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The ESG Regulatory Road Map

What US Companies Can Learn from the UK and EU

Law360

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Evolving ESG considerations have increasingly become mission critical for companies, their boards, and investors in a quest to deliver sustaining and durable enterprise value for stakeholders and shareholders alike.

This cross-section of principles comprising ESG – and each metric represented – has become the North Star for companies seeking to translate corporate responsibility into sustainable value creation, i.e., the oft-quoted: "doing good by doing well." Until recently, companies differentiated themselves from their competitors—and thereby attracted institutional investors—by voluntarily disclosing their corporate-responsibility goals and objectives. Now with the heightened awareness of the growing climate crisis and confluence of social and governance issues facing all manner of public companies, ESG readiness has become the symbol of "future-proofing" corporate strategy.

Recent regulations in the EU and UK are likewise moving the needle by mandating that certain companies affirmatively disclose climate-related and other ESG information to investors, serving as a harbinger of things to come in the US. Against this regulatory patchwork, now is the time for multi-national companies to begin the process of doing the work across their U.S. and foreign operations to ensure consistent, verifiable disclosures to global regulators. Because the UK and EU are farther along than the U.S. on disclosure requirements, multi-national companies will end up doing much of the work that the SEC may later require.

Regulations in the EU and UK

TCFD

Formed in December 2015 by the UK's Financial Sustainability Board, the Taskforce for Climate-related Financial Disclosures, or TCFD, seeks to standardize voluntary climate-risk disclosures across the private sector. Using the recommendations of the TCFD as a cornerstone, the UK became one of the first countries requiring certain UK-registered companies to include climate-related disclosures in their annual financial reports on an enhanced "comply or explain" basis.

The new required disclosures are included within the amendments to Sections 414C, 414CA, and 414CB of the Companies Act of 2006, effective April 6, 2022.

According to a governmental press release, the goal of the new, mandatory reporting requirements is to "increase the quantity and quality of climate-related reporting across the UK business community," which will "ensure businesses consider the risks and opportunities they face as a result of climate change and encourage them to set out their emission reduction plans and sustainability credentials." Translation: in the same way companies have to report on financial risks as part of their annual reports, they are now required to include climate risks.[1]

The climate disclosures must describe, among other things, the company's governance-related arrangements and processes for measuring and managing climate-related risks and opportunities, and explain how they are integrated into the company's overall risk management process. While some larger public entities may already satisfy, or mostly satisfy, the new mandatory reporting requirements, those not already in compliance are likely to face significant compliance burdens and costs.

EU's Taxonomy Regulation

Against the backdrop of its ambitious goal of achieving net zero greenhouse-gas emissions by 2050, the EU enacted the EU Taxonomy Regulation (the "EU Taxonomy"), which took effect January 1, 2022.[2] The framework was established to facilitate sustainable investment, and requires qualifying investment products to make certain disclosures on their investment in environmentally sustainable economic activities.

While the EU Taxonomy does not set forth recommendations or requirements for adopting environmentally sustainable economic activities, it establishes EU-wide ESG-related definitions that may be implemented in future legislation. Under the EU Taxonomy, an economic activity is "environmentally sustainable" if it makes a "substantial contribution" to at least one of six specified environmental objectives ranging from climate change mitigation and adaption to the protection and restoration of biodiversity and ecosystems, does "no significant harm" to any of the objectives, and complies with minimum social safeguards.

The EU Taxonomy represents another set of standards that multi-national companies must report against. Added to these looming regulations, the UK's Financial Conduct Authority is in the processing of developing its own sustainability disclosure framework, which is expected to resemble the EU's Taxonomy Regulation.

1 https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law

2 Mandatory disclosures are governed by the concept of double materiality, and companies must disclose both material climate-related impacts on the company, as well as material impacts of the company on the climate.

Proposed Amendments to Modern Slavery Act

The UK is likewise seeking to address socially unacceptable practices through legislation. In 2015, the UK enacted the Modern Slavery Act, which among other requirements, obligated UK companies with annual revenues exceeding £36 million to disclose a "slavery and human trafficking statement," describing the steps taken to ensure slavery and human trafficking are absent from the business and supply chain. However, an independent review revealed that many companies were treating their obligations as a mere "tick-box exercise" and approximately 40% of companies were not in compliance at all.[3]

As a result, the Modern Slavery (Amendment) Bill, was introduced to the House of Lords on June 15, 2021. Among other things, a new section was added to address the lack of clarity and guidance on disclosure and transparency by requiring organizations to publish and verify information about the country of origin of sourcing inputs in its supply chain, arrange for credible external audits, and report on the use of employment agents acting on behalf of an overseas government.[4] Additionally, the amendment seeks to add criminal liability for intentionally or recklessly false or incomplete disclosures as to material matters.[5] The bill remains pending.

Emerging Regulations and Legislation in the U.S.

