The Road to Decarbonisation Paved by ESG

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Environmental, Social, and Governance (ESG) compliance has been high on the corporate agenda globally in recent years, as stakeholders (from institutional investors and providers of finance to retail shareholders and end customers) and the market more generally demand a higher level of sustainability, accountability, and transparency from companies and those managing them. Whilst listed companies and the very largest private companies across the UK, EU, and US are already required to make certain ESG disclosures and public reports, ESG regulation has largely been a voluntary regime. The regulatory landscape is, however, set to change at an accelerated pace over the next few years. This article note discusses the recent and pipeline changes across the UK, EU, and US.

For more on ESG generally, see Environmental, Social, and Governance (ESG) Resource Kit.

Introduction

Post COP26, countries have been releasing ambitious plans to ensure global warming does not exceed 1.5°C compared with pre-industrial levels in line with the Paris Agreement. These plans include:

- Reliance on cleaner and greener fuels, through the expansion of renewable energy infrastructure, and investment pledges for new technologies such as hydrogen production or carbon capture, utilisation and storage (CCUS) –and–
- More sustainable modes of transport (for example, the UK Government's strategy to ensure all new vehicles sold after 2030 are electric, and that all new vehicles are fully zero emissions at the tailpipe from 2035)

Governmental organisations and regulatory authorities have a key role in driving the transition to a low-carbon economy, from offering grants and subsidies to incentivise and encourage innovation and new ideas, to introducing taxes and penalties to discourage or penalise non-compliance. However, in addition to the role played by governments and international bodies, it is recognised that businesses themselves can demonstrate leadership in the global fight to avoid a climate emergency—directly in terms of their industry practices and value chain ecosystem and indirectly by influencing consumer behaviour and market practice.

Proposed UK Corporate Governance Reforms

The UK Government has outlined its commitment to enhancing corporate transparency and reducing the opportunity for economic crime by proposing to tighten up governance rules and increase board accountability.

In furtherance of this renewed focus on the 'G' in ESG, the UK Government has also announced (via publication of its Corporate Transparency and Register Reform White Paper) its intention to reform the Registrar of Companies in the United Kingdom (Companies House). The key reforms include:

- New Querying Powers: Companies House is currently required by law to accept information if it is "properly delivered" and has very limited powers to correct or query information even if it suspects that submitted information is erroneous or fraudulent. Under the new regime, Companies House will have extended powers to query suspicious appointments or filings, request further evidence or reject filings, and implement sanctions in the event of non-compliance. Further, Companies House is to be granted enhanced data-sharing rights with law enforcement agencies, other governmental bodies and the private sector. The UK Government hopes to shift Companies House's role from a passive administrator of company information to a more active custodian of reliable information on the register.
- New Verification Procedures for Officers / Persons with Significant Control (PSC) over the Company: The UK Government is keen to clamp down on fraudulent filings and shell companies without substance, and to ensure that persons listed as board members and PSCs of companies have actually agreed to act. New digital identification procedures will be required for persons connected with a company (including persons incorporating or filing on behalf of a company, i.e., agents and professional advisers) and Companies House will have the power to reject appointment notifications and sanction companies if such persons remain unverified on the system. Further, the new regime will largely prohibit corporate directorships in line with the UK Government's goal to prevent UK companies being used as vehicles for economic crimes, including money laundering.
- Enhanced Ownership Transparency Requirements: Companies will be required to provide a one-off full shareholder list to ensure more accessible information is on the register. A company claiming an exemption from the requirement to provide details of a PSC will also be required to give a reason.

New UK Climate-Related Disclosures Regime

The Task Force on Climate-related Financial Disclosures (TCFD) was established by the Financial Stability Board (an international body) to help identify the information needed by investors, lenders and insurance underwriters to appropriately assess and price climate-related risks and opportunities. The TCFD's recommendations are contained in its June 2017 report, which is focused on four key pillars:

- Governance: A company's governance and risk management approach thereto
- Risk Management: An assessment of climate-related risks and opportunities material for a company's business
- Strategy: How these risks and opportunities impact a company's strategy and business model –and–
- Metrics and Targets: Indicative targets and performance metrics applied to managing identified risks and opportunities

In April 2022, the UK became the first G20 country to mandate TCFD-aligned requirements to report on climate-related risks and opportunities, including the outlining of a business' emission reduction plans and sustainability credentials.

