CLYDE&CO

ESG – The implications for professions and their insurers

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Overview

What is ESG?

- A definitional problem
- What might fall into the E, S and G categories?
- Different layers of ESG requirements on professional service firms and their clients

Why this matters for professional service firms

- Lawyers / SRA perspective
- Accountants / FRC perspective

Why this matters for the clients of professional service firms

- Lawyers
- Accountants
- Brokers
- Construction
- Consultants

What is ESG?

Environmental, Social and Governance

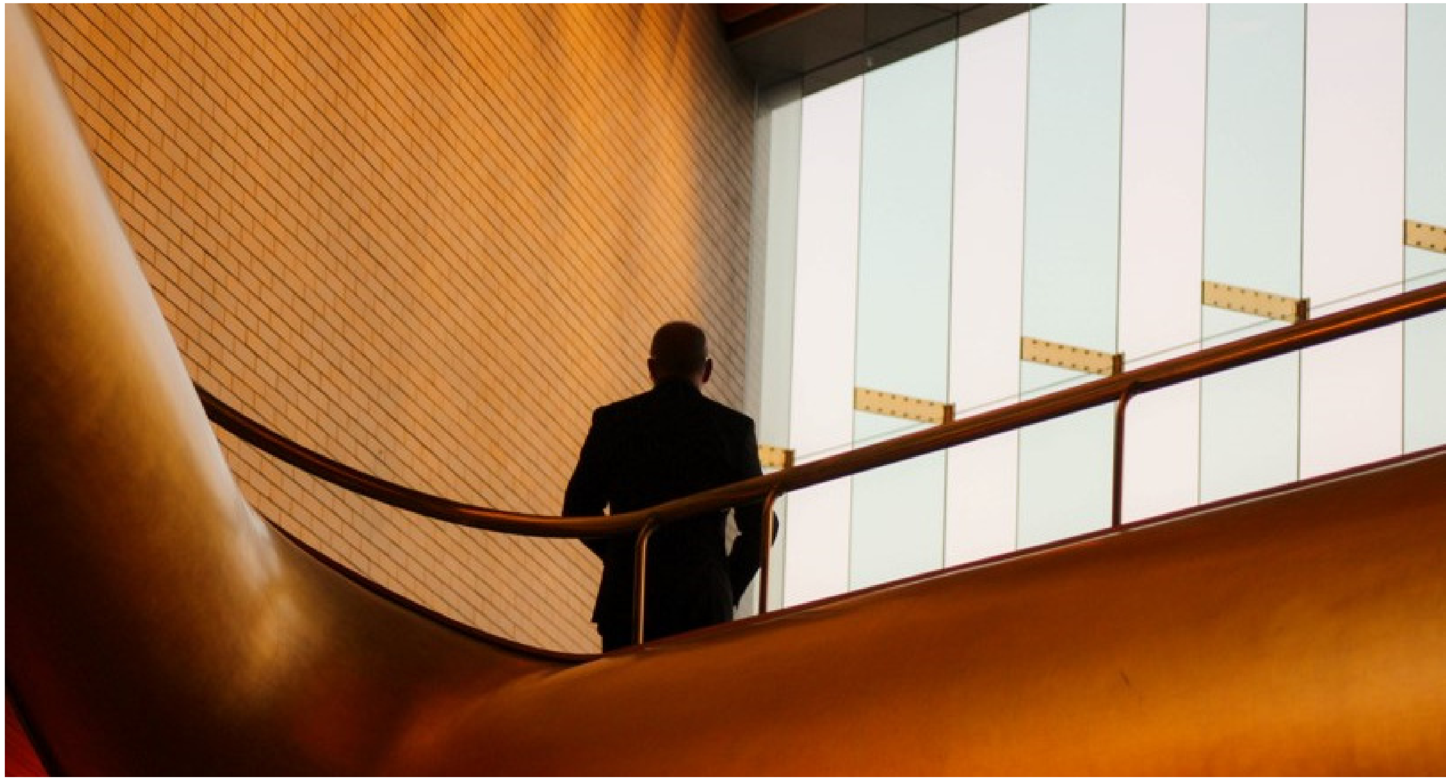
United Nations Principles for Responsible Investment (April 2006)

Reflects ethical and commercial considerations

A definitional problem?

- Broad and constantly evolving parameters
- Difficulty in establishing clear and measurable guidelines and targets

Developing statutory and regulatory positions



What might fall into the E, S and G categories?

Environmental (E)

Issues relating to the quality and functioning of the natural environment and natural systems:

- Biodiversity loss
- Greenhouse gas (GHG) emissions
- Climate change
- Renewable energy
- Energy efficiency
- Air, water or resource depletion or pollution
- Waste management
- Stratospheric ozone depletion
- Changes in land use
- Ocean acidification
- Changes to the nitrogen and phosphorus cycles

What might fall into the E, S and G categories?

