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As predicted in our February 1, 2023, client alert, “[ESG in 2022 and Predictions for 2023](#),” a global economic slowdown and ongoing backlash in the U.S. have slowed the momentum of some aspects of the environmental, social and governance (ESG) movement. However, some ESG topics have continued to develop and play increasing roles for companies and their stakeholders as ESG becomes ever more pervasive.

In this article, we review key ESG topics from the first half of 2023, including the green energy transition, executive remuneration and ESG litigation, as well as regulatory developments, such as upcoming disclosure obligations. We also look ahead at those issues we believe will play an increasingly important role in the ESG sector throughout the remainder of 2023, including biodiversity, ESG rating agencies and the implementation of sustainability standards by the International Sustainability Standards Board.

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Key Trends in 2023 Thus Far

Further Developments in the Green Energy Transition

- The green energy transition continues to be a focus following the invasion of Ukraine.
- Enactment of the Inflation Reduction Act in the U.S. has led the EU to respond with the Green Deal Industrial Plan and the U.K. has outlined its own strategy to compete against the U.S. for clean energy and climate-related projects.

Almost a year and a half on from Russia’s invasion of Ukraine, the dependence of many countries on Russian oil and gas continues to be apparent. Policymakers continue to seek alternative energy sources to combat this reliance, creating strong incentives to fast track renewable energy deployment.

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Scaling up renewable energy projects will require considerable funding. Transmission improvements alone will entail an estimated investment of \$12 trillion by 2050, equal to 30% of all investment required for the energy transition. Given the need for such investment, governments have leaned toward creating financial incentives for the private sector rather than relying primarily on direct government investment, beginning in the U.S. with the Inflation Reduction Act (U.S. IRA).

Alongside a number of other proposals, the U.S. IRA earmarked \$369 billion for clean energy and climate-related projects, seeking to attract both domestic and foreign companies to establish green energy businesses in the U.S. This has resulted in a boom in green energy investments in the U.S., with Europe and the U.K. hurrying to match these incentives to prevent the loss of renewable businesses.

In response, the European Union (EU) set out proposals to compete with the U.S. IRA. The two main aspects are a relaxation of EU state aid rules and the Green Deal Industrial Plan (GDIP). First presented on February 1, 2023, the GDIP aims to provide support to scale up the EU's manufacturing capacity for net-zero technologies and further relaxes state aid rules by means of making additional tax benefits available. The GDIP also proposed a number of new pieces of legislation to encourage the scaling up of clean energy, including the [Net-Zero Industry Act](#) (NZIA), which aims to bolster the EU's renewables manufacturing capacity and strengthen its energy resilience.

In March, the U.K. government released "[Powering Up Britain](#)," a paper setting out its strategy for the transition to net zero. The U.K. seeks to match the opportunities and incentives being offered in the U.S. and the EU.

Despite these commitments to green technology, over 1,000 oil and gas projects are expected to commence operations in North America and Europe in the period 2023-27, and a considerable number of these will be new projects rather than building on existing facilities.¹

Although activists see this as a step backward, the ongoing development of new projects alongside the push for green energy may offer a more realistic roadmap to the green energy transition, given the need to continue to meet demand while green energy providers seek to resolve supply chain issues.

¹ *Offshore Technology*, "The U.K. Leads Upcoming Oil and Gas Projects Starts in Europe by 2027" (February 6, 2023).

Executive Remuneration in the UK

- Executive remuneration is on the rise, despite continuing economic uncertainty.
- Discussions of pay disparity between the U.S. and elsewhere are more nuanced than they may initially seem.
- The incorporation of ESG metrics into incentive arrangements remains a priority for investors.

In our [February 2023 article](#), we discussed the ongoing scrutiny that U.K.-listed companies face regarding executive pay practices. Despite investor guidance continuing to call for restraint in executive remuneration, director compensation appears to have increased to beyond pre-pandemic levels. The Investment Association highlighted in its 2023 Principles of Remuneration that remuneration committees should be mindful of the current cost-of-living crisis, the inflationary environment and continuing economic uncertainty in determining 2022 pay outcomes and setting 2023 remuneration policies. Yet, the median FTSE 100 chief executive's pay rose by a sharp 12% in 2022, and the ratio of CEO pay to median employee pay widened from 76:1 in 2021 to 80:1 in 2022.²

