SLAUGHTER AND MAY/

ESG IN 2023
FORWARD LOOK

GOVERNANCE AND SUSTAINABILITY

Part of the Horizon Scanning series

ESG IN 2023

2023 is already a month old and the ESG landscape continues to evolve at lightning speed. Here are our top 10 ESG topics for businesses to look out for during the remainder of the year, and the reasons why.

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1. A RED LINE ON GREENWASHING?

Greenwashing risks relating to regulation, litigation and reputational concerns will grow in 2023 as businesses are expected to do more on climate under more intense scrutiny. This underlines the benefits of ensuring that any public statement burnishing green credentials is always supported by evidence, given in context, and reflects input from across the business.

The leading risk at present is regulatory action brought on consumer protection grounds. The Advertising Standards Authority, for example, recently upheld a high-profile complaint against a leading bank for giving a misleading impression of its overall green credentials. The Competition and Markets Authority and the Financial Conduct Authority are also both increasingly focused on greenwashing.

Look out for:

- Greater scrutiny of whether companies (and their directors) have failed to make adequate climate disclosures in annual accounts or provided misleading climate-related information in prospectuses and other public documents.
- Increasingly innovative claims against companies, for example claims that directors have breached their fiduciary duties by not adequately addressing climate risks.
- Reputational risks (even where legal action is not brought) with investors and shareholders increasingly holding boards to account on green issues through ‘activist’ means or otherwise.

2. TRANSITION PLANNING TO TAKE CENTRE STAGE

Climate transition plans are a set of goals, actions, and accountability mechanisms to align a business' activities with achieving global net zero. They are currently voluntary in most jurisdictions[1], but legislation mandating transition plans for large businesses is due to enter into force in the EU, UK and elsewhere over the coming years. In advance of such legislation, guidance currently being developed nationally and internationally is expected to articulate what a robust plan should look like.

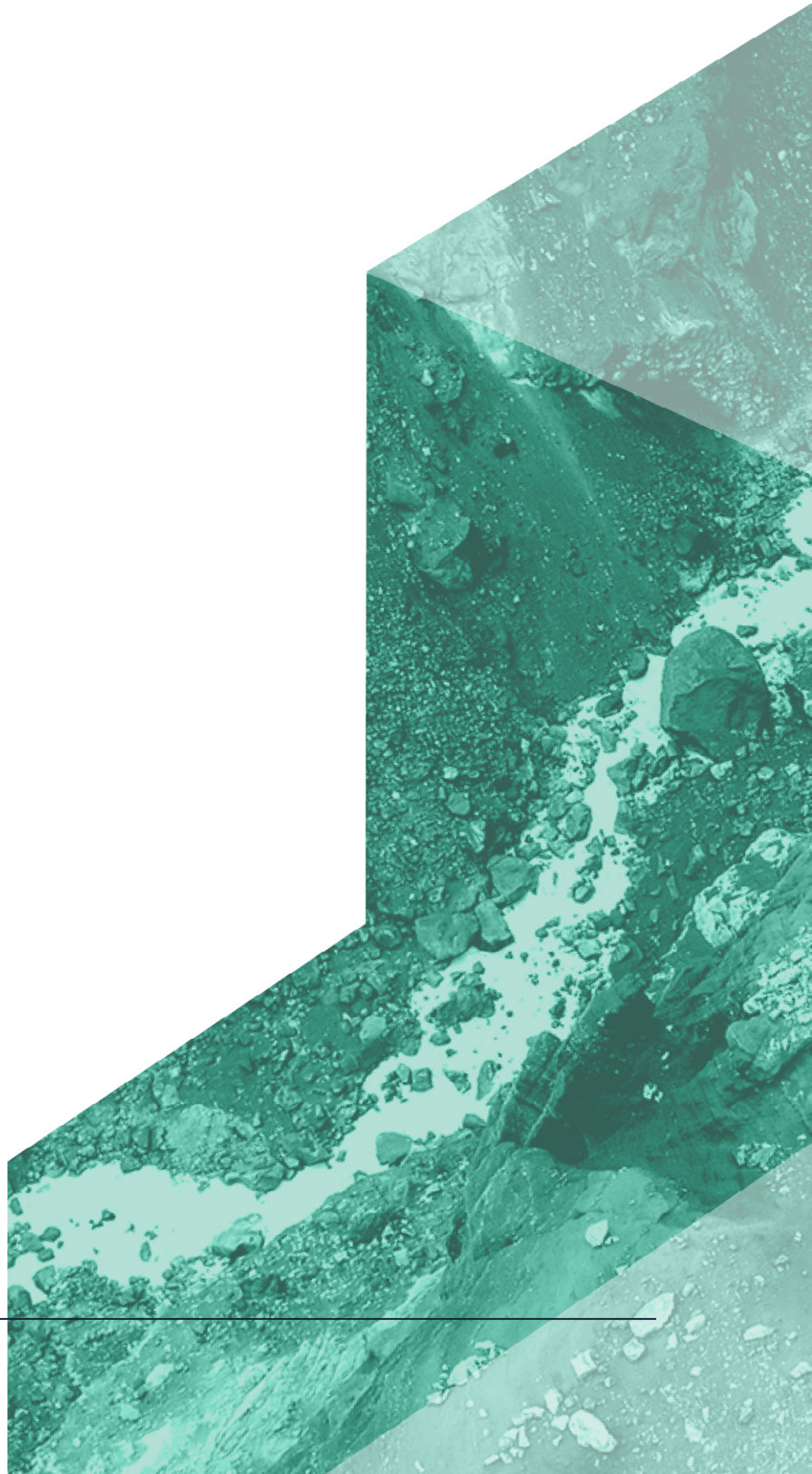
The UK's Transition Plan Taskforce (TPT), for example, is consulting until later this month on a framework to provide recommendations for companies and financial institutions on how to develop "gold-standard" transition plans.