Social (S)

Issues relating to the rights, well-being and interests of people and communities:

- Human rights
- Labour standards in the supply chain
- Child, slave and bonded labour
- Workplace health and safety
- Freedom of association
- Freedom of expression
- Human capital management and employee relations
- Diversity
- Relations with local communities
- Activities in conflict zones
- Health and access to medicine
- HIV/AIDS
- Consumer protection
- Controversial weapons

What might fall into the E, S and G categories?

Governance (G)

Issues relating to the governance of companies and other entities:

- Executive pay
- Shareholder rights
- Transparency / disclosure of information
- In general, issues dealing with the relationship between a company's management, its board, its shareholders and its other stakeholders
- Bribery and corruption
- Internal controls
- Risk management
- May also include matters of business strategy, encompassing both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented

Different layers of ESG requirements for Professional Services Firms and their clients

Statutory obligations	-	Companies Act 2006
	-	Climate Change Act 2008
	-	Equality Act 2010
	-	Bribery Act 2010
	-	Modern Slavery Act 2015
Regulatory obligations	-	Sector specific
Commercial considerations	-	Reputational concerns
	-	Client expectation / demands
	-	Risk management

Why this matters for the Professional Services Firm

Introduction and SRA Perspective

- 2019 Deltek survey: professional service firms struggling to remain compliant, given the increasingly complex and changing regulatory landscapes - https://www.consultancy.uk/news/21530/professional-services-struggle-keeping-up-with-risk-compliance

> "
>
> *Our SRA Principles and Codes of Conduct aim to drive high professional standards. Through them we seek to give a clear message to the public, regulated individuals and firms about what regulation stands for and what a competent and an ethical legal profession looks like.*
>
> *We work in the public interest, protecting consumers, setting and enforcing high professional standards, and supporting access to affordable legal services, the rule of law and the administration of justice.*
>
> *Our regulation therefore seeks to:*
>
> - *ensure a strong, competitive, and highly effective legal market*
> - *ensure a focus on quality and client care*
> - *promote a culture in which ethical values and behaviours are embedded."*

Why this matters for the Professional Services Firm

SRA Perspective

SRA Principles

"You act:

1. *in a way that upholds the constitutional principle of the rule of law, and the proper administration of justice.*
2. *in a way that upholds public trust and confidence in the solicitors' profession and in legal services provided by authorised persons.*
3. *with independence.*
4. *with honesty.*
5. *with integrity.*
6. *in a way that encourages equality, diversity and inclusion.*
7. *in the best interests of each client."*

Why this matters for the Professional Services Firm

SRA Perspective

SRA's corporate strategy document for 2023 to 2026, page 8:

> "
>
> *Over the three-year period of the strategy we will… publish policy statements setting out our position on access to justice, and on matters relating to Environmental, Social and Governance (ESG), including our view of the key regulatory issues and obligations for those that we regulate".*

How is the FRC considering ESG?

“

Of ESG’s three components, environmental is the most amenable to rigorous corporate reporting, because it involves objective, physical measurements of the amounts of gases, solids, and liquids that companies use and produce. This is good news, because the easiest component to measure presents the most urgent threat to humanity.”

Robert S Kaplan, Harvard Business Review – “Accounting for Climate Change”

The new IFRS S1 and IFRS S2, require companies to make climate-related disclosures around the following key heads:

Governance

Strategy

Risk Management

Metrics and Targets

So, how are companies doing?

- Quality of climate statements varied
- Lack of environmental expertise
- Significantly less reporting of Scope 3 indirect emissions

The FRC has also emphasised that in upcoming audit quality inspections, the Audit Quality Review teams will be paying:

"

particular attention to the auditor's work on climate-related risks, including the linkage between the audited financial statements and climate-related disclosures elsewhere in the Annual Report".

FRC "*ESG – what we've achieved so far and what's next webinar*"

So what about the Social element of ESG?

- ensuring professional and ethical standards and protecting the public

And what about Governance?

- the FRC is responsible for revisions to the UK Corporate Governance Code which applies to certain listed companies, as well as being recommended best practice for other companies.

Why this matters for the client

Introduction

- The “client”: stakeholders – such as governments, shareholders, regulators, and insurers
- Insurers face pressures to withdraw from underwriting fossil fuel risks, and are key players in the growing focus on sustainable finance. They will want to be suitably advised on this, and on regulatory exposures that may arise in relation to diversity and inclusion initiatives, metrics and targets.
- Duties under the retainer: straightforward where there is a clear express obligation to advise on these issues. The greyer area is whether there might be a duty to do so by any other route – *eg*:
    - As a matter of construction as part of the agreed tasks?
    - As work “reasonably incidental” to the agreed tasks (*Minkin v Landsberg (Practising as Barnet Family Law)* [2015] EWCA Civ 1152)?
    - By reference to the purpose of the retainer and the risks which it is intended to guard against (*Manchester Building Society v Grant Thornton LLP* [2021] UKSC 20)?
- Putting in policies and procedures will be hard to do when the risk is so fast-developing.

