HERBERT SMITH FREEHILLS

SPOTLIGHT ON MALAYSIA: THE INCREASING IMPORTANCE ON EFFECTIVE ESG RISK MANAGEMENT

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Legal Briefings

Recent and ongoing controversies surrounding labour conditions and deforestation in Malaysia has put environmental, social and governance (**ESG**) compliance by Malaysian companies under the spotlight in a post-Covid world. Even before the pandemic, ESG emerged as an area of focus for governments, regulators, financial institutions, and commercial organisations around the world. This heightened focus by external stakeholders on corporate purpose, accountability and resilience has driven ESG considerations higher up the corporate agenda for major businesses operating globally and within Malaysia.

In this post, we highlight the nature of ESG and the risks and opportunities it poses to companies involved in cross-border business, and how to manage them.

ESG AS A GLOBAL REGULATORY PRIORITY

Management of ESG risks had until recently largely taken place as a voluntary exercise by companies wishing to be seen as responsible, ethical or sustainable. Today, ESG is no longer a law-free zone for businesses. Legal developments in jurisdictions which see an increasing regulatory emphasis on ESG risk management throughout the value chain and the consideration of ESG issues in investment decision-making means that companies in Malaysia now need to understand multiple regimes to comply with stakeholder expectations, and not without risk. In recent years, the US and EU have been applying sanctions more often, and often in a way that is targeted to specific sectors and business industries in countries which are the subject of sanctions. With Europe leading the way, there are now over 170 ESG-related regulatory measures. Though no global, standardised and binding ESG reporting or benchmark instrument exists, 'hard law' measures with punitive sanctions are more common. The volume of new regulatory requirements and standards across numerous jurisdictions and sectors means businesses will have to keep these matters under constant review to manage legal, commercial and reputational risks.

However, sanctions or financial penalties imposed by the courts are not the only risks businesses face; liabilities in relation to other stakeholders (financers, shareholders, customers) and the risk of reputational damage is increasingly seen as a significant concern. Investors focused on thematic ESG investing see ESG risk-management being related to improved long-term returns, stronger brand and reputation, and a decrease in investment risk. Companies with strong ESG credentials stand to benefit from this trend through access to capital and new markets.

ESG AS A GROWTH DRIVER

It is evident that fund and asset managers and other financial institutions are becoming more focused on ESG risk. This is in response to a growing demand from an investor base which takes sustainable investment more seriously, both from an ethical and a commercial perspective. In addition, ESG factors can also be influential in relation to consumer preferences.

As such, poor performance in relation to ESG factors can increasingly be seen to have significant impact on share value and a company's approach to ESG may also be an indicator of its financial performance generally, given empirical data suggesting that companies that pay attention to ESG correlate with higher returns and a reduction of downside risk. Moreover, some now argue that failing to consider ESG issues in investment decision making might even constitute a breach of fiduciary duty.

ESG RISKS

The range of potential ESG risks areas is exceptionally broad, and the salience of individual ESG risks will differ from business to business.

Environmental risk factors include climate change and greenhouse gas emissions, energy efficiency, resource depletion (including water), hazardous waste, air and water pollution, and deforestation. Growing concern regarding climate change, and the inevitable shift towards a lower carbon future, has resulted in a clear trend for heightened scrutiny of the long-term sustainability of significant carbon-emitting assets and, conversely, the opportunities presented by new technologies and renewable energy business which may be beneficiaries of decarbonisation efforts. The effects of Covid-19 on commodity prices in particular has caused some to describe the pandemic as a key pivot for the energy transition, further magnifying the focus on decarbonisation.

Human rights, working conditions (including forced labour and child labour), local and indigenous communities, conflict, health and safety, employee relations and diversity form part of the social facet. As an example, mandatory human rights due diligence requirements have been introduced or are under consideration in multiple jurisdictions. Human rights due diligence refers to the process of identifying and assessing the potential adverse human rights impacts of business activities and relationships. The heightened regulatory need for transparency in supply chain and other anti-modern slavery legislation in the UK, France, Australia, Brazil and California has increased the importance of understanding and risk-mapping the supply chains of potential business partners or acquisition targets, including with respect to geography, sector and labour, outsourcing and recruitment practices.

The spotlight on governance issues cover executive pay, bribery and corruption, data protection, board independence, diversity and structure, tax strategy, transparency, and shareholder rights. For example, in the context of global trends towards anti-bribery regulation, the onus is placed on companies to take active steps to prevent bribery within their businesses. Significant financial sanctions can apply where those requirements are breached. Understanding the internal anti-bribery processes of potential targets is an important tool for understanding the scope for, and level of risk in relation to, potential future regulatory action in both the investor’s home jurisdiction and the target’s jurisdiction.

