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Addressing ESG considerations in the M&A context

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Introduction

Environmental, Social and Governance ("**ESG**") considerations are now essential elements in deal-making. Taken together, ESG covers an extraordinarily broad scope, including but not limited to:

- **Environmental**: climate change and greenhouse gas emissions; energy efficiency; resource depletion, including water; hazardous waste; deforestation; and air, land and water pollution and waste management.
- **Social**: human rights; working conditions, including slavery and child labour; local and indigenous communities; conflict; health and safety; employee relations; and equality and diversity.
- **Governance**: bribery and corruption; tax; transparency; executive pay; political lobbying and donations; shareholder rights; board independence, diversity and structure; and ESG governance framework, including supply chain management and customer engagement.

Although individual elements of the "E", "S" and "G" have been present for decades, organisations are growing more conscious of the dual aims – and, increasingly, the related legal requirements – of building sustainable businesses and managing exposures to ESG risks.

The bifurcation of the ESG landscape that has developed in recent years has continued this year, particularly in the U.S. For some years now, individual U.S. states have started passing "pro-ESG" and "anti-ESG" laws and regulations.

Some states and cities have sought to embed ESG considerations in law. For instance, California integrated ESG factors into its Public Employees' and Teachers' Retirement Systems. Illinois' Sustainable Investing Act (2020) states that "all public or government agencies involved in managing public funds develop, publish, and implement sustainable

investment policies". New York City announced plans to reach net-zero greenhouse gas emissions across its investment portfolios by 2040.

Other states and cities have seen growth in "anti-boycott" bills targeting financial institutions that "boycott" or "discriminate against" companies in certain sectors. States have also seen an increase in "no ESG investment" bills prohibiting the use of state funds for ESG or social investment purposes. Under these anti-ESG bills, states are prohibited from investing in strategies that consider ESG factors for any purpose outside of maximising financial returns. From 2020 to the date of this publication, more than 30 U.S. states have introduced over 100 anti-ESG laws. As of February 2024, there were at least 60 anti-ESG bills that have either been introduced by a state legislature but remain pending in committee or are supposed to carry over from the last legislative session to the 2024 session.[1] The most active states were Oklahoma, South Carolina, Missouri and West Virginia.[2]

At the same time, legislators and regulators around the world increasingly focus on ESG considerations, and related initiatives in the private sector – particularly amongst institutional investors – have proliferated. Regulation has grown on multiple fronts, including new affirmative diligence and disclosure requirements. Cross-border and multinational deals will require purchasers in M&A transactions to be mindful of both; they will be required under the laws of certain jurisdictions to follow mandatory diligence procedures and, in control transactions, to report on the operations of newly acquired businesses. This will become particularly relevant as an ever-increasing number of jurisdictions introduce ESG regulations with wide scopes and differing – and sometimes novel – due diligence and reporting obligations.

Furthermore, regulators and legislators are increasingly attending to antitrust issues, noting that ESG initiatives are subject to antitrust laws, as with all collaborations amongst industry participants.

This chapter focuses on current legal developments and market practice affecting ESG due diligence in M&A transactions. It begins by discussing ESG diligence requirements in selected markets, then highlights certain risk-management concerns, addresses benefits for businesses of robust ESG diligence and concludes with a consideration of ESG metrics and ratings agencies. As this is a limited survey in a rapidly evolving area, there is now, and surely will soon be, other national and super-national legislation that implicates these areas.

ESG: legislative and judicial action

ESG regulations affecting buyers conducting due diligence

Europe

- *European Union Corporate Sustainability Due Diligence Directive ("**CSDDD**")*

The CSDDD is arguably the most significant new EU law. It requires companies to conduct supply chain due diligence in their own operations and along their so-called "chains of activity". The CSDDD will harmonise existing minimum diligence requirements across the EU and may serve as a benchmark for other countries wishing to adopt similar legislation.

Overview: In April 2020, the European Commissioner for Justice, Didier Reynders, announced that the European Commission would commit to introducing rules for mandatory environmental and human rights due diligence.[3] This was followed in February 2022 by the European Commission publishing a proposal for the CSDDD as part of its sustainable corporate governance initiative.[4] The draft is built upon the UN's

Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises' Responsible Business Conduct Matters. Following the adoption of negotiating positions by the Council of the European Union in December 2022 and the European Parliament in April 2023 (the so-called JURI Report) and after intense trialogue discussions between the EU institutions in the beginning of 2024, on 24 April 2024, the European Parliament finally passed the CSDDD.[5] This step marks the end of the key stages of a four-year legislative process. In a last step, the CSDDD must now be formally adopted by the Council of the European Union, which is expected to occur before the end of 2024. Once the CSDDD enters into force, Member States will need to transpose it into national law within two years, i.e., by the end of 2026. Depending on their size, companies will have between three to five years from the directive entering into force to implement its requirements (i.e., likely between 2027 and 2029). The CSDDD will require both EU companies and non-EU companies operating within the EU and meeting certain turnover thresholds to identify and, where necessary, prevent, end or mitigate their activities' adverse impacts on human rights and the environment. Unlike previous drafts, which referred to the entire "value chain" of a company, the final compromise text of the CSDDD now centres around the company's "chain of activities". "Chain of activities" is defined as: (*a*) the activities of "upstream" business partners related to the production of goods or provision of services by the company, including design, extraction, sourcing, manufacture, transport or development of products or services; and (*b*) the activities of "downstream" business partners related to the distribution, transport or storage of products, where undertaken for the company or on its behalf. The disposal of products as well as activities of a company's "downstream" business partners related to the services of the company are excluded. Business partners include entities with whom the company has a commercial agreement (direct business partners) and other entities that perform business operations related to the operations, products or services of the company (indirect business partners). In line with the earlier drafts, the final text also provides for civil liability so that companies can be held liable for damage caused at home or abroad by their own business activities or by those of their subsidiaries. Victims will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures.[6] However, in contrast to the previous draft versions of the CSDDD, the current text excludes liability if the damage was caused only by a company's business partner. EU Member States will be responsible for supervising compliance with these new rules and are required to develop rules on sanctions for noncompliance.[7]

Primary objectives: The CSDDD outlines the following primary objectives: (*i*) to identify and assess potential adverse impacts on human rights, the environment and good governance in a company's own operations, those of its subsidiaries, and those of its direct and indirect upstream and downstream business partners; (*ii*) to prevent, mitigate or bring to an end such adverse impacts; (*iii*) to ensure that companies can be held accountable for such impacts; and (*iv*) to provide anyone who has suffered harm caused by businesses' activities effective remedies in accordance with national law. In addition, companies will need to have a plan to ensure that their business strategy is compatible with limiting global warming to 1.5°C, in line with the Paris Agreement.[8]

Applicability: The directive will apply to:

(1) EU companies with more than 1,000 employees and a net worldwide annual turnover of over EUR 450 million (or ultimate parent companies of such a corporate group);

(2) EU companies with (*a*) EU franchising or licensing agreements for annual royalties that exceed EUR 22.5 million, and (*b*) an annual net worldwide turnover of over EUR 80 million (or ultimate parent companies of such a corporate group);

(3) non-EU companies that generate at least EUR 450 million in net turnover in the EU; and

(4) non-EU companies with (*a*) EU franchising or licensing agreements for annual royalties that exceed EUR 22.5 million in the EU, and (*b*) an annual net turnover of over EUR 80 million in the EU (or ultimate parent companies of such a corporate group).

For both EU and non-EU companies, the thresholds must have been met for at least two consecutive financial years in order for the CSDDD to apply. Smaller "out-of-scope" companies that are part of the "chain of activities" of in-scope companies will also be indirectly affected by the directive as the in-scope companies will require them to comply.

