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A new dawn for global ESG regulation?

Environmental, social & governance obligations are expanding their regulatory reach around the world: Simon Walsh considers the compliance frameworks in the EU & US

IN BRIEF

- Proposed legislation in the EU and US is set to significantly expand ESG-based reporting obligations for companies based or even operating in these jurisdictions.
- Companies subject to some or all of these proposals will have to devote considerable time and effort in order to comply in a timely manner.

Global temperatures are not the only thing on the rise: global reporting requirements in respect of environmental, social and governance (ESG) factors are also on the way up. Newly proposed legislation in both the European Union and in the United States is set to significantly expand ESG-based non-financial reporting obligations for companies based in—or, in some cases, operating in—the EU or the US.

The reach of that legislation will also be expanded to a greater range of entities than ever before. This regulatory growth will not only affect businesses which fall directly within its scope; the impact of these requirements will be felt by any business which is part of the value chain of an entity that does fall within the reporting requirements under certain regulations and frameworks. Compliance is only going to become harder, especially for companies operating in globalised supply chains—which in the modern world comprises most significant operating businesses. What non-financial reporting obligations are businesses going to face in respect of ESG and climate change issues? And how should businesses seek to comply with these regulatory changes?

The EU

The EU has moved swiftly and vigorously in developing regulation around ESG-based disclosures, having already enacted a significant amount of legislation and proposed further measures as part of the EU's 'Green Deal'. In recognition of the fact that the financial sector is a vital contributor to the global sustainability agenda, through incorporating ESG factors into investment decision-making and the allocation of capital to sustainable initiatives, the EU's original focus involved:

- regulating financial disclosures;
- establishing a clear sustainability taxonomy; and
- introducing a common framework and consistent approach across the EU to ensure that benchmarks are robust, reliable, and administered free of conflicts of interest.

To that end, in 2018, the EU published its action plan on sustainable finance, which aimed to:

- reorient capital flows towards a more sustainable economy;
- manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- foster transparency and long-termism in financial and economic activity.

To achieve these goals, in 2019 to 2020 the EU put in place three major pieces of legislation: the Low Carbon Benchmarks Regulation (EU 2019/2089); the Sustainable Finance Disclosure Regulation (EU 2019/2088); and the Taxonomy Regulation (EU 2020/852). However, focus in the EU (and the US) has shifted from primarily regulating financial disclosures to establishing obligations on businesses to go beyond climate-related financial disclosure to report on various aspects of climate, the environment and human rights. That shift of focus, in turn, has led to a proposal and an adoption in the EU of two key legislative advances.

Corporate Sustainability Reporting Directive

As long as ago as 2014, the EU had set out obligations for certain companies in respect of ESG-based disclosures, as part of a wider legislative drive to improve reporting on corporate social responsibility. Under the (EU) Non-Financial Reporting Directive (NFRD), large listed companies, banks and insurance companies ('public interest entities') with more than 500 employees were required to disclose information regarding their business models and policies concerning a number of issues: social responsibility and the treatment of employees; respect for human rights; anti-corruption and bribery; and diversity at board level (age, gender, educational and professional background).

On 10 November 2022, the European Parliament voted to pass the Corporate Sustainability Reporting Directive (CSRD). The CSRD significantly expands the scope and content of the current NFRD obligations, capturing a far wider range of entities and requiring reporting on a broader range of ESG topics (and in far greater detail than under the previous NFRD regime). The CSRD will start to apply as of 1 January 2024.

The breadth of the CSRD's reach is wide: it will apply notably not only to companies established in the EU which meet certain thresholds (eg the CSRD will apply to all listed companies on an EU regulated market, including listed small and medium-sized enterprises (SMEs), but not micro-enterprises), but also to non-EU companies that generate a net turnover of more than €150m, and that have a subsidiary or branch in the EU that generates more than €40m of net turnover. As such, US and other non-EU companies with EU business may be required to produce ESG reports in compliance with EU rules, even if such companies are not listed on a European exchange. In-scope companies will be required to report, in a dedicated section of their company management reports, the information necessary to understand the company's impacts on sustainability matters and how they affect the company's development, performance and position. Those reports must be made in accordance with EU standards. That information must cover, for example:

- environmental matters—including science-based emissions targets and climate risk-related reporting;
- social matters and treatment of employees;
- respect for human rights;
- anti-corruption and bribery; and
- diversity on company boards (in terms of age, gender, educational and professional background).

Such reporting must also be 'qualitative and quantitative', 'forward-looking and retrospective' and based in the short, medium and long-term.

Corporate Sustainability Due Diligence Directive

The second measure proposed by the EU is a proposal for the Corporate Sustainability Due Diligence Directive (CSDDD), which was adopted by the European Commission on 23 February 2022. The CSDDD will require companies falling within its scope:

- to carry out due diligence across their value chains to identify the adverse impacts of their business;

- to implement processes to mitigate those impacts; and
- to integrate sustainability and human rights considerations into their corporate governance and management systems.