Executive remuneration has also been a key factor in recent discussions on how to reinvigorate U.K. capital markets, given the differences in U.S. and U.K. incentives. Although remuneration packages initially do appear higher in the U.S. than in the U.K., the reality is more complex and nuanced than the media portrays and for both executives and companies alike, remuneration is just one of a number of factors considered in decisions on where to work or list. See our June 12, 2023, article, "[Are U.K.-Listed Companies Paying the Price for Executive Talent?](#)"

How the culture and approach in the U.K. toward executive compensation will develop remains to be seen. The debate continues following London Stock Exchange Group plc [CEO Julia Hoggett's recent comments](#) suggesting that executive compensation at U.K. companies may need to be increased in order to attract and retain executives and that broader, systemic reforms may be needed for the U.K. capital markets industry.

Many investors see incorporating ESG metrics into incentive arrangements as a priority and believe that any ESG measures must be objectively measurable to be meaningful.

² Deloitte, "FTSE 100 CEO Pay for 2022 Set to Exceed 2021 Levels by 12%" (April 10, 2023).

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The Financial Reporting Council (FRC), which regulates auditors and sets the U.K.'s Corporate Governance and Stewardship Codes, recently published a consultation paper for proposed revisions to the governance code. A new proposed "Principle P" highlights the importance of clearly aligning remuneration outcomes to company performance and purpose, and specifically mentions ESG objectives. This supports the argument that linking remuneration to ESG outcomes is moving from being a "nice to have" toward a necessity. A Willis Towers Watson's global study found that ESG metrics are now used by over three-quarters of companies when determining executive compensation, ranging from approximately 69% in the U.S. to approximately 90% in Europe and the U.K.

While broader stakeholder issues, including ESG considerations, continue to receive focus in remuneration, maximizing shareholder value creation is still the key objective for most companies and financial metrics remain the most prominent incentive tool for executive pay programmes. ESG metrics typically have an aggregate weighting of approximately 20% and companies will need to ensure that these ESG performance conditions are not used to guarantee or inflate vesting outcomes in an absence of appropriate performance, especially if U.K. investors become more open to more generous compensation packages in the future. ESG targets must be ambitious and not just reward "business as usual" activity if they are to avoid claims of greenwashing and truly incentivize management to pursue the company's ESG agenda.

ESG Litigation and Activist Pressure

- Climate litigation against regulators is on the rise across the globe.
- So far, derivative suits have not fared well in the courts.
- The European Court of Human Rights is hearing a case on the climate crisis for the first time.
- ESG litigation can carry risks not just for companies, but in some cases for activists who bring them.
- Though shareholder activism against oil and gas companies continues, it received less support this proxy season.

Though ESG litigation has previously focused on companies, this year has seen a large number of claims against regulatory authorities and governments across Europe. Recent examples include:

- In the U.K., the Financial Conduct Authority (FCA) is facing a potential judicial review of its decision to approve a prospectus that allegedly failed to make adequate disclosures about climate-related risks, and specifically that the prospectus did not explain how climate change risks affect the business of the

company. The judicial review can only be pursued if the English High Court grants permission, but the complaint may serve to cast a spotlight on the FCA's consideration of prospectuses and to heighten the attention on climate-related disclosures.

- The European Court of Human Rights (ECtHR) has heard a case alleging that the Swiss government's failure to sufficiently reduce the country's greenhouse gas emissions violated human rights to life and health by causing more frequent and intense heat waves. This will be the first time that the ECtHR has decided a case related to the climate crisis, and its decision will be noteworthy for showing how human rights will be interpreted with reference to climate change.
- The International Court of Justice (ICJ) has been asked by the United Nations (U.N.) General Assembly to give an advisory opinion on the obligations of states with regards to climate change, with a focus on human rights and civil, political and social rights.
- Two challenges have been brought in the ICJ to the EU's decision to label nuclear and natural gas investments as sustainable under the EU Taxonomy Regulation if they fulfil certain criteria.

The common thread is that governments are being challenged not only on their current and prospective policies, but also on how they tackled climate issues in the past. Companies need, therefore, to be prepared for increased government scrutiny — even for events that may have occurred several years ago.