These requirements, as currently implemented, apply to large UK companies (including many of the largest listed entities and any private company having over 500 employees and £500 million in turnover) and to UK financial institutions (including banks and insurers). In-scope companies are expected to report at the group level (or at the company level if not included within consolidated group reporting, noting that where a parent company does not produce consolidated group accounts the scope criteria should be applicable to the aggregate number of employees and amount of turnover of the entire group). Where a subsidiary's activities are included within a consolidated group report of its UK parent, such subsidiary will not be required to produce a separate report. The UK Government has further clarified that where a UK group is in-scope, the UK parent will be expected to report (within its annual report) on the global operations of the group (irrespective of whether the activities of the group are conducted through a UK or an overseas subsidiary).

The UK Government plans to roll-out these mandatory TCFD-aligned disclosure requirements to smaller businesses, with the goal being that the entire UK economy is encapsulated within the regime by 2025, in line with the UK Government's strategy for the UK to become the "greenest" financial system in the world.

Proposed EU Corporate Sustainability Due Diligence Duty

The European Commission has outlined a proposal for a Directive establishing a corporate sustainability due diligence duty (CSDD). The CSDD is designed to tackle human capital and environmental issues across a company's value chain, incorporating a company's subsidiaries and its direct and indirect established business relationships. The CSDD will require in-scope companies to:

- Create, manage, and oversee the integration of due diligence into all corporate policies and adopt a standalone due diligence policy, which should describe the company's approach to due diligence and the processes put in place to implement due diligence, and set out a code of conduct for employees and subsidiaries, which will need to be updated on an annual basis.
- Identify and assess the adverse impacts on human rights (including slavery, forced or child labour, exploitation of workers, or poor standards of working conditions) and the environment (including pollution, harmful emissions, biodiversity loss or other negative impact on natural resources) of a company's operations.
- Take steps to prevent and mitigate and, if possible, end any identified potential and actual adverse impacts on human rights and the environment, including the development and implementation of a prevention action plan in conjunction with affected stakeholders.
- Establish a complaints procedure and monitor the relevant operations and measures on an ongoing basis.

In-scope companies will be required to publicly report on these matters.

The CSDD, once enacted, will not just apply to EU companies. It will apply to the following:

Group 1: EU companies having more than 500 employees with a net global turnover greater than EUR 150 million in the last financial year (Group 1 will affect around 9,400 companies)

Group 2: EU companies having more than 250 employees, with a net global turnover greater than EUR 40 million in the last financial year, provided at least half of this turnover is generated in a defined high-risk sector, including textiles, agriculture, forestry and fisheries, manufacture of food products, wholesale trade of certain agricultural or consumer products, or the extraction or wholesale trade of mineral resources (Group 2 will affect around 3,400 companies)

Group 3: Third country (i.e., non-EU) companies with either:

a) A turnover generated in the EU greater than EUR 150 million in the last financial year (Group 3a will affect around 2,600 companies) –or–

b) A turnover generated in the EU greater than EUR 40 million, provided at least 50% of its net worldwide turnover is generated in a high-risk sector (Group 3b will affect around 1,400 companies)

The CSDD also introduces duties for directors of the EU companies falling into Groups 1 and 2, requiring them, in the course of their acting in the best interests of the company (the existing duty), going forward to specifically consider the human rights, climate change and other environmental consequences of company and board decisions.

The proposal also sets out, where the law governing their relations so entitles them to, temporary suspension (whilst prevention and minimisation efforts are being pursued) or termination (if the potential adverse impact is so severe, and only in a last resort scenario) actions for companies in the context of their contractual dealings in the event that a business within their value chain is unable to meet the requirements of the CSDD (including the requirement to refrain from entering into new or extending existing relationships with such non-complying businesses). The CSDD prioritises engagement with businesses (via avenues such as industry cooperation, industry schemes and multi-stakeholder initiatives) rather than termination of contractual relationships, with the aim being that all parties work together to prevent and mitigate adverse potential impacts on human rights and the environment.