The UN's High Level Expert Group on the Net-Zero Emissions Commitments of Non-State Entities (UNHLEG) has released a major new report setting out 10 recommendations for transition plans for companies and financial institutions, as well as cities and regions, which is expected to inform the global standard.

Lastly, the Glasgow Financial Alliance for Net Zero (GFANZ), has published its final report focussing specifically on recommendations and guidance for financial institutions' transition plans.

Look out for:

- A clearer picture of what a "good" transition plan looks like in 2023, and with it, a better idea of what regulators, investors and others will expect.
- Opportunities to engage internally and externally with transition planning now to be in a good position for when it becomes mandatory[2].
- Pressure to upskill and develop the necessary resources to develop and update a robust plan that will impact on overall business strategy, governance and M&A.



[1] France, which requires businesses to have a 'Vigilance Plan' that considers "serious violations of the environment", is the exception.

[2] For example, the CSDD and the UK's proposed Sustainability Disclosure Requirements regime, if they are enacted on their currently proposed terms.

3. THE JUST TRANSITION

Businesses starting to engage with the transition to a zero or low emission future will also be under pressure to consider how to reduce carbon emissions in a way that is fair towards their employees and local communities, as part of a "Just Transition"[3]. Those that do not will be at greater risk of future human rights claims and reputational damage.

The guidance from the TPT, UNHLEG and GFANZ mention respectively:

1. the need to consider "material interdependencies" between climate action, the natural environment and stakeholders;
2. specific recommendations relating to "People and Nature in the Just Transition" and "Investing in Just Transitions"; and
3. the need for a "managed phaseout" of high-emitting physical assets, in support of "an orderly and just transition".

Look out for:

- Increased expectations from regulators and market participants that companies decarbonise in a way that protects (or doesn't adversely impact) people and communities.
- Developing guidance and practice on what "good" looks like in this evolving and complicated area.

[3] As with many ESG phrases, there is no single definition of "Just Transition". It has featured in a number of international climate agreements, including in the preamble to the Paris Agreement, and the International Labour Organization ("ILO") describes it as "greening the economy in a way that is as fair and inclusive as possible to everyone concerned, creating decent work opportunities and leaving no one behind…".

4. HUMAN RIGHTS DUE DILIGENCE – PRESSURE INCREASING

Human rights due diligence for business will remain largely voluntary in 2023[4], but expectations and awareness in this area are likely to increase:

1 **Forthcoming mandatory supply chain due diligence.** Although some way off, the EU's Corporate Sustainability Due Diligence Directive (CSDD) will require businesses to assess and address adverse human rights (and environmental) impacts across their value chain[5]. The EU's forced labour regulation proposal will also ban forced labour-derived products from the European market.