In comparison, as predicted in our December 2022 article "[The Evolving Climates in the U.S. and U.K. for Environmental Damage Claims](#)," derivative claims as a tool for climate activists to apply pressure on companies in the U.K. have not gained much traction. There are several hurdles to the courts permitting such claims to be heard, as evidenced in the leading case to date, *Client Earth v Shell*,³ where the English High Court found this year that:

- There was no *prima facie* case for permission to be granted for a claim alleging that an oil company's directors' emission reduction targets are inadequate.
- The autonomy of the directors' decision-making should be emphasized and insufficient evidence was adduced to indicate that the directors had no reasonable basis for reaching the policy decisions.
- Client Earth had an ulterior motive in bringing the claim — to advance its own policy agenda — rather than to promote the success of the company, which is the goal of derivative claims. The court also noted that the overwhelming majority of the company's shareholders were supportive of its policies.

³ *ClientEarth v Shell Plc* [2023] EWHC 1137 (Ch).

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However, in the U.S. companies are facing increasing challenges from shareholders. As explored in more detail in our June 2023 article “[Companies Face Increasing Scrutiny Over Their ESG Disclosures — Including by ESG Critics](#),” shareholders have continued to file derivative and securities lawsuits alleging that companies have not lived up to their stated commitments to environmental and diversity goals. But, while initial suits in the U.S. challenging the accuracy of disclosures about corporate commitments to diversity have generally been dismissed, shareholders remain undeterred and have resorted to requesting access to corporate books and records, including board materials, under Section 220 of the Delaware General Corporation Law in hopes of gathering information to help bolster claims in amended complaints.

In addition to the scrutiny companies face from shareholders, the U.S. Securities and Exchange Commission (SEC) has proposed rules that would require detailed ESG disclosures and, while those proposals are pending, the agency has brought a number of enforcement actions challenging companies’ ESG-related disclosures and initiatives.

Alongside these pressures for more robust ESG policies and disclosures, U.S. companies are also contending with countervailing forces in the form of state officials seeking to restrain ESG initiatives, as discussed below in the “ESG Backlash in the U.S.” section.

It should be noted that ESG litigation is not without risk for the plaintiff. A French oil company is challenging assertions by an environmental NGO that its greenhouse gas emissions have been underestimated. The company is seeking withdrawal of the published assertions and asking that a penalty be imposed on the NGO and its supporting consultants. Where companies believe that allegations are misleading or exaggerated, they may go beyond a robust defense and actively seek vindication.

In addition to increasing litigation, climate activists have continued to utilize shareholder resolutions to challenge energy companies during the annual general meeting season. The goals of the resolutions ranged from seeking to alter internal climate policies to implementing stricter emissions standards.

Despite these efforts, most resolutions failed to gain widespread support this year and have not been implemented. For instance, support for a resolution proposed by Follow This at Shell’s annual meeting fell to 20% from 30% in 2022, and the proxy advisory firm Institutional Shareholder Services recommended that investors vote against the measure.

Although ESG activism remains focused on the oil and gas sector, the introduction of climate disclosure requirements in a number of jurisdictions may result in activists exploring targets in other industries.

Competition Issues

- The EC has published revised guidelines on agreements among competitors to pursue sustainability initiatives.
- The U.K.’s Competition and Markets Authority is consulting on its own proposed guidance, which allows more latitude than the EU’s approach.
- In contrast, in the U.S., competition concerns on climate-related business collaborations continue to be raised.

The debate on the role of antitrust in tackling climate change has continued to develop, with the publication of antitrust guidance on collaborative sustainability initiatives in both the EU and U.K. in the first half of 2023. This guidance is designed to help businesses seeking to work together on sustainability initiatives by providing greater clarity on how to assess these projects under competition laws.

The EC’s [revised horizontal guidelines](#), which include a new section on the assessment of agreements that pursue sustainability initiatives, were adopted on June 1, 2023, and will enter into force following their publication in the Official Journal of the EU. Now that the EC’s guidelines have been finalized, the Dutch Authority for Consumers and Markets has announced that it will bring its own, more expansive, draft guidelines on sustainability agreements in line with the EC’s.

In the U.K., the Competition and Markets Authority (CMA) issued for consultation draft guidance on environmental sustainability agreements on February 28, 2023. The CMA has diverged from the EC’s approach and proposed a broader interpretation of the exemption criteria for climate change agreements, framing these developments as a post-Brexit dividend.

