GIBSON DUNN

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LATEST OVERVIEW OF GREEN BONDS AND OTHER ESG FINANCIAL PRODUCTS

To Our Clients and Friends:

In 2019, we witnessed ESG matters solidify their place at the center of corporate governance discussions. This was most notably illustrated by the Business Roundtable's departure from shareholder primacy in its "Statement on the Purpose of the Corporation" issued on August 19th and signed by 181 CEOs. This embrace of corporate social responsibility is unsurprising in light of the emerging institutional investor consensus on the importance of sustainability and other social issues, what a recent Harvard Business School study of 43 global investment and pension funds termed the "investor revolution." In addition to embracing ESG at the level of governance, issuers have also responded to this investor focus by embracing both well-established and emerging ESG financial products. For example, 2019 was a banner year for "green bond" issuances. While such issuances have grown steadily in the past half-decade, from under $40 billion in 2014 to over $170 billion in 2018, in 2019 green bond issuances globally surpassed $250 billion, an increase of over 40% from the 2018 period. With global issuances surpassing $200 billion in 2019, issuers in an increasing number of industries have begun to explore both the traditional green bond market and emerging alternative ESG financial products.

Offerings under the Green Bond Principles Framework

Historically green bond offerings have allowed issuers in industries with pronounced environmental exposure, such as energy, transportation, and utilities, to enhance their sustainability reputation and attract investment from ESG-focused funds. With the steady increase in investor pressure on ESG issues, the now well-established model of green bond issuances presents an attractive and accessible opportunity for issuers across a range of industries to highlight their commitment to sustainability. The Green Bond Principles ("GBP"), promulgated by the International Capital Markets Association ("ICMA") and last updated in June 2018, have created a standard model for green bond offerings. The GBP framework establishes the generally accepted definition for green bonds as bonds "where the proceeds will be exclusively applied to finance or re-finance, in part or in full, new and/or existing eligible Green Projects," with eligible projects defined according the following 10 non-exclusive categories:

- renewable energy;
- energy efficiency;
- pollution prevention and control;
- sustainable resource and land use management;

- biodiversity conservation;
- clean transportation;
- sustainable water and wastewater management;
- climate change adaptation;
- eco-efficient products, production technologies and processes; and
- green buildings.

The GBP also outlines the four key components of offering documents that distinguish a green bond offering:

- a designation and description of Green Projects to be financed by offering proceeds;
- a description of how such projects are evaluated and selected by the issuer;
- a description of how offering proceeds will be managed and tracked to ensure they are used for qualifying Green Projects; and
- a description of any ongoing commitment to report publicly on the use of proceeds until full allocation.Other than this supplemental disclosure in offering documents and the focus of marketing efforts, a green bond offering is largely identical to a traditional bond offering, with no difference in pricing mechanism, offering process or legal liability regime. In addition, there is generally no difference in covenants between green bonds and traditional unsecured bonds, with covenants determined by issuers' particular credit ratings and market demands and no covenants related to Green Projects.

Questions for Green Bond Issuers

The process of preparing a green bond offering will be very familiar to existing debt issuers. Although underwriters may request additional information on an issuer's ESG initiatives or ongoing or planned green projects, the diligence exercise should primarily focus on the issuer's business, operations and financial condition, as in traditional bond offerings. Similarly, the content and preparation of offering documentation, such as the underwriting agreement, indenture or supplemental indenture, comfort letter and opinions of counsel, will be largely identical to a traditional bond offering. The only exceptions are the prospectus or prospectus supplement, which will include green bond specific disclosure in the "Use of Proceeds" section, and the preparation of related materials such as "green bond frameworks" or second party opinions, as discussed below.

The GBP and market practice have established a relatively well-trodden path for new green bond issuers; however, several decision-points exist for issuers. Although not required under the GBP, a green bond framework or other advance work to identify eligible green projects and establish reporting processes is