2 **Increased reputational consequences of 'falling behind'.** A breach, even of voluntary requirements or international standards, can be damaging to a business' reputation. Recent complaints to National Contact Points for breaches of the OECD Guidelines for Multinational Enterprises, for example, have attracted increasingly significant negative press for the companies implicated.

3 **Investors are also tooling up.** In December 2022, the PRI launched the world's largest stewardship initiative on human rights, 'Advance', to put pressure on portfolio businesses.

Look out for:

- Human rights becoming increasingly relevant to corporate strategic planning, legal and reputational management, and efforts to address climate change.
- Mandatory legal requirements around due diligence, and in the meantime, a range of voluntary measures that businesses can take to help differentiate themselves from competitors.
- Ways to respond to investors and shareholders holding businesses to account for their human rights records, including through industry bodies and associations.

[4] The UN Guiding Principles on Business and Human Rights are the current, non-binding 'global standard' of human rights due diligence for companies. That said, some European countries (such as Germany) are introducing binding domestic diligence requirements.

[5] We consider the CSDD in more detail here: The Corporate Sustainability Due Diligence Directive - Changing the Game? - Slaughter and May Insights.

5. REPORTING REQUIREMENTS SET TO BECOME MORE STANDARDISED

In the UK, certain large UK-registered companies now have to include climate-related financial disclosures in their Strategic Report in what is now called the Non-Financial and Sustainability Information Statement[6]. Companies who disclose against TCFD for Listing Rules purposes are likely to already comply, although the Regulations mandate compliance, whilst the Listing Rules allow for a "comply or explain" approach.

In the EU, the recently adopted Corporate Sustainability Reporting Directive (CSRD), will require in-scope businesses to provide a broad range of sustainability reporting, including on their strategy, governance, sustainability impacts, opportunities and risks and targets[7].

The CSRD will use the standards being developed by the European Financial Reporting Advisory Group (EFRAG), which take a 'double materiality'[8] approach.

The International Sustainability Standards Board (ISSB) is still looking to establish a global baseline standard for climate change and sustainability disclosures. There has been no update on this front since 'exposure drafts' were published for comment last year, but final versions are now expected in the first half of 2023, and the UK intends to implement them.

Look out for:

- The widening and hardening of reporting requirements and expectations (on climate in particular), both as a result of new legislation and enhanced shareholder pressure.
- Final EFRAG and ISSB disclosure standards and other sector-specific standards to be released in 2023, which will likely overlap but be slightly different, potentially increasing reporting burdens and leading to a transitional period of regulatory uncertainty. However, harmonisation will eventually arrive – perhaps in 2024.

[6] As introduced by the Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022.

[7] For a more in-depth analysis about the scope of the CSRD and its provisions, please refer to our blog post.

[8] Where the impact a business has on the planet and the people around it is considered as well, not just (as the TCFD does, for example) the non-financial risks and opportunities facing the business.

6. BIODIVERSITY AND NATURE – GROWING IN IMPORTANCE

Biodiversity, sometimes called “natural capital”, and nature-based solutions are the other side of the coin to carbon reductions in addressing climate change. The biodiversity COP15 last year saw substantial progress with the establishment of the Global Biodiversity Framework (GBF). It has four main goals: protect the resilience of all ecosystems; make exploitation of biodiversity sustainable by 2050; equitably share the benefits from genetic resources, and ensure adequate implementation (money, capacity, expertise and cooperation).

Inspired by the success of TCFD, the Taskforce on Nature-related Financial Disclosures (TNFD) is also developing a reporting framework for nature, currently out for consultation.

Look out for:

- How pressure on governments to integrate GBF goals and principles into national law, including into corporate reporting, will filter through to business strategy, governance, and assurance.
- Progress with the TNFD reporting framework, which is expected to be widely adopted and likely incorporated into reporting regimes in the same way as TCFD.
- An increased pressure from investors and others on businesses to engage with nature-based solutions to address biodiversity impacts and carbon emissions.

7. CARBON CREDITS AND MARKETS – A FOCUS ON INTEGRITY

Carbon credits and voluntary carbon markets are expected to play a small but growing role in businesses' plans to offset their emissions over the next 10 years. They are a relatively 'quick fix' but need to be handled with care. As the UK Climate Change Committee's Voluntary Carbon Markets and Offsetting Report makes clear, credits and carbon markets can help, but only if they are of high integrity and are used in combination with direct emissions reductions.