Meanwhile, in the U.S., competition concerns continue to be raised about business collaborations designed to help reduce GHG emissions and advance the implementation of the Paris Agreement on Climate Change. In May 2023, a group of 23 Republican state attorneys general sent a critical letter to the U.N.-convened Net-Zero Insurance Alliance, suggesting that this collaboration may violate U.S. federal antitrust laws and certain state laws. Several insurers have since withdrawn from the alliance.

The potential for competition authorities to take divergent views on the legality of industry ESG initiatives is likely to result in companies continuing to take a cautious approach, particularly on cross-border ESG projects.

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Combatting Greenwashing

- The EC has published its proposed common criteria targeting greenwashing regarding products and services, and the U.K. FCA's anti-greenwashing rules will come into effect during the third quarter of 2023.
- The ESAs have published reports on the progress on greenwashing in the financial sector, identifying key greenwashing risks.

In March 2023, the EC published its proposed criteria aimed at limiting greenwashing and misleading environmental claims. The Green Claims Directive proposal aims to provide consumers with better quality information to choose environment-friendly products and services. Under the proposal, "green claims" made by companies will need to be independently verified and proven with scientific evidence before being communicated to consumers. Furthermore, the rules are also designed to ensure that any "green claims" are communicated clearly, including by ensuring that any comparisons made with other products or organizations are based on equivalent information and data.

The U.K. FCA's anti-greenwashing rule will come into effect during the third quarter of 2023. The rule requires firms to ensure that any references to the sustainability characteristics of a product or service are: (i) consistent with the sustainability profile of the product or service, and (ii) clear, fair and not misleading. All FCA-regulated firms will be subject to the rule and it will apply to all sustainability-related claims in client communications relating to products and services, regardless of whether the communication is with a retail client or not.

Alongside the ongoing consultations on SFDR, on June 1, 2023, each of the ESAs published their respective progress reports on greenwashing in the financial sector, reaching consensus on the definition of greenwashing as "a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services." The reports also note that the claims can occur intentionally or unintentionally, and can occur at both entity and product levels. ESMA's report is focused on investment management (including investment service providers), issuers and benchmark administrators, while the EBA and EIOPA reports are focused on the banking, insurance and pension sectors.

ESMA's report identifies key greenwashing risks, including ESG strategy and policy, ESG governance, fund names and fund manager's engagement with investee companies. In terms of mitigating such risks, ESMA has set out potential avenues for remediation, which include:

- Clarifying key concepts in the SFDR, such as what qualifies as a "sustainable investment," as discussed above.
- Clarifying due diligence responsibilities of managers in value chains in order to reduce the risk of unintentional misleading claims.
- Enhancing the reliability and comprehensiveness of sustainability data by improving ESG data methodologies and through verification and auditing.

The ESAs are due to publish their final reports in May 2024.

ESG Backlash in the US

- ESG continues to be a contentious topic in the U.S. at both the state and federal level, with pressure for both more and less emphasis on ESG considerations.
- As ESG becomes increasingly politicized, companies are working to navigate between these competing approaches.

In the U.S., ESG efforts have become highly politicized, a trend that is likely to increase as the 2024 election approaches. Approximately 100 anti-ESG bills have been introduced in state legislatures around the country. These bills cover a range of topics including blocking state entities from considering ESG factors when making investment decisions, prohibiting and defunding state entities' diversity and inclusion efforts, and protecting fossil fuel and other industries.

In addition, in a decision that may have implications for corporate diversity and inclusion efforts, the U.S. Supreme Court ruled on June 29, 2023, that college admissions processes that take applicants' race into consideration are unlawful. Although the decision was limited to the college admissions context, U.S. companies likely will review and reassess their hiring, promotion and other diversity, equity and inclusion efforts in light of the ruling. For a more detailed discussion of the case, see our July 6, 2023 client alert, "[Potential Private Sector Implications of the Supreme Court's Affirmative Action Ruling.](#)"

At the federal level, although the U.S. Department of Labor adopted a rule that permits retirement plan fiduciaries to consider ESG factors when making investment decisions, Congress adopted a joint resolution to nullify the measure. President Biden vetoed that effort, but members of the House of Representatives have introduced a bill that would amend federal law to specify that retirement plan fiduciaries could consider only pecuniary factors when making investment decisions. In addition, a Republican House of Representatives working group recently issued a preliminary report that may serve as a roadmap for additional

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legislative initiatives including, among others, changing the SEC shareholder proposal rules and related no-action processes, and regulating proxy advisory firms.

