Regulatory Hotline

June 22, 2021

ESG, A NEW VALUE CREATOR

WELCOME TO THE BRAVE NEW WORLD!

The pandemic has put many things into perspective. The way we live, work and socialize, for instance. Our priorities have also undergone transformation. The stark differences in social and economic indicators have not been so pronounced as they are now. The digital divide has had an unequal impact on access to education and healthcare, especially in the developing world. Meanwhile, global quantitative easing, spurred on by the pandemic, has made the world flush with funds. Stock markets, commodities, real estate are all on the upward trajectory. Feels a little bit ironic given the grave circumstances we are surrounded by.

At the same time, economists and central bankers are hopeful that economies will rebound fast. I too am hopeful that the "new world" bounces back and puts this pandemic behind us, at least its most virulent form. But a lot is now at stake. There hasn't been a time in the last century when we have got a real chance to focus on and create real value out of the environmental, social and governance (ESG) paradigm. The corporate and finance world needs to lead by example. ESG has been around for a while with a large emphasis on the E. Climate change has propelled the E into our living rooms and board rooms. The importance of clean, renewable and sustainable energy will continue to be critical. The regulatory focus globally as well as in India has rightly put a lot of emphasis on the E and the quest for cleaner and greener energy.

There is now a similarly important emphasis that must be placed on the S and G. We now need to move away from ad hoc approaches to more defined and measurable targets with respect to ESG. This would go in sync with the adage, 'that which cannot be measured, cannot be managed'. Corporations and financial institutions who are already doing a fair bit on the ESG front, will need to do a lot more. Not only will society benefit, but the corporations themselves will be able to raise more sustainable finance.

Most corporate and financial legal and regulatory systems have some aspects of ESG reporting and ratings built in. Let's briefly look at India, Singapore and the EU.

INDIA

In India, the Securities and Exchange Board of India ("**SEBI**") has the Business Responsibility and Sustainability Reporting by listed entities framework ("**Framework**"). It mandates that the top 1000 listed entities by market capitalization meet the ESG disclosure and reporting requirements set on in the Framework. A listed entity is required to provide an overview of the entity's material ESG risks and opportunities, approach to mitigate or adapt to the risks along-with financial implications of the same.[1] The Framework first came into existence in 2012 and was limited to the top 100 listed entities. This has been expanded over time to cover a larger cohort of 1000 entities, by market cap, in 2019. The Framework itself was overhauled from its earlier avatar as the Business Responsibility Reports to its current form. The disclosures and reporting enables these entities and various stakeholders to course correct and to take important investment decisions. In the private equity and M&A world, ESG diligence has gained a lot of significance especially in sectors which could have a significant impact on ESG indicators. And these sectors are now all encompassing from manufacturing to services. Factories, education, healthcare and myriad others. India has also placed Corporate Social Responsibility obligations on its larger companies, as legislated under the Companies Act, 2013.

SINGAPORE

The Singapore stock exchange, SGX, introduced sustainability reporting on a "comply or explain" basis in June 2016. All listed issuers need to prepare a sustainability report annually, as per the requirements set out in the SGX Listing rules and the sustainability reporting guide. These reports of environmental, social and governance factors disclose the risks and opportunities related to the business and combined with general financial reporting, allows stakeholders to get a much clearer insight into the prospects of the business and its management. The SGX has also developed an ESG stock rating indices. These ratings provide a measurable metric along with the traditional financial metrics.

EU

The European Union is by far the leader in the space. The EU has legislated the Non-Financial Reporting Directive ("**NFDR**") in 2014 and the Sustainable Finance Disclosure Regulation ("**SFDR**") which came into effect on March 10, 2021. Under the NFDR, EU law requires certain large companies to disclose information on the way they operate and manage social and environmental challenges. This helps investors, civil society organizations, consumers, policy makers and other stakeholders to evaluate the non-financial performance of large companies and encourages these companies to develop a responsible approach to business.[2] Similarly, in pursuance of the objectives of the European Green Deal, under the SFDR, sustainable finance refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector. The EU is also working on a EU wide classification system, EU Taxonomy for sustainable activities, to establish a list of

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environmentally sustainable economic activities. This could become a good benchmark for adoption globally. As one can see the EU is primed to lead in the overall ESG space and has a lot to offer as export of these pathbreaking legislations and directives.

CONCLUSION

Last but not the least is the G. Governance reform at corporations and financial institutions is critical to ensure that ESG priorities are measured and strictly adhered to. Governance deals with a corporation's leadership amongst other things. An example of failure governance is the use of child labour in manufacturing and production in various industries across the globe. From a measurement perspective, this would lead to negative points on the governance metrics of that user. Such a non-financial metric failure would have adverse consequences on its business and access to sustainable finance. It is therefore imperative that boards act in a steadfast manner to ensure strict compliance and to course correct when needed. The role of the Independent director becomes even more important. Legal systems must evolve to enable directors to carry out not only their fiduciary responsibilities to the company but also to society at large.

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[1] https://www.sebi.gov.in/sebi_data/meetingfiles/apr-2021/1619067265752_1.pdf

[2] https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en

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