Lawyers - Reputation and retainer

(Environmental)

- The relevance to lawyers' practice too – driven by client needs
- Law firm being judged on ESG credentials by clients/new recruits - sustainability-driven protests by Harvard Law School students, and grading list by Yale Law School students; and activism by Extinction Rebellion.
- Law firms judging their clients on their ESG credentials; and advising on climate legal risks becoming part of lawyers' duty of care, in some scenarios:

  - Law Society Climate Change Resolution:
    - Future-proof the profession
    - Reduce greenhouse gases
    - Encourage firm policies on indirect emissions
  - Law Society Climate Change Guidance:
    - Follows on from Resolution
    - Ambitious and wide-ranging, but non-binding guidance

Lawyers - Greenwashing

(Environmental)

Law firms' risk of greenwashing / overstating own position re. ESG metrics	The ESG litigation greenwashing trends; Blended Capital report, *"Riding The Dragon: The Future of the ESG Law Firm"* – some law firms' ESG-related achievements and initiatives, on closer inspection, seem largely unsubstantiated	Increased scrutiny of public pledges, versus actual performance

Lawyers - Liability, regulatory in practice, and the press

(Social and Governance)

- Lawyers' freedom to take positions on ESG issues – regulatory concerns
- Conflicting rights, views and societal tensions over the extent to which lawyers' own values do or should align with their clients'.
  - "Lawyers are Responsible" and the "Declaration of Conscience": 'breach' of Rule 29 of the BSB Handbook, known as the 'cab rank' rule
- Firm publications, and the right to express your view?
  - SRA case study of alleged bullying complaint, in relation to an article on a client's approach to climate change.

What are the Risks for Accountants?

- Most ESG related claims against accountants are likely to arise in relation to climate and its impact on the financial statements of a company.
- Failing to identify climate-related impacts on financial statements can risk regulatory proceedings or litigation.

"

There was little evidence that auditors considered the impact of material climate-related matters … 96% of auditors did not sufficiently address how they considered the impact of climate."

Carbon Tracker initiative and the Climate Accounting and Audit Project, October 2022

Why does ESG matter for Accountants?

There are reputational risks for accountants in not complying with their environmental responsibilities

For example In November 2021, Sarasin & Partners together with a group of institutional investors managing assets worth around $4.5tn wrote to the heads of the UK audit divisions of PWC, Deloitte, KPMG and EY, claiming that the first Carbon Tracker report (published earlier in 2021):

> “
>
> provides overwhelming evidence of auditors failing to check whether and how global decarbonisation is being reflected in company accounts, even where the move away from fossil fuels poses an existential threat to the business

Brokers

- Levels of ESG-related risk to brokers will vary dependent on market / industries supported
- Potential sources of claims:
  - Failure to obtain sufficient information from insured as to requirements around ESG
  - Failure to give suitable advice or recommend suitable cover taking account of ESG considerations
  - Failure to explain limits on cover / key policy provisions relating to ESG concerns
  - Greenwashing allegations
- Steps to reduce risk of ESG-related claims:
  - Ongoing training around ESG issues
  - Specific questioning of insureds to identify ESG requirements
  - Ensure availability of up to date information on ESG issues in market, including latest policy wordings re ESG risks
  - Provide advice in writing / keep written notes of oral advice

Construction

ESG considerations for design and construction professionals:

Environmental

- Greenhouse gas emissions
- Material selection
- Mineral extraction
- Water consumption
- Methods of construction
- Waste management
- Recycling
- Future proofing design
- Technology

Social

- Community impact and integration
- Accessibility
- Heath and well-being
- Emergency response planning

Governance

- Business strategies
- Procurement and supply chain management
- Stakeholder engagement

Construction

Potential sources of claims:

- Developing common law duties
- Reliance on flawed or outdated industry regulations and standards (see *MT Højgaard v E.ON* [2017] UKSC 59)
- Changing statutory and regulatory obligations (e.g. Building Safety Act 2022)
- Group litigation

Steps to reduce risk of ESG-related claims:

- Dedicated monitoring of ESG issues, industry practice and changes in standards
- Ongoing training / internal dissemination of ESG information
- Independent ratings (e.g. BREEAM, Greenroads, WELL Building, LEED, Green Globes

How does ESG affect consultants?

- Some may be a member of a regulated profession, for example an in-house legal team. However, most consultants are not members of a regulated profession.
- However, this does not mean that consultants can ignore ESG issues. There have been a significant number of recent regulatory interventions stressing that consultants need to consider the nature of the business that they take on.
- Consultants would be well advised to consider ESG principles when deciding to accept business and may wish to implement some of the best practice recommendations coming out of the regulated profession.

In Conclusion…

We have looked at the definitional problem of ESG, what it actually means in itself and what it means for the professions and their clients.

Potential civil liability exposures due to changes in client expectations, the legislative and regulatory landscape, financial and diversity based disclosure requirements, and more.

Part of the challenge for insurers: determining what ESG information is relevant to the risk being placed.

Start by educating ourselves on how risks posed to our firms and to the wider community interrelate; and perhaps considering in each case the risks around acting for a particular client.

Ensure underwriters and brokers are fully trained on ESG; that up to date market information is available to them; ensuring that the insured’s instructions are clarified on cover for ESG risks if necessary.

Thank you. Any questions

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