Climate Change Regulations

Similar to the regulations enacted in the EU and UK, anticipated U.S. legislation aims to provide greater transparency on companies' ESG efforts. On March 22, 2022, the SEC proposed new, broad-sweeping rules (the "Proposed Rule") that would impose reporting requirements on companies analogous to those in the UK, marking the first-ever standardized reporting requirements for climate-related information in the U.S. Under the Proposed Rule, the SEC seeks to require public companies to include certain climate-related information in their registration statements and periodic reports, "including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements."[6] The Proposed Rule would also require companies to report their Scope 3 greenhouse gas emissions (i.e., emissions that result of activities from assets not owned or controlled by the organization, but that indirectly impact its value chain) and provide details on their climate-related targets or goals and any transition plans.

While the SEC's proposal is likely to receive plentiful public comments and may face legal challenges, it will nevertheless influence investor expectations in the interim. For example, the Proposed Rule is largely based on the similar enactments by the TCFD in the UK, both of which seek to provide investors and the public with transparency concerning companies' climate-change initiatives and goals. Similar to the disclosures required by the TCFD in the UK, the Proposed Rule requires participating companies to implement robust procedures and practices to manage the extensive amounts of data that underlie the new information that must be disclosed. The Proposed Rule would apply only to public companies, but private companies may feel the impact of Scope 3 emissions disclosures, as many privately-held companies act as vendors within the "value chain" of public companies subject to the Rule, and therefore, may face pressure to disclose their emissions in order to enable reporting of Scope 3 emissions by public companies subject to the Proposed Rule.

Social Regulations

ESG-related measures in the U.S. are not limited to the environment. Consistent with regulations and legislation abroad, regulators at both the federal and state levels have focused on key social issues, such as eliminating the importation and consumption of goods produced inhumanely. In keeping with these nationwide measures, President Biden signed the Uyghur Forced Labor Prevention Act ("UFLPA") in December 2021, which creates a rebuttable presumption that all goods manufactured, even in part, in China's Xinjiang Uyghur Autonomous Region ("XUAR") are the product of forced labor, and therefore barred from importation into the U.S. The rebuttable presumption against the importation of goods produced in the XUAR is set to take effect 180 days after the UFLPA's enactment on June 21, 2022.

At the state level, New York lawmakers recently proposed on October 20, 2021 the New York Fashion Sustainability and Social Accountability Act ("Fashion Act"), which would impose regulations on companies within the fashion industry with at least $100 million in annual revenue that operate in New York, which would cover the majority of the world's largest fashion brands. Among other requirements, the Fashion Act would require companies to list and track at least 50% of their supply chain from start to finish and publish annual "social and environmental sustainability" reports. The Act remains pending.

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/803406/Independent_review_of_the_Modern_Slavery_Act_-_final_report.pdf

4 https://bills.parliament.uk/publications/41860/documents/531

5 *Id.*

6 https://www.sec.gov/news/press-release/2022-46

Bottom Line

Regulations and legislation like the SEC's Proposed Rule, the UFLPA, and New York's Fashion Act are examples of ESG measures that are now law or may likely become law in the not-so-distant future, and are largely modeled on existing UK and EU regulations. This patchwork of regulation is reflective of the prevailing view that ESG measures are no longer optional. Virtually every industry and publicly-traded company may be subject to regulation and legislation addressing ESG disclosure requirements in the short term, and investors are demanding more transparency and disclosure as a result.

So what does this mean for multi-national companies doing business in the U.S. and abroad? At a minimum, U.S. multi-nationals operating in the UK and EU should have processes in place for ESG data collection. If not, these companies should assemble an appropriate cross-functional team (with a designated leader to "own" the ESG function) and begin the process of collecting, analyzing, and mapping disclosures subject to existing regulations, including, but not limited to, the EU Taxonomy's and TCFD's climate-related disclosures. This gap analysis will be helpful in identifying shortfalls in compliance and assessing whether a company's targets or previous representations should change or improve. Because of the overlap between the UK and EU regulations and those in the U.S., companies that comply with these existing requirements will be ahead of the curve in preparing disclosures subject to future climate-related regulations that the SEC may eventually adopt, which will likely mirror some portion of the TCFD requirements. Mapping to the TCFD now will ultimately streamline reporting obligations and centralize ESG compliance when some iteration of the Proposed Rule takes effect.

Much like efforts in the U.K. to create greater supply chain transparency abroad with stronger proposed amendments to the Modern Slavery Act, current and pending legislation in the U.S. likewise seeks to hold companies more accountable for unethical practices within their supply chain. This emerging trend of ensuring that companies and the goods they produce are socially responsible is a mainstay, and other state legislatures will likely follow suit in proposing equitable labor and supply chain practices across diverse industries. Companies would be wise to start taking a closer look at their supply chains, including requesting data regarding the sourcing, manufacturing, and delivery of goods in their value chain continuum.

Beyond the prescriptive mandates of the UK and EU regulations, these laws foreshadow the regulations on the horizon in the U.S. and serve as a road map for ESG disclosure and compliance, even in the absence of similar (but expected) regulations in the U.S. Publicly-traded companies should take advantage of this critical window now.

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