UK / non-EU companies (and their directors and officers) need to be aware of these changes if they fall within Group 3, but even companies not falling within the scope of the CSDD should familiarise themselves with the scope of the CSDD if they interact with or form part of the value chain of any of the companies falling with Groups 1–3. Micro companies and SMEs are not directly concerned by the CSDD (as they are under the turnover thresholds set out above). However, the European Commission proposes to provide supporting measures (such as platforms, portals, websites and potential financial support) for micro companies and SMEs, which could be indirectly affected as a result of falling within the value chain of an in-scope company. Further, the CSDD sets out measures to limit the passing on of the burden from large in-scope companies to smaller out-of-scope suppliers in the value chain and to use fair, reasonable, non-discriminatory and proportionate requirements vis-à-vis micro companies and SMEs.

A new authority (the European Network of Supervisory Authorities) will be set-up by the European Commission to take charge of administrative supervision of the CSDD and related changes, including, in conjunction with relevant Member States, being granted powers (such as compliance orders, sanctions and civil liability) to enforce non-compliance.

Proposed EU Corporate Sustainability Reporting Directive

The Council of the European Union and the European Parliament reached a provisional agreement on 21 June 2022 to amend the 2014 Non-Financial Reporting Directive (Directive 2014/95/EU) (NFRD) with a new Corporate Sustainability Reporting Directive (CSRD) which would introduce more detailed reporting requirements on sustainability issues such as ESG impacts and human rights to a wider group of companies. One of the key aims of the CSRD is to end greenwashing and lay the foundations for a uniform set of sustainability reporting standards on an international scale. CSRD reporting must be certified by an accredited independent auditor or certifier (either in the EU or one established in a third country, as the case may be).

The proposal is for the CSRD requirements to apply to the following types of companies:

- All large EU companies having more than 250 employees with an annual turnover greater than EUR 40 million
- All EU companies listed on regulated markets
- Listed EU SMEs –and–
- All third country (i.e., non-EU) companies having both an annual turnover generated in the EU greater than EUR 150 million and at least one subsidiary or branch in the EU

Planned implementation of the new CSRD regime is from 1 January 2024 for companies already subject to the NFRD, from 1 January 2025 for other companies that are not already subject to the NFRD, and from 1 January 2026 for listed SMEs (subject to an opt-out for a transitional period, which would not bring qualifying SMEs in-scope until 2028).

Proposed US Disclosure of Climate-Related Risks, Financial Impacts, and Emissions

The US Securities and Exchange Commission (SEC) has proposed a substantial set of new rules that would, for the first time, mandate a wide range of climate-related disclosures to the public. When finalized, these proposed rules may carry significant costs by requiring each US registered company to integrate additional internal controls, financial reporting, emissions tracking, disclosures, and in some cases, third-party attestation.

The proposed rules would mandate a number of new climate-related disclosures by a US registrant (whether domestic or foreign) in its registration statements and annual reports filed with the SEC. The proposed disclosure framework is modeled primarily on the TCFD recommendations, while the proposed emissions reporting requirements are based on the Greenhouse Gas Protocol's concept of scopes and related methodology.

The key new disclosure obligations proposed by the SEC include the following:

- Greenhouse Gas (GHG) Emissions Reporting: The proposed rules mandate disclosures on an annual basis of the registrant's direct GHG emissions (commonly referred to as Scope 1 emissions) and separately, disclosures of indirect GHG emissions from the purchase of electricity and other forms of energy (Scope 2 emissions). These disclosures would need to be expressed both as disaggregated constituent GHGs and GHG emissions in the aggregate, as well as in absolute terms (i.e., excluding carbon offsets) and in terms of intensity (i.e., per unit of economic value or production). GHG Scope 1 and Scope

2 emissions reporting would be required without regard to materiality.