highly recommended to avoid any delays at the time of an offering resulting from questions around the use of proceeds. In addition to selecting a general area of sustainability-focused investment, issuers must decide on the level of specificity in their use of proceeds disclosure, i.e. whether to define a broad category of eligible investments or specify particular projects. The GBP also recommends that the process for project selection be subject to third-party review, with many issuers achieving this by preparing a separate "green bond framework" in advance of a first offering, which outlines eligible projects and project evaluation processes, as well as post-offering proceed allocation reporting processes. Preparing such a framework in advance provides issuers time to consult with third-party review firms, with the framework later referenced or summarized in the eventual offering documents. Although recommended under the GBP, issuers must also decide whether to engage a third-party firm to provide a "Second Party Opinion" covering the alignment of the use of proceeds with the GBP and/or the issuer's compliance with the reporting goals outlined in the offering materials. In addition to such opinions, issuers may also seek a "Climate Bond Certification" pursuant to the Climate Bonds Initiative, which requires issuers to appoint an approved outsider verifier prior to issuance in order to evaluate the proposed bond under sector-specific eligibility criteria. For marketing purposes, issuers who receive second party opinions and certifications from the Climate Bond Initiative generally disclose these facts in their offering prospectuses.

Although green bond offerings involve additional disclosure regarding the use of proceeds and ongoing reporting on proceed allocation, there are no specific provisions in green bond indentures or supplemental indentures that create penalties for non-compliance with the "eligible projects" definition or reporting commitments. Offering materials are often silent on this fact, though some issuers include an explicit statement that non-compliance with its proceeds allocation and reporting commitments does not constitute a default under the indenture. While green bond offerings do not involve additional covenant burdens, they give rise to liability concerns regarding issuer ESG disclosure. Many offering documents include an explicit statement that corporate social responsibility reports and other ESG materials on the issuer's website do not constitute a part of the offering materials. Nonetheless, green bond offerings, whether through the inclusion of ESG-related disclosure in offering documents or by simply by focusing attention on an issuer's ESG performance, may draw increased attention to the quality and accuracy of ESG disclosure. As a result, green bonds provide further reason for issuers and underwriters to carefully review and diligence ESG-related disclosure.

Emerging Alternative ESG Finance Products

While 2019 was a record year for green bond issuances, new alternative green finance products continue to attract attention. For example, AXA's June 2019 proposed "Transition bond" guidelines would create a new category of bonds for projects outside the bound of the GBP's "Green Projects." Similar to traditional green bonds in structure, transition bond offerings would be defined by their "use of proceeds" and reporting on proceed allocation; however, as the name suggests, transition bonds would allow for investment in "climate-transition related activities," i.e. transitions to more climate-friendly forms of energy and industrial production. AXA's examples of such transition investments include "Cement, metals or glass energy efficiency investments," "gas transport infrastructure which can be switched to lower carbon intensity fuels," and "coal-to-gas fuel switch in defined geographical areas." Transition bonds focus on the climate-impact of investments in the context of specific industry transitions, rather

than the inherent sustainability of the financed projects, and, therefore, would conceivably open up the sustainability finance market to traditionally excluded industries such as oil and gas and heavy transport.

In addition to alternative sustainability-focused products, there has also been increased recent attention on "social bonds," which under the ICMA's "Social Bond Principles," finance non-environmental socially beneficial projects, such as investments related to access to health, educational and financial services and "socioeconomic advancement and empowerment." With the first social bond issuance by a U.S. financial institution in January, 2019 and the ICMA's June, 2019 publication of a framework for harmonizing social bond and green bond reporting, the social bond market promises to further expand the scope of ESG-finance.

Emerging ESG finance products also provide alternatives to the "use of proceeds" focus of traditional green bonds and social and transition bonds. For example, in September 2019 the first "green ratchet bond" was issued in a $1.5 billion European offering by an Italian energy company. Unlike traditional green bonds, green ratchet bonds involve variable pricing based on the issuer's environmental performance and do not allocate proceeds to specific green projects. In particular, this bond contains a coupon increase if the issuer does not achieve a target for the renewable energy share of its power generation capacity.

Consistently strong and expanding investor demand has drawn an increasingly broad set of companies into the ESG-finance market. As a result, the maturing of this market is both a story of growth and diversification. The success of traditional green bonds should be expected to attract additional investors and issuers *and* increase demand for alternatives to the standard GBP approach. In addition to the proliferation of products financing industries and projects outside the "eligible green projects" framework, we may also witness a push for grading within the green bond market itself, with mechanisms such as the Climate Bond Certification being used to introduce greater differentiation and hierarchy.

Gibson Dunn's Capital Markets Practice Group is available to answer questions about green bonds and other ESG financial products and our experience with them. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's Capital Markets practice group, or the authors:

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