The ESG backlash is not limited to legislative action. For example, an employee of a large U.S. company has brought a class action lawsuit alleging that the company's retirement plan has underperformed because of its investments in funds pursuing ESG goals in violation of federal law. Retirement plans will closely monitor the progress of this lawsuit, which could have a chilling effect on ESG-related investments.

Alongside legal challenges, there has also been increasing focus on the political activities of companies and how these tie to ESG considerations. Over the last two decades, shareholder proposals asking for disclosure of political activities have been commonplace, but there is growing pressure for these disclosures to be made in order to assess a company's ESG commitments. A recent Public Affairs Council Pulse survey found that more than 60% of survey respondents from the general public believe that Americans would like major companies to advocate on certain social issues, including environmental protection and ending gender, racial and sexual orientation discrimination.

As a result, nearly 20% of the ESG-related proposals filed in the 2023 proxy season related to disclosure on political activities. However, alongside this, the number of anti-ESG proposals has grown, reflecting the ongoing ESG backlash and companies involving themselves in these matters.

Given there is no sign of these contending pressures abating in the near term, companies should look to build on their strategies to combat the proposals from both sides and work on clear and objective messaging on their political activity expenditure. See our June 2023 article "[Companies Face Increasing Scrutiny Over Their ESG Disclosures — Including by ESG Critics.](#)"

Key Regulatory and Legislative Updates

Changes to and Impacts of the EU's Sustainable Finance Disclosure Regulation

- The European Commission has clarified the interpretation and application of certain Sustainable Finance Disclosure Regulation (SFDR) requirements.
- The European Supervisory Authorities published a consultation paper on proposed changes to SFDR relating to the principal adverse impact indicators, the "do no significant harm" requirements and the inclusion of the greenhouse gas disclosure

Since the implementation of the EU's Sustainable Finance Disclosure Regulation (SFDR), entities falling within its scope

(referred to as financial market participants or FMPs) have faced difficulties in interpreting the law; *e.g.*, construing terms such as "sustainable investment" and applying labelling requirements meant to prevent exaggerated green credentials.

The European Supervisory Authorities (ESAs) — the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) — submitted questions regarding the interpretation of SFDR terms in September 2022, which the European Commission (EC) responded to in May this year.

Regarding "sustainable investment" and whether it applies to investments in funding instruments that do not specify the use of proceeds, the EC confirmed that the SFDR does not prescribe any specific approach to determining the contribution of an investment to environmental or social objectives, and confirmed that the notion of "sustainable investment" is measured at the level of the company, rather than the specific economic activity.

The EC has also confirmed that the SFDR does not set minimum requirements for other concepts such as "contribute" and "good governance" and has advised FMPs to make their own assessments and disclose their underlying assumptions.

The EC also provided guidance regarding Article 8 of the SFDR (Transparency of the Promotion of Environmental or Social Characteristics in Pre-Contractual Disclosures), saying this provision does not limit the types of characteristics that may be promoted, as opposed to having these characteristics as its objective. However the EC reminded FMPs to be mindful of their obligations not to mislead investors into believing a product pursues sustainable investment as its objective, where the promotion of carbon emissions reduction is a mere characteristic of the investment strategy.

In April 2023, the ESAs published a joint consultation paper outlining proposed changes to the SFDR's regulatory technical standards. The proposed changes relate to the following areas:

- **Principal adverse impact indicators (PAIs):** Adding more mandatory and optional social indicators with regard to tax, tobacco and employee relations.
- **"Do no significant harm" requirements:** Reducing the discretion afforded to FMPs in designing the methodology used to assess compliance with the "do no significant harm" requirements to minimize the risk of greenwashing.
- **Inclusion of greenhouse gas emissions in disclosures:** Adding a new section specifying pre-contractual, website and periodic disclosures for Article 8 and Article 9 products to cover greenhouse gas (GHG) emissions, requiring FMPs to insert details relating to the target, the removal and storage, any carbon credits used, and progress made in relation to GHG emissions.

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- **Pre-contractual and periodic disclosures:** Simplifying the disclosure templates and including a dashboard of key information to make the disclosures more accessible for retail investors.