Effects: The CSDDD will force companies to understand the details and actors within their chains of activity, particularly where they may be at risk in the areas of: (*i*) human rights (e.g., charters and conventions relating to social rights, trade union activities and investment chains); (*ii*) environment (e.g., the impact on climate change, deforestation, water quality, use of sustainable resources, biodiversity and ecosystems); and (*iii*) good governance (e.g., bribery, anti-money laundering and tax-compliance issues).

The final compromise text of the CSDDD establishes a corporate due diligence obligation and requires in-scope companies to implement certain human rights and environmental due diligence measures. These include the following:

- developing and integrating due diligence into existing corporate policies and management systems and implementing a dedicated due diligence policy;
- identifying actual and potential adverse human rights and environmental impacts arising from the company's own operations or those of its subsidiaries and, where related to their chains of activities, those of its business partners;
- preventing or, where appropriate, mitigating potential adverse impacts, including implementing prevention action plans, seeking contractual assurances from direct business partners that they will ensure compliance with the company's code of conduct/prevention action plan (including by establishing corresponding contractual assurances from their respective partners if their activities are part of the company's chain of activities), investing into management or production processes, providing targeted and proportionate support to enable small and medium-sized enterprises ("**SMEs**") to comply and, where relevant, collaborating with other entities to bring the adverse impact to an end;
- bringing actual adverse impacts to an end or minimising the extent of their impact by taking appropriate measures;
- establishing a complaints procedure that enables affected persons, trade unions and civil society organisations to submit complaints where they have legitimate concerns about the actual or potential human rights and environmental impacts of the company's operations and along its chain of activities; and
- monitoring the effectiveness of identification, prevention, mitigation, ending and minimisation of the adverse impacts by carrying out periodic assessments of the company's operations and measures.

Companies not already in scope of certain other reporting requirements must publish an annual statement on their websites, reporting on matters in scope of the CSDDD. The

European Commission has been tasked with adopting delegated acts by March 2027, providing further information on the content and criteria of such disclosures.

The definition of "chain of activities" excludes "downstream" business partners in respect of services. As a result, any services provider, including a financial sector undertaking, is not required to apply the due diligence obligations to its clients, borrowers and other users of its services. Financial sector undertakings are required to apply the due diligence obligations to their "upstream" suppliers, but there is some uncertainty as to the relevant types of suppliers and the scale of their due diligence.

Recital 51 notes that the OECD Guidelines for Multinational Enterprises and ancillary financial sector guidance provide "indications of the types of measures that are appropriate and effective for financial undertakings to take in due diligence processes" and states that "[r]egulated financial undertakings are expected to consider adverse impacts and to use their so-called 'leverage' to influence companies". Recital 51 further explains that "[t]he exercise of shareholders' rights can be a way to exercise leverage". It is unclear which obligations in the operative part of the directive these recital refer to.

Civil liability: This new directive is notable because companies can be held liable in accordance with national law for any violations arising out of adverse impacts on human rights, the environment and governance that either they or their subsidiaries have caused or contributed to by acts or omissions. While a company will not incur civil liability for damage caused only by a business partner in its chain of activities, the final compromise text of the CSDDD notably provides for joint and several liability where the damage was caused "jointly by the company and its subsidiary, direct or indirect business partner". Claims can be brought by so-called stakeholders, which include: the company's employees; the employees of its subsidiaries; trade unions and workers' representatives; consumers and other individuals, groupings communities or entities whose rights or interests are or could be affected by the products, services and operations of the company, its subsidiaries and its business partners; national human rights and environmental institutions; and civil society organisations whose purposes include the protection of the environment. The CSDDD sets out procedural provisions relating to disclosure of evidence, injunctive measures and costs.

Unlike the European Commission and the European Parliament's proposals, the final text of the CSDDD does not extend a director's duties of care to act in the best interest of the company to encompass the short-, medium- and long-term consequences of their decisions on human rights, climate change and the environment.

Areas of consideration: Companies will incur administrative and financial burdens in connection with changes required to implement the obligations imposed by the CSDDD. These burdens include engaging with potentially different tools to understand and track their chains of activity.

- *European Union Deforestation Regulation (the "**EUDR**")*

On 29 June 2023, the EUDR came into force.[9] The EUDR aims to curb the EU's contribution to trade-induced global deforestation by keeping products linked to illegal production and deforestation off the EU market. From 30 December 2024 (or 30 June 2025 for micro or small businesses), it prohibits the placing and making available on the EU market, as well as the export from the EU market, of certain commodities (cattle, cocoa, coffee, oil palm (i.e., palm oil), rubber, soya and wood ("**Commodities**")) as well as products that contain, have been fed with or have been made using these Commodities ("**Products**"). The only exceptions are if: (*i*) they are deforestation free (i.e., the relevant Commodities used were produced on

land that was not subject to deforestation or forest degradation after the cut-off date of 31 December 2020); (*ii*) they have been produced in accordance with the relevant legislation of the country of production (including human rights and Indigenous Peoples' rights laws); and (*iii*) they are covered by a due diligence statement, which contains information to ensure that the Commodities and Products are deforestation free and compliant with all relevant applicable laws.[10] Notably, the EUDR only applies to Commodities and Products produced on or after 29 June 2023 (except for timber and timber products, which are covered if produced before that date and placed on the EU market from 31 December 2027).[11]

The EUDR applies to any natural or legal person who, in the course of a commercial activity, places Products on or exports Products from the EU market ("**Operators**") as well as any person in the supply chain who trades Products already available on the EU market ("**Traders**").[12]

Operators and non-SME Traders must assure traceability to plot level and implement a due diligence system to avoid sourcing of Commodities or Products that are not deforestation free or have not been produced in accordance with the relevant legislation of the country of production. The regulation sets out three steps of the due diligence process:

(1) gathering all relevant information (e.g., country and geolocation of production facility/plot, adequately conclusive and verifiable information that the relevant products are deforestation free and that the production of the Commodities has been conducted in accordance with the relevant legislation of the country of production);

(2) assessing the risk of noncompliance with this regulation; and

(3) mitigating risks, if present, to a negligible level.[13]

In addition to the due diligence requirements, Operators and non-SME Traders must annually report on their due diligence system and the steps taken by them to implement their due diligence obligations.[14]

Member States' must designate competent authorities responsible for (*i*) verifying compliance of Operators and Traders with due diligence requirements, and (*ii*) verifying compliance of relevant goods and products with this legislation. Risk analysis information and the benchmarking system, among others, are intended to support and guide this process.[15] The EUDR also provides a list of sanctions to be established in national legal systems, which includes fines, seizure of goods and products, confiscation of revenues, prohibition of economic activities and exclusion from public tenders.[16]

Other European due diligence regulations

- *French vigilance law*

In 2017, France introduced into law a duty of vigilance, which requires large companies to design, implement and publish a vigilance plan that includes due diligence measures to identify risks and forestall serious infringements of, or harm to, human rights and fundamental freedoms, personal health and safety and the environment.

In-scope, companies are required to implement the following vigilance measures:

- risk mapping to identify, analyse and rank those risks;
- due diligence on all subsidiaries, subcontractors or suppliers with which a commercial relationship is established;
- appropriate actions to mitigate risks or prevent serious harm;

- the creation of a system to ensure alerts are raised over risks that eventuate; and
- a system to control the implementation of the above measures.

The law applies to companies with a head office in France that, for two consecutive financial years, (*i*) employ at least 5,000 employees (themselves or together with their direct or indirect subsidiaries whose head offices are also located in France), or (*ii*) employ at least 10,000 employees (by themselves or together with their direct or indirect subsidiaries, regardless of where their head offices are located).