- Attestation of Scope 1 and Scope 2 Emissions Reporting: In addition to the mandated reporting for all filers, the proposed rules require third-party attestation for Scope 1 and Scope 2 disclosures for accelerated filers or large accelerated filers. The attestation would be provided by an independent GHG emissions attestation provider who meets certain requirements.
- Scope 3 Emissions Reporting: The proposed rules also may require similar disclosure of indirect upstream and downstream emissions from a registrant's value chain (Scope 3 emissions). These Scope 3 disclosures are required only if the emissions are "material" quantitatively or qualitatively, or if the company has set a GHG emission reduction target that includes Scope 3 emissions.
- Climate-Related Risk, Impacts, and Governance: Additionally, the proposed rules would implement a new climate-related risk disclosure framework modeled on guidance published by the TCFD and which also relies on the GHG Protocol. The required disclosures would include, among other things: how the company identifies climate-related risks; how those risks have materially impacted or are likely to materially impact the company's business and financial statements in the short-, medium-, and long-term; and how those climate-related risks have affected or are likely to affect the company's strategy, business model, and outlook.
- Climate-Related Targets, Goals, and Transition Plans: The proposed rules would mandate further disclosure of information related to a registrant's publicly announced climate-related targets, goals, and/or transition plans. Critically, the proposed rules would require disclosure of the scope of such goals, the company's timeline to meet those goals, how the company intends to meet those goals, and any relevant metrics and progress.
- Climate-Related Items in Financial Statements: The proposed rules would require registrants to analyze and disclose whether and how climate-related events (i.e., severe weather events as well as physical risks) and transition activities impact line items above a threshold amount on their consolidated financial statement, as well as impact the financial estimates and assumptions used.

The SEC will consider the public's comments on the rules before they are finalized and voted on by the SEC Commissioners. Overall compliance costs are front and center with the SEC's proposal. While the proposal is designed to be easily socialized due to its heavy reliance on terminology and work done globally in this arena, particularly by the TCFD, the demands required of reporters in order to comply with the proposal will be a topic of significant debate. Whatever the outcome of the rulemaking process, the final rules will most certainly be subject to legal challenges.

Push to Expand US Human Capital Disclosure

In 2020, the SEC adopted new disclosure rules that required each registered company to provide a description of the company's human capital resources and any human capital measures or objectives that the company focuses on in managing the business. The rules did not define human capital or elaborate on specific requirements for human capital disclosures beyond a few examples provided in the text of the rule.

The SEC has indicated that it plans to revisit the human capital disclosure requirements and potentially adopt more prescriptive rules. The expanded rules could touch on turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety. SEC Chair Gensler has stated that he supports enhanced disclosure requirements for human capital disclosure, and he has suggested that disclosure requirements should include increased use of metrics and quantitative information. Certain lawmakers are pushing even further. Two members of Congress recently wrote Chair Gensler calling for the SEC to require the disclosure of standardized data of race, ethnicity, gender, sexual orientation, and disability status, not only at the board, executive, and workforce levels – but also when it comes to supplier diversity and procurement data. It is likely the SEC will propose some expansion of the human capital disclosure rules in the near future, but it remains to be seen how far that proposal will go.

Key Takeaways

Governments and regulators are starting to focus on the 'S' and 'G' in ESG, in addition to the direct relationship the 'E' has on the journey to decarbonisation. As legal counsel, you should stay abreast of key developments by lawmakers, who will need to ensure that the new requirements (including additional costs and administrative burdens) on companies and the new duties and responsibilities to be shouldered by directors and officers are proportionate to effecting the desired change. Additionally, you should expect to see developed nations endeavor to balance the aspiration to implement market-leading ESG regulation with the economic necessity of ensuring that countries with such rules remain attractive for business and investment.

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Derek Jones has extensive UK and cross-border corporate finance and mergers and acquisitions experience, including acquisitions, disposals, joint ventures, reorganisations, takeovers, mergers and demergers and equity issues. His particular focuses are the technology and energy sectors and investments by and in Russian companies.