The consultation closed on July 4, 2023 and the ESAs are expected to submit a final report to the EC later in the year.

New Emphasis on Biodiversity

- Biodiversity has emerged as a new and growing issue within ESG.
- A number of stakeholders are working to establish a reliable reporting framework in order to assist in assessing biodiversity impacts.
- Biodiversity credits have been created, similar to the current carbon credit system

Since January, biodiversity on both land and sea has emerged as a new ESG frontier. The U.N.'s [30x30 policy](#), aiming to conserve 30% of all land and marine habitats by 2030 in order to protect biodiversity, was adopted by a large number of countries at COP15 in December 2022, and 2023 has seen renewed levels of interest in and encouragement of private investment, incentives and new opportunities in this area. Even though investment in biodiversity-focused projects has risen over the last decade (including a wave of new biodiversity funds in the last 12 months), issues remain. In particular, the scaling of these projects while meeting requirements for a transparent and rigorous impact-assessment process means that the sector is having to adapt quickly to meet investor needs.

The business-backed [Taskforce on Nature-related Financial Disclosure](#) (TNFD), whose purpose is to develop a reliable nature-related risk management and disclosure framework, published the fourth version of its framework in March 2023 for consultation. The TNFD is similar to the Financial Stability Board's Taskforce on Climate-related Financial Disclosure, and it is hoped that this will assist investors in evaluating the reputability of biodiversity assets. The TNFD's consultation closed at the start of June and the full framework for market adoption is expected to be released in September 2023.

The Global Reporting Initiative (GRI), an independent standards organization, also closed a [consultation on its topical standard for biodiversity](#) in response to growing pressure for accountability. It expects to release a revised standard in the fourth quarter of 2023. This should assist companies and investors in accurately reflecting biodiversity in their reporting and investment decisions.

A number of jurisdictions are also considering the introduction of biodiversity credits, which would enable companies to purchase environmental credits on an annual basis to compensate for the impacts of their operations. This year, the U.K. government

published a [policy paper](#) on a possible new framework, intended to be similar to the voluntary carbon markets framework. This would assist with the scaling up of private investment in nature recovery as well as sustainable farming. The Australian parliament is also considering a [voluntary nature market](#) intended to enable private investment in biodiversity through the creation of tradable units or credits.

Beyond the US, UK and EU

- ESG is becoming pervasive in policy and regulation globally.

Although the focus in past years has been on the U.S., U.K. and EU, jurisdictions across the globe have looked to introduce similar ESG reporting requirements. Some examples from the past six months alone include:

- A proposal for the Hong Kong Stock Exchange to change from a "comply or explain" climate risk disclosure regime to a mandatory one.
- A Canadian proposal to amend corporate governance disclosure rules in order to increase board diversity beyond gender.
- In India, the 250 largest businesses will be required to provide assurance on their ESG reporting and supply chain disclosures starting in 2024.

As increasing numbers of jurisdictions seek to meet stakeholder expectations with ESG legislation and regulation, companies will need to carefully monitor and consider the implications of these on their business. In particular, multinationals will need to be mindful of the potential divergences in reporting requirements and how they can ensure consistent reporting at the group level while complying with local requirements.

Incoming ESG Disclosure Obligations

- The European Parliament approved the Corporate Sustainability Due Diligence Directive in June 2023, which will require companies to conduct due diligence across their value chains.
- The EU intends to publish in July the revised European Sustainability Reporting Standards to compliment the Corporate Sustainability Reporting Directive.
- The U.K.'s Financial Reporting Council is currently consulting on the U.K. Corporate Governance Code and has asked for stakeholder input on the current disclosure obligation burden in the U.K.
- The SEC is targeting October 2023 for the adoption of rules on climate change disclosure.

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Starting in 2023, companies face a considerable increase in standardized ESG disclosure rules and standards from a number of jurisdictions. This growing kaleidoscope of obligations means companies will face increasing demands for high quality data disclosure not just from stakeholders but regulators. Indeed, as regulators globally seek to accelerate the adoption of increasingly complex and comprehensive ESG disclosure rules, companies and auditors alike will need to ensure they are prepared to respond to new compliance regimes.