Foreign companies (i.e., companies without a head office in France) do not fall into the scope of the act as the legislation is part of the chapter of the French Commercial Code on joint-stock companies (*sociétés anonymes*) and simplified joint-stock companies (*sociétés par actions simplifiées*) governed by French law. However, it would apply to their French subsidiaries if they reach the relevant threshold.[17]

The law provides for a civil liability proceeding, whereby companies failing to comply can be sued and ordered to compensate the loss that could have been avoided had the vigilance law's obligations been fulfilled. Claims have been brought on that basis, but there have been no decisions yet.

The vigilance law also provides for injunctive relief, whereby the Paris Civil Court can order companies to comply with their duties. Any person with a "legitimate interest" has standing to initiate that proceeding. There are two stages to any application for an injunction under the vigilance law: (*i*) the party with standing must first send the relevant company a *formal notice* demanding that it complies with its obligations (i.e., to correctly establish and implement a vigilance plan); and (*ii*) if the company does not comply within three months, the notifying party can then file an injunction request with the Paris Civil Court.[18]

Six years after France adopted its law on the corporate duty of vigilance, the Paris Civil Court has rendered several decisions in injunction proceedings brought by non-governmental organisations to compel compliance by companies with their obligations under the law. The first decision was issued in November 2021, with four having been issued between February and December 2023. While the first four requests were all dismissed as inadmissible (on the basis that all the requirements regarding the *formal notice* had not been complied with), the December 2023 decision marked the first time a company was mandated to comply with the vigilance law through an injunction. In its December 2023 ruling, the Paris Civil Court held that the French Postal Service company offered insufficient protection for its employees and ordered the company to confer with employees' representatives to adopt a new plan for subcontractors to minimise the risk of employing undocumented workers.

In January 2024, the Paris Court of Appeal set up a new chamber dedicated to the duty of vigilance and other corporate environmental disputes. In March 2024, that chamber "5-12" held its first hearings in relation to some of the aforementioned injunction requests previously dismissed by the Paris Civil Court, and is expected to render its first decisions during the summer of 2024.

- *German Act on Corporate Due Diligence in Supply Chains*

On 22 July 2021, the German Parliament adopted the Act on Corporate Due Diligence in Supply Chains. This human rights due diligence act aims to implement the 2016 "National Action Plan for Business and Human Rights in the Federal Republic of Germany", which was based on the 2011 UN Guiding Principles on Business and Human Rights. It requires companies to appropriately identify, address and report on human rights risks in their supply and value chains and to enable persons to notify relevant risks and infringements

by means of a complaints procedure or grievance mechanism. The German due diligence obligations along the supply chain extend to the company's own business operations and direct suppliers, and – in a weakened form – to indirect suppliers. As defined by the act, the "supply chain" thereby includes all steps, both domestically and internationally, required to manufacture a company's products and provide its services, starting with the extraction of raw materials and ending with delivery to the end customer. The actions required under the German Act vary based on a number of factors such as the nature and scope of the business, the in-scope company's ability to influence entities in their supply chain, the extent and expected severity of a violation, the possibility of reversing an error and the probability of the reoccurrence of a violation.

The German Act came into force on 1 January 2023 after a one-year grace period, giving companies a transitional period to prepare for their new supply chain due diligence obligations by revising existing compliance management systems, establishing new processes and training employees accordingly. The act applies to companies – regardless of their legal form and including German subsidiaries of foreign companies – that have their registered office or principal place of business in Germany and regularly employ more than 1,000 employees (this threshold was lowered from 3,000 employees at the beginning of this year as part of the tiered application of the act).[19] Additionally, and notably, the act also applies to German branches of foreign companies if such branches themselves meet the employee threshold. Within group companies, the employees employed in Germany by all companies belonging to the group must be considered when calculating the number of employees.

If companies fail to comply with their legal obligations, fines can be imposed. These can amount to up to EUR 8 million or up to 2% of global annual sales, though the turnover-based fine framework only applies to companies with annual sales of more than EUR 400 million. In addition, the company may be excluded from the award of public contracts if the fine exceeds a certain minimum amount.

United Kingdom

The Environment Act 2021, a vehicle for delivering the UK government's 25-year environmental plan, had a significant impact on environmental governance in the United Kingdom. It requires the UK government to set out binding environmental targets and includes significant powers to make regulations that may translate into new obligations for private entities.[20]

United States

- *The Enhancement and Standardization of Climate-Related Disclosures for Investors: Final Rule*

The U.S. Securities and Exchange Commission (the "**SEC**") adopted the Enhancement and Standardization of Climate-Related Disclosures for Investors: Final Rule on 6 March 2024.[21] These rules add new, often prescriptive, climate-related disclosure requirements to Regulation S-K, which primarily governs qualitative disclosures, and Regulation S-X, which governs financial statements.[22] In general, these disclosures address various climate-related risks to the registrant's business, operations and financial condition including disclosure of a registrant's greenhouse gas emissions.[23] The rules require domestic and foreign registrants, including foreign private issuers, to include information related to greenhouse gas emissions, climate-related risks, corporate governance, public climate goals (if any) and transition plans.[24] Registrants must disclose this information in their registration

statements and annual reports filed with the SEC.[25] The Regulation S-K climate-related disclosure must also be included in a filing with the SEC, such as a registration statement or annual report.[26] Finally, the climate-related disclosures must be electronically tagged.[27] However, following its adoption, the SEC has stayed the Final Rule pending the outcome of civil suits brought in the Eighth Circuit challenging the rule's requirements and the SEC's authority to enact such climate disclosure measures (see below).[28]

- *Section 1502 of the Dodd-Frank Act*

Section 1502 of the Dodd-Frank Act – implemented as a rule by the SEC in 2012 – requires all publicly listed companies to disclose their use of tantalum, tin, gold or tungsten sourced from the Democratic Republic of the Congo and its neighbours, if "necessary to the functionality or production" of a product manufactured or contracted to be manufactured by the company.[29] While companies are not required or even encouraged to stop sourcing from the region, they must disclose due diligence efforts – including tracing and auditing – and other steps taken to ensure their purchasing is not funding armed groups or human rights abuses and to address identified risks.[30]

Under the rule, a company that uses any of the designated minerals must conduct a reasonable "country of origin" inquiry, performed in good faith and reasonably designed to determine the source of the material.[31] If the company either knows the mineral did not originate in the covered countries or has no reason to believe the minerals may have originated in the covered countries, then the company must disclose this determination along with a description of its inquiry.[32] If, on the other hand, the company knows or has reason to believe that the minerals may have originated in the covered countries, the company must undertake due diligence on the source and file a "Conflict Minerals Report" outlining the chain of custody of the mineral.[33] Both determinations must be made publicly available on the company's website.[34]

- *2010 California Transparency in Supply Chains Act (the "**Supply Chains Act**")*

The Supply Chains Act became effective in January 2012, making it the first supply chain disclosure act focused on consumers in the U.S.[35] The Supply Chains Act requires all retailers and manufacturers doing business in California "and having annual worldwide gross receipts that exceed one hundred million dollars" to disclose "efforts to eradicate slavery and human trafficking from its direct supply chain for tangible goods offered for sale".[36]

More specifically, the disclosure must outline to what extent, if any, the retailer or manufacturer: (*i*) verifies, evaluates and addresses the risks of human trafficking and slavery in its product supply chain; (*ii*) audits suppliers to ensure compliance with company standards; (*iii*) requires direct suppliers to certify that the supply chains for all constituent parts comply with human trafficking prohibitions enshrined in domestic law where the part is produced; (*iv*) maintains internal accountability standards and procedures in case of violation; and (*v*) trains employees and managers with direct responsibility for supply-chain management.[37] At a minimum, the Supply Chains Act requires disclosure on the company's website "with a conspicuous and easily understood link" or written disclosure within 30 days of having received a request for disclosure from a consumer.[38]

With this focus on disclosure, the Supply Chains Act is intended to provide consumers with the information they need to be "able to force the eradication of slavery and trafficking by way of their purchasing decisions". In other words, the Supply Chains Act may encourage consumers to reward companies with stronger practices and penalise those that fail to effectively monitor their supply chains.[39] Like other reporting statutes, the Supply Chains

Act does not require that companies take steps to monitor their supply chains or eradicate forced labour. It also fails to outline what effective monitoring looks like or what adequate due diligence would entail. Thus, a company that states that it takes no efforts in any of the required reporting areas is still in compliance with the Supply Chains Act.