Travis Wofford, Partner, Baker Botts L.L.P.

Travis Wofford is Chair of the Corporate Department in Houston, Vice Chair of the Global M&A Practice, and member of the Securities Opinion Committee. His practice focuses on mergers and acquisitions, shareholder engagement and corporate advisory work, for which he has been recognized in, among others, Lawdragon's "500 Leading Dealmakers in America" (2021). He regularly counsels clients on fiduciary duty, sustainability and corporate governance matters, including controlling stockholder and related party transactions, for which we has been recognized by, among others, the National Association of Corporate Directors' "Directorship 100: Governance Professionals and Institutions" (2022). Travis has assisted many clients in takeover defense planning, including "poison pill" rights plans. Travis has particular experience in the energy and TMT sectors.

Travis is regularly sought after for complex securities matters. He was named a "2021 Texas Trailblazer" by *Texas Lawyer Magazine/Law.com* for his financing structures, including those for renewable energy investments. Travis also represented Liberty Media Corporation in sponsoring the first public-company-sponsored special purpose acquisition company (SPAC) for corporate financing purposes, as well as numerous parties to SPAC IPOs and "DeSPAC" business combinations.

Travis routinely advises management and directors of public companies on day-to-day corporate and securities matters, including corporate governance, public company reporting, and stock exchange rules and requirements. As an avid proponent of corporate governance education, Travis sits on the board of directors of NACD's Texas Tricities chapter and regularly provides board, individual director and general counsel training and guidance.

Travis has been sought out for his views on the market by, among others, *The Wall Street Journal*, *The Financial Times*, Politico, *Law360*, MergerMarket, and *Institutional Investor*.

Sterling Marchand, Partner, Baker Botts L.L.P.

Sterling Marchand's practice focuses on complex litigation, including environmental and commercial matters, as well as corporate investigations and white-collar criminal defense.

Mr. Marchand represents corporate and individual clients at trial in state and federal courts in matters involving contractual disputes, allegations of price fixing, and the Clean Air Act.

Mr. Marchand counsels corporate clients in investigations by government agencies, in both criminal and civil contexts, including FCPA, fraud, securities, and antitrust investigations. He also assists in conducting internal investigations and advising clients on risk management and compliance.

Additionally, Mr. Marchand guides clients on campaign finance, ethics, and lobbying compliance. He has assisted corporate clients with investigations by the FEC and in establishing a PAC.

Prior to joining Baker Botts, Mr. Marchand served as a policy advisor to the U.S. House Committee on Homeland Security. In that capacity, he worked with members of Congress, advising them on legislation and oversight of the Department of Homeland Security. Mr. Marchand was responsible for matters pertaining to critical infrastructure protection (e.g., energy sector, chemical facilities, public transportation).

Quentin Wiest, Special Counsel, Baker Botts L.L.P.

Quentin advises companies on compliance with federal securities laws and stock exchange listing requirements. In his practice, he assists companies with SEC and stock exchange reporting and disclosure requirements, stockholder meetings and proxy statements, stockholder proposals, beneficial ownership reporting requirements and corporate governance. Additionally, Quentin represents companies in a broad range of corporate transactions, including offerings of equity and debt securities as well as mergers and acquisitions.

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SJ Beaumont advises clients on a wide range of corporate matters, including cross-border mergers, private acquisitions, public takeover offers. She has business fluency in French and has transactional experience in France and the wider Francophone world.

SJ's practice primarily focuses on Energy and Technology (with a particular focus on the Low Carbon Economy Transition and its interaction with disruptive and innovative technologies, including Blockchain / DLT).

SJ is a member of the ESG Group and is actively involved in the firm's Diversity & Inclusion efforts, including leading the firm's summer internship programme with the Social Mobility Foundation. She also lectures part-time at the Notre Dame Law School on the subject of Cross-Border Transactional M&A.

Prior to joining Baker Botts in June 2016, SJ worked at a magic circle firm in both London and Paris.