diligence practices is also a prerequisite to supporting uniformity in contractual provisions. It is also necessary to consider "materiality" – which is discussed at length in Chapter 3 – when assessing the appropriate contractual standard.

Understandably, contractual disclosures and covenants that align to ESG metrics will strengthen the overall ESG message and reinforce the commitment of both the investor and the borrower. To this end, in drafting any new contractual provision, it is important that it is "achievable" and readily accepted by the market, and does not inadvertently result in default hair triggers. A delicate balance must be maintained between introducing contractual provisions that are both meaningful for investors, but do not create unnecessarily onerous obligations on the borrower. In addition, any provision should be complementary to similar protections being included within the documentation.

The below identifies our initial suggestions for potential features of ESG-specific contractual provisions:

- an [annual / quarterly] on-going information undertaking (to take a form similar to the delivery of budget or financial model);
- reporting to be in the form of a stand-alone agreed-form "compliance" certificate (to be scheduled to the loan agreement);
- reference to an issuer / borrower group's internal policies and procedures (to take the form similar to a sanctions / bribery covenant); and
- third-party verification (optional).

Going forward, and as ESG metrics become more prevalent in the European leveraged loan and high yield bond markets, we anticipate that covenant protections may be elaborated to refer to pre-determined performance thresholds or metrics (more akin to a financial covenant). We will monitor developments in this area and intend to update this Guide to reference examples and summarise emerging market practice.

About the ELFA

The ELFA is a trade association comprised of European leveraged finance investors from over 35 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information, please visit the ELFA website: www.elfainvestors.com.

About the LMA

The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 750 organisations across over 65 jurisdictions and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA's overall mission is to act as the authoritative voice of the EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties. www.lma.eu.com

About the PRI

The PRI is the world's leading proponent of responsible investment. It works: to understand the investment implications of environmental, social and governance (ESG) factors; to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. The PRI now has over 3,300 signatories who collectively manage US$100 trillion in AUM. www.unpri.org

Important Information:

The ELFA would like to thank the following institutions for the feedback provided during our September 2020 and November 2020 ESG workshops:

Banks
Barclays
BBVA
BNP Paribas
Credit Agricole
Credit Suisse
Goldman Sachs
ING
J.P. Morgan
Société Générale

Companies
Arrow Global
eir
Encore Capital
Fedrigoni
Grupo MásMóvil
Intrum
HRA Pharma
Liberty Global
Sappi
TalkTalk
TDC
Tele Columbus

Credit Rating Agencies
Fitch Ratings
KBRA
Moody's Investors Service
Qivalio
S&P Global Ratings
Scope Ratings

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