The Supply Chains Act also does not create a private right of action but instead provides that the exclusive remedy for violation "shall be an action brought by the Attorney General for injunctive relief".[40] However, some consumers and their attorneys have begun to bring cases under California consumer protection statutes focused on unfair competition and false advertising.[41]

- *Uyghur Forced Labor Prevention Act (the "**UFLPA**")*

On 23 December 2021, President Biden signed into law the UFLPA, which took effect 21 June 2022.[42] The bill imposes various restrictions related to China's Xinjiang Autonomous Region, including prohibiting certain imports from Xinjiang and imposing sanctions on actors responsible for human rights violations there.

Securities issuers required to file annual or quarterly reports with the SEC must disclose certain information related to such issuer's activities in Xinjiang, including certain details on: (*1*) the nature and extent of the activity; (*2*) the gross revenues and net profits attributable to the activity; and (*3*) whether the issuer or affiliate intends to continue the activity.[43] Such information would require disclosure in cases where the issuer knowingly engaged in activity with an entity engaged in building or running detention facilities or providing technology to create mass population surveillance systems in the Xinjiang Uyghur Autonomous Region of China. This would include any entity on the Department of Commerce's Entity List.[44] Additional circumstances requiring disclosure are outlined in the bill, including: (*1*) knowingly engaging in an activity with an entity or affiliate of an entity described in section 7(c)(I) of the UFLPA, including any entity engaged in the "pairing-assistance" programme that subsidises the establishment of manufacturing facilities in the Xinjiang Uyghur Autonomous Region or entities for which DHS has issued a "Withhold Release Order"; and (*2*) knowingly conducting any transaction or dealings with: (*i*) any person the property and interests in property of which were sanctioned by the Secretary of State for the detention or abuse of Uyghurs, Kazakhs, Kyrgyz or other members of Muslim minority groups in the Xinjiang Uyghur Autonomous Region; (*ii*) any person or the property and interests in property of which are sanctioned pursuant to the Global Magnitsky Human Rights Accountability Act (22 U.S.C. 2656); or (*iii*) any person or entity responsible for, or complicit in, committing atrocities in the Xinjiang Uyghur Autonomous Region.[45]

The scope of activities covered by the UFLPA could require companies to examine their supply chains. In particular, the Act extends to cover transactions with entities or affiliates of entities that are themselves engaging in activity in Xinjiang. This is the case even if the issuer itself is not engaging in such activity. The Department of U.S. Homeland Security conducted a request for comment ending March 2022, which included the following question: "What due diligence, effective supply chain tracing, and supply chain management measures can importers leverage to ensure that they do not import any goods mined, produced, or manufactured wholly or in part with forced labour from the People's Republic of China, especially from the Xinjiang Uyghur Autonomous Region?"[46] The U.S. Secretary of Homeland Security is tasked with developing and submitting to Congress a strategy to support enforcement of the provisions of the UFLPA.[47]

Accompanying the UFLPA is the Strategy to Prevent the Importation of Goods Mined, Produced, or Manufactured with Forced Labor in the People's Republic of China (the "**UFLPA Strategy**"), promulgated by the Forced Labor Enforcement Task Force of the Department of Homeland Security. The UFLPA Strategy provides guidance to importers on the nature of due diligence. It also discusses supply-chain management controls expected of importers seeking to comply with the UFLPA, along with the types of evidence required to rebut the presumption.

On 16 April 2024, Representatives Raja Krishnamoorthi (D., Ill.) and Mike Gallagher (R., Wis.), serving as Ranking Member and Chairman respectively of the House Select Committee on the Chinese Communist Party, requested that Secretary of State Antony Blinken "expand and elevate U.S. diplomatic efforts to combat PRC state-sponsored forced labour and strengthen international coordination against this egregious violation of human rights".[48] They stated that while other nations had announced their own versions of the UFLPA to combat forced labour in China, those measures fall short of the standard set forth by the UFLPA.[49] The UFLPA standard would allow companies to build two separate supply chains – one for the U.S. rid of forced supply and another for the rest of the world using forced labour.[50]

- *U.S. Environmental Protection Agency's (the "**EPA**") Final Rules to Reduce Pollution from Fossil Fuel-Fired Power Plants*

On 25 April 2024, the EPA announced final rules to reduce pollution from fossil fuel-fired power plants under the Clean Air Act, Clean Water Act, and Resource Conservation and Recovery Act.[51] With these rules, the government hopes to foster investments in clean energy.[52]

The rules provide that:[53]

(1) existing coal-fired plants and new gas-fired plants must control 90% of their greenhouse gas emissions by using available control technologies (effective 8 July 2024);

(2) coal-fired power plants must comply with the updated Mercury and Air Toxics Standards, which tighten emissions standards for toxic metals by 67% and reduce the emissions standard for mercury from existing lignite-fired sources by 70% (effective 8 July 2024);

(3) coal-fired power plants must limit discharge of pollutants in wastewater (effective 8 July 2024); and

(4) coal ash must be safely managed in areas that previously were unregulated at the federal level (effective 8 July 2024).

- *California Climate Corporate Data Accountability Act*

On 7 October 2023, California's Governor Newsom signed the California Climate Corporate Data Accountability Act, which forces the "State Air Resources Board to develop regulations requiring corporations that do business in California, with annual revenues over USD 1 billion, to publicly disclose their greenhouse gas emissions".[54] Starting in 2026, these corporations must provide annual disclosures for so-called scope 1 and scope 2 emissions, while scope 3 emission disclosures must start in 2027.[55]

California defines "doing business" in its state as a corporation meeting any of the following requirements:[56]

(1) engages in any transaction for the purpose of financial gain within California;

(2) is organised or commercially domiciled in California; or

(3) California sales, property or payroll exceed set thresholds or 25% of total sales, property or payroll in California.

California is the first state to enact such a disclosure act, though it is similar to the European Union's Corporate Sustainability Reporting Directive (the "**CSRD**") (see below).[57]

- *New York Fashion Sustainability and Social Accountability Act (the "**FSSAA**")*

New York legislators introduced the FSSAA, which would require fashion retail sellers and manufacturers to disclose environmental and social due diligence policies. The Bill aims to target "fast fashion" and to create legislation to govern the fashion industry. Under the bill, fashion retailers doing business in the state and with global revenue of at least USD 100 million would be required to disclose various environmental and social impacts, diligence policies and outcomes.

Disclosures would include, at a minimum, the following:

(1) supply chain mapping and disclosure, including information on suppliers at all stages of production, from raw material to final production;

(2) due diligence disclosures, including social and environmental sustainability reports and identification of risk areas in the supply chains; and

(3) impact disclosures.