For instance, on June 1, 2023, the European Parliament approved its report on the proposed Corporate Sustainability Due Diligence Directive (CSDDD). The CSDDD is intended to harmonize rules across EU member states and would apply to EU companies with over 250 employees and worldwide turnover exceeding €40 million. Non-EU companies with a turnover of €150 million or more will also be included if at least €40 million of that was generated in the EU. The CSDDD would require these companies to conduct due diligence across their value chains and address any human rights abuses in addition to any environmental harm. Companies would also be required to implement a Paris Agreement-aligned transition plan, with non-compliant businesses risking fines of at least 5% of their net worldwide annual turnover.

In addition, the European Sustainability Reporting Standards (ESRS) that define the rules of the Corporate Sustainability Reporting Directive are intended to be adopted as delegated acts in July 2023. For additional information on the directive, see our January 9, 2023, article [“Q&A: The EU Corporate Sustainability Reporting Directive: To Whom Does It Apply and What Should EU and Non-EU Companies Consider?”](#)

In the U.K., the government and other corporate regulators have also revisited a wide range of ESG disclosure obligations in the first half of 2023. The FRC has included a number of ESG proposals in its consultation on the U.K. Corporate Governance Code and, alongside the U.K. Department for Business and Trade (DBT), is conducting a review of the non-financial reporting requirements of U.K. companies under the Companies Act 2006 (CA 2006).

The FRC and DBT have asked for responses relating to the costs and benefits of the current reporting framework, and DBT have asked stakeholders to provide information on the ease of gathering the requisite information, whether the information produced is useful to stakeholders and whether the CA 2006 requirements successfully align with those set out in other legislation relating to non-financial reporting, such as the Gender Pay Gap Reporting Regulations and the Modern Slavery Act.

These consultations provide an indication that the U.K., while looking to adopt effective legislation and regulation to meet its net zero goals, is also keen to ensure that the regulatory and reporting burden does not deter businesses from operating in the U.K.

In the U.S., the SEC’s most recently published rulemaking agenda — which is non-binding — indicates that the SEC is targeting October 2023 for adoption of final rules on climate change disclosure applicable to U.S.-registered public companies in October 2023. As described in our May 24, 2022, client alert [“SEC Proposes New Rules for Climate-Related Disclosures,”](#) the rules as proposed would add extensive and prescriptive disclosure requirements relating to climate-related risks and GHG emissions.

Considering the number of developments that have occurred in 2023 alone, it is no surprise that high-profile officials such as French President Emmanuel Macron are now calling for a break from further legislation in order to allow businesses to adapt to the swathe of new green regulation. However, the next six months will likely bring new challenges as teething issues and adjustments under the new rules begin to arise.

Expected for the Remainder of 2023

ISSB Financial Reporting Standards

- The International Sustainability Standards Board issued its inaugural financial reporting standards at the end of June.
- These standards will be effective from January 2024 and are intended to assist in standardising ESG data.

A wide range of market participants have worked together to respond to the demand for increasing ESG data and clear standards. The International Sustainability Standards Board (ISSB), formed by the International Financial Reporting Standards Foundation (IFRS), issued its inaugural financial reporting standards, IFRS S1 and IFRS S2, on June 26, 2023. At the London Stock Exchange Group plc’s launch event for the standards, the exchange’s CEO Julia Hoggett hailed this as a “landmark day for the global economy.”

S1 is the “core baseline” of sustainability reporting and is designed to apply globally to corporates in all sectors to better unify disclosures on factors such as waste and emissions. It sets out how companies can integrate reporting and links sustainability with financial information. S2 details more specific topics such as climate mitigation and adaptation, and will build on existing disclosure frameworks.

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ISSB Chair Emmanuel Faber stated that the standards are intended to cut through the “alphabet soup” that has hampered companies in the past few years, reiterating that the standards are not a suite of ESG metrics or disclosures but “a comprehensive language which is deemed to be consistent, verifiable and therefore decision-useful” for market participants.

Both S1 and S2 will be effective from January 2024 and corporate reports should align with the standards beginning FY 2025.

Challenges Facing ESG Rating Agencies

- The ongoing divergences between ESG rating agencies will remain a focus for U.K. and EU regulators in the second half of 2023.

Dissonance across the ESG ratings industry might soon be resolved after U.K. and EU regulators raised concerns about rating agencies’ “opaque” practices. Currently, not only approaches, but objectives, methodologies and indicators vary significantly, making it difficult for customers and investors to appreciate precisely what and how ESG metrics should shape investment decisions.