EFFECTIVE ESG RISK MANAGEMENT WITHIN THE BUSINESS

These new risks require compliance and diligence to secure finance for projects, manage operational and legal risks, attract and retain high-performing employees, attract investors and protect businesses’ social license to operate. With ‘hard law’ frameworks coming into force, and heightened expectations in relation to ESG from investors, external stakeholders and broader society, identifying key ESG risks through the due diligence process will be critical as the global economy emerges from the Covid-19 pandemic.

The measures that companies doing business in Malaysia will need to take to mitigate ESG risks will inevitably be context specific, but should include the following:

- Implementing appropriate ESG policies and procedures within the business.
- Conducting ESG impact assessments as part of pre-investment due diligence to identify

potential risk areas, and taking steps to mitigate these during the course of the investment.

- Keeping ESG risks under ongoing review to identify emerging or evolving risks, including those related to supply chains (and requiring business partners and suppliers to similarly manage and mitigate adverse impacts). For subsidiaries and related supply chains in Malaysia, regular ESG due diligence will also be necessary to enable investors to comply with reporting requirements in their home jurisdictions.

- Assessing the effectiveness of actions taken in response to ESG impact and issuing strategic reports.

- Reviewing existing and proposed contracts with business partners, with a view to enabling the investor to take remedial action should business partners' practices pose ESG risks.

- Ensuring that, where adverse ESG impacts do occur, fair and effective remedies are available to those affected, for instance by establishing mechanisms whereby individuals and communities can raise grievances and propose remediation where appropriate.

Legal teams play a central role in implementing, monitoring, reporting and enforcing ESG standards within their organisations. A full understanding of the standards and ESG risks, as well as regular coordination and information sharing between legal, compliance and operations teams is essential to ensure that risks are identified early and that a responses is a meaningful one which takes account of potential compliance risks.

SECTOR-WIDE ESG INITIATIVES: COLLABORATE OR COMPETE?

As companies are increasingly scrutinised in relation to their ESG initiatives, this has led to more collaboration between competitors with the common goal of avoiding the adverse impact their operations and supply chain arrangements can have on the environment and society. Collaboration on such matters can take many forms, ranging from ad-hoc cooperation amongst small groups of companies to sector-wide initiatives or initiatives coordinated by industrial or trade associations.

While collaboration towards these objectives is welcome, it can give rise to risks in a competition law context, particularly if it involves the sharing of competitively sensitive information. Globally, many competition authorities consider that even the exchange or flow of competitively sensitive information between competitors amounts to a serious infringement of competition law (even in the absence of any agreement on present or future conduct). Competition law advice should be sought prior to sharing information, attending meetings, or before taking any material steps to collaborate with potential competitors.

FURTHER INFORMATION

Malaysia’s regulatory environment and business practices have much room to grow in terms of providing comprehensive solutions to environmental sustainability, modern slavery, bribery and corruption. Although the focus on ESG is still in its relative infancy in Malaysia compared to the more developed markets in North America and Europe, ESG issues are rapidly becoming more mainstream in the country over the past two years. We have seen private equity funds in Malaysia move in this direction and having regard to ESG factors in their investment consideration. This is driven largely by the country’s large foreign investor base, and evidenced by recent reports on ESG concerns in Malaysia within its agriculture, infrastructure, manufacturing, and oil and gas sectors.

Increasing global attention to ESG is generating more rigorous supply chain due diligence, which will lead to a host of increasingly complex compliance questions. Responding to these compliance issues in a robust way and integrating them into due diligence practices while also seeking to mitigate or remediate underlying ESG breaches can be a complex exercise.

We can help you take advantage of the opportunities that is presented by the new ESG-led investment environment and navigate this complex landscape through our holistic approach to ESG considerations by combines in-depth knowledge of global regulatory trends and the myriad of international and national laws and standards, with wide-ranging sector expertise.

- Our expertise spans a variety of areas, including business and human rights, climate change-related litigation, green and sustainable finance, impact investment, reporting and disclosures, corporate governance, the development of ESG-related legislation, due diligence and the M&A process and ESG issues relating to funds and asset management.
- Our experience is broad, from advising clients looking to issue bonds to fund the development of renewable energy projects or raising debt that satisfies issuers’ environmental policies and investors’ ESG mandates, to helping our clients get in front of new risks and to ensure that their compliance and diligence places them ahead of the pack in securing finance for new projects, managing operational and/or litigation risks, retaining high calibre employees and attracting like-minded investors.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.




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