The introductory language contemplates that citizens may commence civil actions against a business in violation of the legislation. The bill would also amend the state finance law in order to establish a community benefit fund, which would allow the U.S. Department of Environmental Conservation to expend funds for implementing environmental benefit and environmental justice projects.

Senate Bill S7428 was introduced in October 2021 and was referred to the Consumer Protection Committee on 5 January 2022.[58] The bill was discharged by the committee and twice amended and recommitted to the Consumer Protection Committee (now Senate Bill S4746B).[59] The Assembly version of the bill (Assembly Bill A4333B) passed both the Consumer Affairs and Protection Committee and the Ways and Means Committee.[60] However, it did not reach the Assembly Floor in time for a vote during this legislative session.[61] As a result, the Bill will have to be reintroduced during a future legislative session, with January 2025 being the earliest available.[62]

ESG regulations mandating ESG disclosure

Europe

- *European Union's CSRD*

After going through the EU's standard legislative process, the European Commission published the CSRD, which finally came into force on 5 January 2023. The CSRD superseded the Non-Financial Reporting Directive (the "**NFRD**") as of the fiscal year 2023 and will apply starting from the financial year 2024. The CSRD applies to all "large" EU companies (meeting two of the following criteria: balance sheets greater than EUR 25 million; net worldwide turnover exceeding EUR 50 million; or more than 250 employees) and all EU listed companies (including SMEs, but excluding micro-enterprises). EU subsidiaries or branches of non-EU parent companies are also in scope of the CSRD to the extent that the latter generates turnover of more than EUR 150 million in the EU, and the former is a large or listed EU company or a significant EU branch (generating more than EUR 40 million in turnover).

The CSRD introduces two important assessments. Firstly, the so-called "double materiality" test, requiring companies to consider their material impacts on the environment, society (e.g., human rights) and governance. It also requires that companies consider the impact of a sustainability matter on the company's financial health (e.g., development, financial position, financial performance, cash flows, access to finance or cost of capital). Secondly, companies must assess their value chain and the extent to which they must consider their upstream and downstream value chain to be part of their "operations" for the aforementioned double materiality assessment.

In-scope companies must report under the detailed European Sustainability Reporting Standards (the "**ESRS**") framework. The general standards (ESRS 1 and 2) are mandatory for all in-scope companies. All other standards are again subject to a materiality assessment. However, a company concluding that the climate-change standard (ESRS 1) is "not material" must provide a detailed explanation for such conclusion. Market consensus seems to indicate that all in-scope companies are likely to consider climate reporting as material. For the first three years a company is subject to the CSRD, it may elect to "comply or explain", citing its efforts made and reasons for the lack of data in the value chain. Additionally, companies with less than 750 employees may omit reporting on scope 3 emissions for the first reporting period.

Reporting requirements under the CSRD will apply on a phased basis, as follows: from 1 January 2024, for large public interest companies with over 500 employees that are already subject to the NFRD; from 1 January 2025, for large companies not currently subject to the NFRD (exceeding at least two out of the three criteria: 250 employees and/or EUR 50 million in net turnover and/or EUR 25 million on its balance sheet); and from 1 January 2026, for listed SMEs. SMEs can opt out until 2028. Starting 1 January 2028, for in-scope EU companies with non-EU parents, consolidated sustainability reports at the non-EU parent level will be subject to certain thresholds (please see above). However, where an in-scope EU subsidiary is included in its non-EU parent's sustainability report (prepared in accordance with the ESRS), the application of the CSRD is deferred until January 2030, and the in-scope EU subsidiary may rely on the group reporting exemption.

- *European Union Sustainable Finance Disclosure Regulation and Taxonomy Regulation (the "**SFDR**")*

In December 2019, the SFDR entered into force. It requires all EU financial market participants and financial advisors (including non-EU firms marketing in the EU) to make ESG disclosures in relation to their financial products, sustainability risks and adverse sustainability impacts, in their investment processes. The level of disclosure and obligations depends on the level of integration of ESG considerations within the financial product. Products promoting environmental or social characteristics (Article 8 products) and products having sustainable investments as their objective (Article 9 products) are subject to pre-contractual and ongoing disclosures on sustainability indicators used to monitor performance.[63]

The SFDR's Level-1 requirements have applied since March 2021. These Level-1 disclosures are entity-level and product-level disclosures, which require fund managers to: (*i*) assess the potential for ESG factors to negatively impact the returns of funds under management; and (*ii*) disclose the outcome of that assessment to investors both in the funds' prospectus documents and on the firm's website. The Level-1 disclosures also require in-scope firms to publish an adverse impacts statement on their website. Firms with 500 employees or more have been required to publish a statement describing the due diligence policies that are applied by the firm to identify the adverse impacts of investment decisions on sustainability

factors; firms with fewer than 500 employees have the option either to publish a statement or clearly state that adverse impacts are not taken into account as long as they detail why they do not and, where relevant, whether they intend to do so in the future.[64]

In September 2023, the European Commission conducted a consultation for a general revision of the SFDR. In particular, the European Commission suggested a new categorisation system for sustainable products based on four sustainable investment strategy categories, including "products aiming to meet credible sustainability standards" and "products with a transition focus". Any such system could be directed at retail and/or professional investors. The criteria for such categories may be based on matters such as degree of Taxonomy alignment, engagement strategies and exclusions. The criteria may even be based in pre-defined and measurable environmental or social outcomes, such as minimum year-on-year improvement of chosen Key Performance Indicators. The European Commission is still working on this revision, and it is unlikely that a new regime will come into force any time soon.

The SFDR's Level-2 disclosures were published in April 2022 and applied from January 2023. They provide regulatory technical standards specifying the details of the Level-1 disclosures, notably including the disclosure templates for Article 8 and Article 9 products. In December 2023, the European Supervisory Authorities proposed amendments to the Level-2 regulatory technical standards, with the key changes being: (*i*) new mandatory and opt-in (voluntary) social PAIs; (*ii*) changes to the overall PAI reporting framework such as reporting on the use of estimates; (*iii*) changes to the way in which fund managers' report on the outcome of the "do no significant harm" test; (*iv*) a new set of disclosures for funds with greenhouse gas emission reduction targets; and (*v*) simplifications and new layout for the disclosure and reporting templates. The amended Level-2 regulatory technical standards are yet to be published.

Alongside the SFDR, the European Union adopted the EU Taxonomy Regulation, which will apply from 1 January 2022.[65] The Taxonomy Regulation puts forward a common set of technical screening criteria to test and measure to what extent an economic activity qualifies as environmentally sustainable. It applies where financial market participants make available products that promote specific environmental characteristics or products that have sustainable investment as an objective. The Taxonomy Regulation (and associated technical screening criteria) initially focused on climate change issues, with the Taxonomy Regulation applying from 1 January 2022 in respect of the two climate change objectives, and on 1 January 2024 for the other environmental objectives.[66]

Together with the SFDR, the Taxonomy Regulation ensures that investors investing in financial products in scope will obtain adequate information about the alignment of their portfolios to the Taxonomy. Moreover, together with the CSRD, the Taxonomy Regulation ensures that companies falling under the scope of the CSRD disclose information about a company's Taxonomy-aligned economic activities.

The European Union has also adopted the Low Carbon Benchmark Regulation. This regulation seeks to ensure that low-carbon benchmarks comply with a standard methodology to limit the possibility of presenting outcomes without a proper basis (otherwise known as greenwashing).[67]

- *CSDDD*

The CSDDD provides an obligation for in-scope companies that are not subject to the reporting obligation under the EU Accounting Directive (Directive 2013/34/EU of the

European Parliament and of the Council) to publish an annual statement on their compliance with the requirements under the CSDDD on their website. The statement must be published within 12 months of the end of their financial year, covering the previous calendar year.