The proposed CSDDD will apply not only to companies based in the EU, but to non-EU companies (including UK corporates) that generate a net turnover in the EU of either:

- more than €150m in the financial year preceding the last financial year; or
- between €40m and €150m in the financial year preceding the last financial year where at least half of its worldwide turnover was generated in one or more of the following high-risk sectors:
  - the manufacture of textiles, leather and related products, and the wholesale trade of textiles, clothing and footwear;
  - agriculture, forestry, fisheries, the manufacture of food products, and the wholesale trade of agricultural raw materials, live animals, wood, food, and beverages; and/or
  - the extraction of mineral resources regardless from where they are extracted (including crude petroleum, natural gas, coal, lignite, metals and metal ores, and quarry products), the manufacture of basic metal products, other non-metallic mineral products and fabricated metal products (except machinery and equipment), and the wholesale trade of mineral resources, basic and intermediate mineral products.

Companies that are not themselves in-scope, but that form part of the value chain of an in-scope business, are likely to be affected indirectly by the actions taken by in-scope companies to mitigate (or not) human rights and environmental impacts.

The US

The development of ESG regulation in the US has been slower, and more politically charged, than developments in Europe. However, this year, the United States Securities and Exchange Commission (SEC) issued for comment a proposal to regulate climate change disclosures by regulated companies.

On 21 March 2022, the SEC set out its proposed rules requiring disclosures by listed companies in their registration statements and annual reports of: greenhouse gas emissions (GHG); certain financial statement disclosures; and of qualitative and governance disclosures around climate change risks. While the SEC stated that certain aspects of the disclosures that companies would be required to provide are likely already required under existing materiality standards and/or prominent disclosure frameworks and standards (such as the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) and the Greenhouse Gas Protocol), some commentators take the view that the proposals represent a significant enhancement to the existing disclosure requirements.

The proposals include disclosure of:

- the company's governance of climate-related risks and relevant risk management processes;
- how any climate-related risks identified by the company have had, or are likely to have, a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term;
- how any identified climate-related risks have affected or are likely to affect the company's strategy, business model, and outlook;
- the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a company's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements;
- GHG from operations owned or controlled by the company and from purchased electricity, as well as GHG from indirect upstream and downstream activities in its value chain. That requirement is likely to be a significant burden for many businesses: under the proposed rules, an attestation report covering the Scope 1 and Scope 2 emissions disclosures must be included in the annual reports and registration statements of large accelerated filers and accelerated filers. The requirements of that attestation will initially be required to provide limited assurance (equivalent to a Form 10-Q), but will reach a requirement for reasonable assurance (equivalent to a Form 10-K). Further, attestation reports from public companies must be from an attestation provider that meets certain requirements, including minimum standards of expertise and independence; and
- If the company has disclosed climate-related targets or goals publicly:
  - the scope of activities encompassed, the time horizon envisioned, and any interim targets established;
  - how the registrant plans to achieve its targets or goals; and
  - an update each year of how the company is progressing relative to its targets or goals and how such progress has been achieved, should all be disclosed.

These more detailed disclosures about climate change strategies in prospectuses and annual reports apply to any company listed on a stock exchange in the United States, whether the company is incorporated in the US or outside of it. Accordingly, foreign domiciled companies listed on US exchanges will need to comply.

How to comply

Companies subject to some or all of these proposals will have to devote time and effort to be in a position to comply in a timely manner. The CSDDD, which will extend to businesses globally through turnover generated in the EU or through catching entities whose supply chains affect the EU, heralds a new stage in global ESG regulation: imposing obligations that seek to prevent human rights and environmental adverse impacts. Equally, according to certain commentators, the SEC's proposal marks a sea-change in the subject matter, volume and detail of disclosures that will need to be made on climate change issues. Companies that fall within the scope of these new regulatory provisions should review their existing policies and procedures, as well as their business strategies in preparation for these incoming regulations.

The reality for many businesses operating in global supply chains may be that it will be safer from a regulatory risk perspective, and potentially less of an administrive and compliance burden, for the business to apply a 'highest common denominator' or 'least favourable nation' approach, in applying the most onerous standards applicable in any jurisdiction in which the business operates to all of its global operations (as opposed to having to manage the risk profiles in each individual jurisdiction).

That will be a substantial burden for many businesses, and much is likely to need to change: with the reach of, for example, the CSDDD deep into supply chains, it will be necessary for business to revisit their ESG diligence and data collection policies. Further, companies will need to determine where in their business responsibility for making and monitoring ESG and climate change-related risks lies. Will that be a governance issue for the board of directors, or will it reside within the finance or audit groups? Additionally, internal timing deadlines for the collection and processing of climate-related information will need to be aligned with those imposed by the SEC. And it goes without saying that regular monitoring of changes in legislation will be key. All these burdens will come at a cost to businesses; the extent of that cost remains to be seen. **NLJ**

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