ESMA has described the market for ESG ratings as “immature” based on the structure and dispersion of methodologies.⁴ A Stanford business school researcher has noted that the input variable between rating agencies is “massively large”⁵: FTSE Russell claims its model uses 300 indicators; Refinitiv uses 630 ESG metrics; and S&P Global uses 1,000 underlying data points. This lack of standardization at a high level is problematic for companies reporting the same information to different providers, as their scales are not directly comparable.

In a [Dear CEO letter](#) dated September 2022, the U.K.’s FCA set out perceived risks in providing ESG ratings. This letter’s sequel, “[ESG Benchmarks Review](#),” dated March 2023, was harsher: It warned that benchmark administrators are fuelling greenwashing after identifying “widespread failings” with ESG benchmarks. The second letter signals that these ratings are rising to the top of regulatory priorities.

Efforts to improve their practices are underway in the market. MSCI, the index provider, changed its criteria for ESG labelling of ETFs in March 2023.⁶ Most “physical” funds, which directly hold bonds and equities, saw their ESG ratings lowered, while

⁴ ESMA, “ESMA Publishes Results of Its Call for Evidence on ESG Ratings” (June 27, 2022).

⁵ Bryan Tayan, “ESG Ratings: A Compass Without Direction,” Harvard Law School Forum on Corporate Governance (August 24, 2022).

⁶ MSCI, “Enhancements to MSCI’s Fund ESG Ratings” (March 2023).

the number of AAA-rated European ETFs was estimated to fall from 1,120 to 54, and the number with “no rating” was estimated to rise from 24 to 462. All “synthetic” ETFs, which use swaps to track the value of assets, were expected to have lost their ESG rating even if the funds that own the identical underlying asset were rated highly. MSCI explained that it would only rate synthetic ETFs once it has developed a method to rate consistently the data of the constituents of the underlying index being tracked, rather than the data of the swap collateral holdings. This is in contrast to Dow Jones’ ESG ratings, which are based on indices rather than funds, so a swap-based ETF will have the same rating as a physical one replicating the same index.

Granular divergence such as this, as well as the aforementioned broad brush concerns already raised by regulators, explain the rationale behind [HM Treasury’s proposal](#) for a regulatory regime for rating providers in the U.K. In the U.K., credit ratings agencies, like benchmark administrators, are regulated by the FCA, which has expressed support for introducing regulatory oversight of ESG data and rating providers specifically. In the meantime, a [voluntary Code of Conduct for ESG data rating and agency providers](#), published on July 5, 2023 has been developed by an industry working group led by the FCA. The U.K.’s move is in tandem with EU sentiment: Draft EC proposals indicate that companies providing ESG ratings must explain their methodologies and obtain regulatory authorization to continue to provide these services.

In both jurisdictions, bringing ESG rating providers within the regulatory perimeter will involve consultation of the International Organization of Securities Commissions and likely adoption of its recommendations. Regulating ESG data and rating agencies in that way would harmonize expectations and practice, particularly where rating agencies might also be benchmark administrators. To encourage such uniformity would be to instill confidence in investors and consumers alike.

United Nations COP28

- The COP28 conference will be held in the United Arab Emirates in November 2023.
- The conference president has announced a focus on the reduction of emissions rather than the phasing out of fossil fuels, which has sparked complaints.

This year’s United Nations Climate Change Conference (COP28) is set to take place in the United Arab Emirates this November and, despite being nearly six months away, is already the subject of much debate. The appointed president of COP28, Sultan al-Jaber, is also the head of the Abu Dhabi National Oil Company, and has stated that fossil fuels will continue to play

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a key role for the “foreseeable future.” This has resulted in a number of climate activists and stakeholders criticizing the conference before it has even begun as placing too much emphasis on fossil fuels, but others believe this may represent a more realistic approach to climate change.

As the halfway point of the commitments made under the 2015 Paris Agreement, COP28 will attempt to reassess the steps

necessary to meet the treaty’s 2030 climate goals, which involve further reducing emissions by 43% to achieve the initial 1.5° reduction target. The preliminary policy agenda focuses on global climate finance, proposes a \$100 billion fund to assist impoverished nations adapting to climate change, and stresses reducing emissions rather than phasing out production of fossil fuels. The outcome of COP28 and its implications for companies will therefore be interesting to see.

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