- *EUDR*

The EUDR requires Operators and non-SME Traders, on an annual basis, to publicly report as widely as possible, including on the internet, on their due diligence system. This includes the steps taken by them to implement their due diligence obligations.[68] Companies that also fall within the scope of other EU acts that establish value chain due diligence requirements may elect to comply with their EUDR reporting obligations by including the required information in the reporting under those other EU acts (i.e., in the annual report on CSDDD compliance).[69]

Germany

- *German Act on Corporate Due Diligence in Supply Chains*

The German Act on Corporate Due Diligence in Supply Chains requires in-scope companies to continuously document the compliance with due diligence requirements and prepare an annual report thereon, which must be made publicly available on the company's website and electronically transmitted to the German Federal Office of Economics and Export Control.

United Kingdom

- *UK Modern Slavery Act 2015 (the "**MSA**")*

The United Kingdom implemented the MSA in 2015, one of the first global modern slavery regulations. The MSA requires large businesses to produce a statement each financial year stating the steps an organisation has taken during that year to ensure that slavery and human trafficking is not taking place in any part of its own business or in any part of its supply chains. Alternatively, large businesses may produce a statement that the organisation has taken no such steps. This requirement applies to all commercial organisations (wherever formed) that carry on a business (or part of a business) in any part of the United Kingdom that supply goods or services and have an annual turnover of at least GBP 36 million (calculated on a group-consolidated basis).[70]

The statement may include information about the organisation's policies regarding slavery and human trafficking, its due diligence processes in relation to slavery and human trafficking in its business and supply chains and its effectiveness in ensuring that slavery and human trafficking are not taking place in its business or supply chains. The statement must be approved by the board and signed by a director. The organisation must publish this statement on its website and include a link to the statement in a prominent place on the homepage.[71]

In March 2021, the UK government created a central registry for publishing MSA statements and announced the creation of a government watchdog to protect the rights of UK workers. Additionally, two bills to amend the MSA are currently before the House of Lords: one aims to strengthen enforcing obligations under section 54 of the MSA, and the other aims to support victims of modern slavery. While both bills had their first reading in late 2021, neither has had its second reading scheduled.[72] It is therefore unclear whether these amendments will be enacted and, if so, when.

- *Task Force on Climate-related Financial Disclosures (the "**TCFD**")*

The United Kingdom has implemented legislation to make the voluntary disclosure framework under the TCFD mandatory for UK companies, UK asset managers and types of regulated investors. Each would be subject to a size threshold. This requires entities in scope to publish detailed TCFD reports that cover their approach to climate risks (the impact of climate change) and opportunities (the transition to a lower-carbon economy) in terms of governance, strategy and risk management. Entities in scope will also need to collect and disclose data on carbon emissions and climate-related targets.

Premium-listed companies have been required to publish TCFD reports for financial years beginning on or after 1 January 2021, and large UK occupational pension schemes will first need to publish information for scheme years ending on or after 1 October 2021. From 6 April 2022, "large" UK companies (those with a turnover above GBP 500 million *per annum*) and LLPs in scope must include TCFD-aligned disclosures in their strategic reports. Furthermore, large UK asset managers (those with GBP 50 billion in assets under management) and standard listed companies must make TCFD-aligned disclosures at an entity level and a product level for accounting periods commencing on or after 1 January 2022.[73] Other firms with assets under management greater than GBP 5 billion are subject to the new rules from 1 January 2023, with reports due by 30 June 2024.[74]

- *Transition Plan Taskforce*

The UK government also confirmed in November 2021 that it would require certain companies to publish climate transition plans to set out how they would decarbonise by 2050. A Transition Plan Taskforce was launched to determine the "gold standard" for transition plans. The taskforce published a draft Disclosure Framework and Implementation Guidance in November 2022, with final versions expected in summer or autumn 2023.[75]

United States

Historically, the SEC generally has taken a principles-based approach to ESG disclosure, focusing on materiality relative to each company's results. However, in spring 2021, the SEC released its rulemaking list, including several proposed regulations that would bolster ESG disclosure in the areas of climate change, board diversity, human capital management and cybersecurity risk governance.[76] Then, in March 2024, as detailed above, the SEC adopted its long-awaited rules for enhanced climate change disclosures.[77]

Indeed, since 2021, the SEC has taken a number of steps towards regulating ESG issues. In March of that year, the SEC launched a Climate and ESG Task Force in the Enforcement Division with a mandate to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules";[78] the Division of Examinations also announced climate-related risks as one of its 2021 examination priorities.[79] On 7 July 2021, the SEC's Asset Management Advisory Committee adopted recommendations to the SEC regarding disclosures of material ESG matters by issuers and ESG investment product disclosures.[80]

In addition, on 3 November 2021, the SEC issued a Staff Legal Bulletin that would make it easier for shareholder proposals related to ESG issues to remain on the agenda.[81] Staff Legal Bulletin No. 14L (CF) stated the following: (*1*) shareholder proposals related to emissions limits or targets will not *per se* fall under the micromanagement exception; (*2*) the SEC staff will focus more on the social policy significance of an issue, as opposed to the nexus between a policy issue and the company, in determining whether the significant social policy exception applies; and (*3*) whether an issue is "too complex" under the micromanagement exception

must be judged in light of the sophistication of investors and the robustness of public discussion.[82] Looking ahead to the 2022 proxy season, there was a significant increase in the number of environmental- or social-related shareholder proposals. The SEC also rejected a significant number of company requests to exclude such shareholder proposals.[83]

On 7 February 2023, the SEC announced its 2023 examination priorities, which included a focus on ESG-related advisory services and strategies that incorporate certain ESG criteria, including whether funds are operating in the manner set forth in their disclosures.[84] This was the second year in a row that the SEC prioritised ESG-related products and services, including preventing greenwashing.[85] In line with these priorities, on 25 May 2022, the SEC proposed an amendment to the funds Names Rule, which would expand its 80% requirement to include ESG fund names.[86] The SEC approved this rule in September 2022.[87] The SEC also issued a proposed rule related to ESG disclosures of funds and fund managers (the Climate Disclosure Rule for Funds).[88] If adopted, the rule would create additional disclosure requirements in a number of areas – including fund prospectuses, annual reports and adviser brochures – for entities that consider ESG factors in their investment processes. The proposed rule applies to certain registered investment advisers, advisers exempt from registration, registered investment companies and business development companies. In May 2024, Democratic Senators and Representatives asked SEC Chair Gary Gensler to finalise the rule to target greenwashing and other false ESG claims by funds and investment advisers.[89]

However, the SEC's ESG focus has been met with pushback. In the week following the adoption of the Final Rule for the Enhancement and Standardization of Climate-Related Disclosures for Investors, state attorneys general, energy companies and oil industry groups brought seven lawsuits in the Fifth, Sixth, Eighth and Eleventh Circuits.[90] Pending the resolution of the Eighth Circuit claims, the SEC decided to stay the rule to avoid regulatory confusion.[91] The Court could stay the Final Rule, which would offer the SEC the opportunity to correct it by the stay's expiration.[92] If it is not corrected by the expiration date, the Court may vacate it.[93] Further, in April 2024, House and Senate Republicans introduced bills to overturn the Final Rule through the Congressional Review Act.[94] If the House, Senate and President vote to overturn the rule through this Act, the SEC will be barred from proposing similar regulations.[95]

In parallel, and up until Republicans took control of the House in 2022, the U.S. Congress under Democratic control passed significant ESG-related legislation. On 16 June 2021, the U.S. House of Representatives passed legislation that would impose new ESG due diligence and disclosure requirements on publicly traded companies. H.R. 1187, the ESG Disclosure Simplification Act of 2021 (the "**ESG Disclosure Simplification Act**"), would require publicly traded companies to disclose their efforts to ensure that ESG standards are reflected in their operations, activities and supply chains based on metrics established by the SEC. The ESG Disclosure Simplification Act would also allow the SEC to incorporate any internationally recognised, independent, multi-stakeholder ESG disclosure standards in defining ESG metrics and the disclosure process.