Look out for:

- The risks associated with over-reliance on offsets as part of corporate transition plans, including increased stakeholder criticism and potential court challenges where offsets undermine the credibility of a transition plan.
- A focus on developing high-integrity carbon crediting standards that will offer businesses higher levels of assurance when using credits/offsets. Developments at COP28 later this year on international standards for carbon markets and privately-led initiatives including the Integrity Council for the Voluntary Carbon Market, the Voluntary Carbon Markets Integrity Initiative, Science-Based Targets initiative, and UNHLEG will all contribute towards this.
- Greater sophistication from carbon markets in how they operate, including a greater emphasis on high-quality removals of carbon from the atmosphere, the accounting and institutional frameworks used, and jurisdiction-specific standards, transactions and initiatives.

8. SUSTAINABLE FINANCE CONTINUES TO GROW

Growing numbers of businesses are turning to sustainable debt products – both “use of proceeds” and “sustainability-linked” – for funding in 2023. An increased focus on the implementation of sustainable finance frameworks is expected, as these communicate a business’ sustainability goals to lenders and investors.

The increased emphasis on transition plans will also sharpen focus on transition finance, with the Loan Market Association (LMA) set to ramp up its work in this space in the first half of the year.

On all transactions, not just those with specific ESG features, the focus from lenders on borrowers’ sustainability profiles and strategies can be expected to intensify because of increasingly stringent regulatory reporting requirements on financial institutions, both as businesses in their own right and as regulated organisations.

Look out for:

- The impact of various industry initiatives aimed at harmonising ESG-related disclosure in lending transactions (including, for example, the recently launched ESG Integrated Disclosure Project template and the GIIA ESG covenant package).
- Revised sets of principles governing green, social and sustainability-linked loans, expected to be published by the LMA in Q1 2023, followed by template provisions for sustainability-linked loans.
- Ways to respond to the output of the FCA’s recently established working group on ESG data and ratings providers.

9. CLIMATE TECH ON THE RISE

Technology aimed at addressing climate change is growing faster than ever, with the number of climate tech companies quadrupling since 2010 to reach almost 45,000 in 2022. Even as recessionary headwinds gather, investment is still flowing as climate action remains a top priority for companies globally, attracting over a quarter of venture capital investment last year.

Climate tech can help accelerate a business' net zero transition, make its supply chains more sustainable, and help with measuring and reporting on ESG progress whilst addressing rapidly developing areas like greenwashing.

Look out for:

- Ways to engage with the risks and opportunities that disruptive climate tech presents, from implementation challenges, regulatory change and unintended consequences to differentiating a business from its competitors, helping with reporting, supply chain due diligence, transition plans and nature and biodiversity solutions.
- The role AI is likely to play and how the regulatory landscape will need to change quickly to keep up.

10. THE EVOLVING ENVIRONMENTAL LAW LANDSCAPE

Significant uncertainty surrounds the environmental law landscape in the UK, which could change dramatically in the coming years. If the Retained EU Law (Revocation and Reform) Bill (the “Revocation Bill”) becomes law, large swathes of EU-derived law will be automatically revoked at the end of 2023 unless saved by ministers. New laws could be brought in, for example under the framework laid out in the Environment Act 2021. This will likely mean increased regulatory divergence between the EU and UK and more complexity for businesses. We are already seeing this with UK and the EU proposals regarding deforestation.

The passing of a resolution by the UN General Assembly recognising the right to a clean, healthy and sustainable environment as a human right in July last year also has the potential to (eventually) drive changes in national legislation.

Look out for:

- The Revocation Bill’s progress, which is expected to face opposition in the House of Lords, Scottish Parliament and Senedd Cymru.
- The EU formally adopting its anti-deforestation and forest degradation regulation, which will give businesses 18 months to prepare and develop the necessary internal expertise, and likely require them to review their supply chains for provenance.
- Further detail about the extended producer responsibility regime (EPR) in the UK. EPR is a “circular economy” policy approach giving producers responsibility for the treatment and disposal of products they have placed on the market. In-scope businesses need to start collecting packaging data as of January this year.

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