H.R. 1187 would also establish the Sustainable Finance Advisory Committee (the "**SFAC**"), a permanent body with no more than 20 members that would advise the SEC on ESG metrics, standards and disclosure, as well as sustainable finance issues more broadly. Section 4 of the Act would require that the SFAC submit to the SEC recommendations regarding which ESG metrics the SEC should require companies to disclose. Within 18 months after the SFAC's first meeting, the body would be required to issue a report that identifies challenges and opportunities for investors associated with sustainable finance. The body would

also be required to recommend policy changes that facilitate the flow of capital towards environmentally sustainable investments.

The Act was drafted by the House Financial Services Committee. When the Committee came under Democratic control in 2019, it spearheaded a parcel of legislative initiatives focused on increasing accountability and social responsibility within the corporate sector. In championing the legislation, the Financial Services Committee noted that: (*i*) the SEC does not currently require companies to disclose information related to their ESG commitments or to adhere to standards for disclosing such information; (*ii*) investors have reported that voluntary disclosures of ESG metrics are inadequate; (*iii*) statutes and regulations requiring reporting and standardisation of ESG disclosures are in the interest of investors; and (*iv*) ESG standards are "material to investors" such that the SEC is obligated to establish standards for disclosure of such matters.[96]

Since Republicans took control of the House in 2022, Congress has seen a marked shift towards anti-ESG initiatives. In February 2023, Chairman of the House Financial Services Committee Patrick McHenry announced the formation of a Republican working group to "combat the threat to our capital markets posed by those on the far-left pushing environment, social, and governance proposals".[97] The working group's threefold mandate includes "rein[ing] in the SEC's regulatory overreach", "reinforc[ing] the materiality standard as a pillar of our disclosure regime" and "hold[ing] to account market participants who misuse the proxy process or their outsized influence to impose ideological preferences in ways that circumvent democratic law making".[98] Moreover, in a February 2023 letter to SEC Chair Gensler, Chairman McHenry and two other Republican Committee members demanded information on the SEC's proposed climate disclosure rule for investors; they alleged the rule "exceeds the SEC's mission, expertise, and authority and, if finalized in any form, will unnecessarily harm consumers, workers, and the U.S. economy".[99] The authors alleged that, under Chair Gensler's leadership, the "SEC has shifted away from its principles-based disclosure regime to a partisan, activist, and prescriptive approach" with an impermissible "climate agenda".[100] In July 2023, Republicans on the House Financial Services Committee introduced four anti-ESG bills. For example, the Business Over Activists Act argues the SEC does not have the authority to regulate shareholder proposals, while the Protecting Americans' Retirement Savings from Politics Act allows companies to exclude environmental, social and political shareholder proposals.[101] Additionally, in September 2023, the House Education and Workforce Committee passed an additional four measures meant to restrict "investment advisers and financial institutions from considering ESG factors in retirement-investment advice".[102] Despite the promised legal challenges from House Republicans, further SEC regulations on ESG disclosures are likely forthcoming. The then-Acting Chair Allison Lee directed the Division of Corporate Finance to "enhance its focus on climate-related disclosure in public company filings", with the ultimate aim of revising the Commission's 2010 Climate Change Guidance.[103] Towards that revision, the SEC solicited input from the public[104] and received over 5,000 comments.[105] In March 2021, the SEC launched a Climate and ESG Task Force in the Enforcement Division with a mandate to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules";[106] the Division of Examinations also announced climate-related risks as one of its 2021 examination priorities.[107] On 7 July 2021, the SEC's Asset Management Advisory Committee adopted recommendations to the SEC regarding disclosures of material ESG matters by issuers and ESG investment product disclosures.[108] Looking ahead, the current SEC Chair Gary Gensler's agenda includes a commitment to expanding ESG disclosures.[109]

ESG: executive action

United States

- *Inflation Reduction Act (the "**IRA**")*

The IRA was signed into law by President Biden in August 2022. The U.S. Environmental Protection Agency described the IRA as the most ambitious climate-related legislation in the U.S.' history.[110] Most of the Act's provisions came into effect on 1 January 2023. The IRA introduced reduced renewable energy costs for "Green Power Partners", a voluntary programme that encourages businesses, non-profits, educational institutions and state, local and tribal organisations to buy green energy. The IRA's provisions include: clean energy tax credits, which allow taxpayers to deduct a percentage of the cost of renewable energy systems from their federal taxes; an emphasis on application to disadvantaged populations and communities with environmental justice concerns; and a range of options for tax credit monetisation. In particular, the IRA promises a near-USD 370 billion investment into disadvantaged communities, with an emphasis on projects that repurpose old fossil fuel infrastructure for green initiatives and employ displaced workers. The IRA also supports projects that facilitate the use of electric vehicles and allots funds towards climate resilience efforts and green power infrastructure. The impact of the IRA on the U.S.' transition towards green energy will be evaluated in the years to come.

Benefits of robust ESG due diligence: According to one 2022 survey, four out of five dealmakers consider ESG factors in their M&A activities, with nearly half of the respondents stating that, going forwards, deals are expected to involve ESG due diligence. The same survey noted that two-thirds of respondents would pay a premium for a target that demonstrates a high level of ESG maturity in areas that align with their own ESG priorities. Close to half of all respondents put the premium at somewhere between 1% and 5%, and one in five respondents would pay a premium of 5% or more.[111]

There is strong evidence that ESG integration into business and investment, and the robust due diligence required to ensure that this is done successfully, has a positive financial effect. A 2023 joint study by Bain & Company and EcoVadis assessed the ESG activities and outcomes of 100,000 companies. The study found that ESG activities correlate with stronger financial profitability and growth for private companies. For example, companies that rank in the top quartile of their industry for gender diversity in their executive teams enjoy annual revenue growth approximately 2% above companies in the bottom quartile. The study also found a positive correlation between renewable energy usage and higher EBITDA margins in carbon-intensive industries. It assessed that companies focusing on ethics, environmental and labour practices in their supply chains are 3% to 4% more profitable than those companies that do not consider their suppliers' ESG credentials.[112]

Furthermore, there is evidence of positive ESG-related debt issuance. Although the issuance of green bonds fell by 25.6% globally in 2022 compared to 2021, green bond sales rose to USD 575 billion last year, beating 2021's USD 573 billion performance.[113] Some analysts forecasted a rebound in 2023 thanks to supportive policies such as the U.S.' IRA (above).[114] A 2022 study of a global panel of green and conventional bonds found that, on average, green bonds have a yield spread of eight basis points lower relative to conventional bonds.[115] Green bonds also garner institutional support from international actors. For example, the UN Development Programme has promoted and assisted with the issuance of green bonds in numerous countries in the recent past, including Mexico's EUR 1.25 billion SDG bond issued in July 2021 and Indonesia's EUR 500 million SDG bond issued in September 2021.

Gains through the establishment of a level playing field: The legal framework described in the section "ESG: legislative and judicial action" above is significant in ensuring that businesses are provided legal certainty and clarity at both national and supra-national levels. This is especially necessary in an area of the law that has often been filled with many, sometimes confusing, non-mandatory codes, principles and guidelines as to best practices.

Gains from improved governance: A study by the *Financial Times* Moral Money Forum found that a long-term approach to corporate governance could have a positive effect on corporate and financial performance and long-term productivity. Such effects are competitive advantages that could make companies more attractive to investors and more successful in the long run.[116]

Valuation gains: One FactSet study[117] suggested that companies under the Ethical Sustainability Index Europe and the MSCI Global Environment Index trade at about 12x the EV/EBITDA enterprise multiple, compared to 10x EV/EBITDA for the Stoxx Europe 600. A McKinsey survey of investment professionals suggested that the majority would be willing to pay a premium of about 10% to acquire a company with a positive ESG profile compared to a negative one.[118] Similarly, a survey of private equity partners found that 54% had reduced a bid price after ESG due diligence, while 32% had increased the bid price.[119] Other surveys have cast doubt on the extent to which market participants might in fact be willing to pay a premium for acceptable ESG performance, but suggest that the vast majority have reduced the valuation of an acquisition target or abandoned a deal because of poor performance on ESG factors.[120]

Financial incentives and disincentives. There have also been a number of recent efforts to link ESG performance with financial incentives (or disincentives). Examples include the following:

- Close to half of the **FTSE 100 companies** including an ESG target in the annual bonus, the Long-Term Incentive Plan or both.[121]
- 73% of **S&P 500 companies** tying executive compensation to some form of ESG performance as of 2021.[122]
- Companies that are invested in by the "Big Three" of asset management – **Vanguard, BlackRock and State Street** – are more likely to link ESG incentives with executive pay given asset managers' desire to see such ties with compensation.[123]
- The **Net Zero Banking Alliance**, representing over 40% of global banking assets, committing to align the group's lending and investment portfolios with net-zero emissions by 2050.[124]
- **Nordea** committing to facilitate over EUR 200 billion in green and sustainable financing by 2025.[125]
- **BlackRock**'s USD 4.4 billion lending facility linking borrowing costs to staff diversity targets.[126]
- **WSP Global**'s USD 1.2 billion syndicated revolving credit facility with borrowing costs linked to greenhouse gas emissions, "green revenues" and the proportion of women in management positions.[127]
- **Enerplus**'s USD 900 million bank credit facility where borrowing costs vary by plus or minus five basis points according to performance against targets on greenhouse gas emissions, water management and health and safety.[128]

- **Gibson Energy**'s USD 750 million revolving credit facility with borrowing costs linked to the diversity of its board and workforce.
- **Bridgestone**'s USD 1.1 billion credit facility with an interest rate based on its ESG risk rating as determined by independent ratings providers Sustainalytics and FTSE Russell.
- **Carlyle Group**'s USD 4.1 billion credit facility linked to achieving 30% diversity on the boards of the companies it controls within two years of ownership.[129]

ESG metrics

When conducting ESG due diligence in an M&A context, it is important to understand how the buyer intends to account for and potentially disclose ESG information. For example, diligence conducted for an impact-focused fund will likely serve as the baseline from which the fund will measure and report ESG changes during its period of ownership. Similarly, a social impact fund aimed at improving financial inclusion will want to know the number of "unbanked" people currently served by a target company so that it can measure the shift in access to financial services during the life of its investment.

As discussed above, some regulators have mandated ESG-related reporting on specific matters, such as supply chain or climate risks. Beyond those legally mandated, various systems of ESG reporting standards have arisen over the last few years. Most notable is that of the International Sustainability Standards Board (the "**ISSB**"). Launched during the 2021 COP26 summit in Glasgow, the ISSB published its inaugural standards – IFRS S1 and IFRS S2 – in June 2023 with the aim to create a "high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets".[130] The ISSB enjoys global support from coalitions such as the G7, the G20, the International Organization of Securities Commissions and the Financial Stability Board. It is expected that the new ISSB standards will help to improve trust and confidence in company disclosures about sustainability to inform investment decisions.

Other recent examples of ESG reporting standards include the Value Reporting Framework (the product from the merger of the Sustainability Account Standards Board (the "**SASB**") and the International Integrated Reporting Council) and the Global Reporting Initiative (the "**GRI**"). The SASB's set of 77 Industry Standards identifies "the minimal set of financially material sustainability topics and their associated metrics for the typical company by an industry".[131] The GRI Standards are divided by topic: the three universal Standards are used by every organisation that prepares a sustainability report; and the remainder are chosen by an organisation from topic-specific Standards.[132]

Efforts are currently underway to harmonise these standards to allow better direct comparisons of ESG reporting (see, for example, the discussion above regarding the Taxonomy Regulations). Certain sustainability accounting standards are designed to be aligned with other ESG projects. One example is the Climate Disclosure Standards Board Framework, which has been explicitly designed to be aligned with TCFD recommendations. Others seek to provide a high-level reporting framework to improve harmonisation across the board, such as the International Integrated Reporting Council Framework or the Institutional Limited Partners Association ESG Data Convergence Project.

There are also public and private efforts to create resources by which investors can incorporate ESG into their activities and reporting, as well as compare different investments according to ESG performance. For instance, the UN Principles for Responsible Investment are aimed at investors seeking to incorporate ESG issues into their investment decision-making. The

Impact Management Project is a collaboration amongst environmental accounting standards organisations, impact organisations and investment managers to create norms to measure ESG impacts, against which companies and investors can assess their impact performance.

ESG ratings

As sustainable investment has continued to become more integrated into the financial ecosystem, investors have increasingly come to rely on ESG ratings agencies to provide data points that allow a comparison of companies' ESG credentials. ESG ratings are used more often to both validate the ESG characteristics of financial products or companies and indicate the ESG risk exposure of an equity or debt issuer. The Big Three credit ratings agencies – namely Standard & Poor's, Moody's and Fitch Ratings – all provide ESG rating services. Specialised ESG ratings agencies have also been gaining in popularity, including Sustainalytics and the Carbon Disclosure Project.

In 2022, there were increasing calls in the U.S. for government regulation of the ESG ratings industry, though this has not translated into government action despite recent updates by the UK and EU.[133]

In the United Kingdom, the Financial Conduct Authority is looking to provide greater oversight through regulation to bring ESG data and rating providers within its purview. It also suggested that a globally consistent regulatory approach should be adopted, which is in line with the International Organization of Securities Commissions' recommendations on ESG data and ratings.[134] Furthermore, HM Treasury launched a consultation in March 2023, proposing a requirement that ESG ratings providers must know who is accessing their services and how they are being used.[135]

As part of the European Commission's 2021 consultation on its renewed sustainable finance strategy, stakeholders were asked for their views on the quality and relevance of ESG ratings to their investment decisions, the degree of concentration in the market and the need for regulation and action at the EU level.[136] The European Commission went on to undertake a targeted consultation on ESG ratings and sustainability factors in credit ratings that will directly feed into an impact assessment evaluating the impacts, costs and options of a possible EU intervention in the ratings space.[137] In parallel, a call to evidence was issued by ESMA in February 2022, aimed at mapping rating providers operating within the EU and assessing the possible costs of supervision.[138]

Final thoughts

ESG due diligence can prove instrumental in evaluating both the value and appropriateness of a particular transaction. Especially given unavoidable resource and other constraints in the M&A context, successful execution of such due diligence requires carefully identifying and assessing the key ESG exposures and related mitigation efforts.

In this regard, the ever-increasing legal requirements around ESG due diligence should help level the playing field amongst businesses as the momentum shifts from voluntary due diligence and self-regulation towards mandatory diligence and disclosure along the lines discussed above. As the ESG landscape continues to evolve, there are significant opportunities for businesses to reap the rewards of more stringent due diligence, including through gains in valuations, improvements in governance and in value chains, and incentive-based dealmaking.

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