SULLIVAN & CROMWELL LLP

ESG Monthly Newsletter

January 2023

This memorandum highlights key recent developments in environmental, social and governance matters of relevance to public and private companies globally. For more information on this evolving business and legal landscape, we encourage you to reach out to your regular Sullivan & Cromwell contact or the lawyers listed on our **ESG practice website**.

In this Issue

- Legislative/Regulatory Updates
  - Global
  - United States
  - United Kingdom
  - European Union
  - Australia
  - New Zealand
  - Japan
- Financial Institutions Developments
  - Global
  - United States
- Sustainable Finance Updates

Key Developments

- **EU finalizes new Corporate Sustainability Reporting Directive.** The directive will introduce more detailed sustainability reporting requirements for EU companies, non-EU companies meeting certain thresholds for net turnover in the EU and companies with securities listed on a regulated EU market. The scope of required reporting covers environmental factors (including Scope 1, 2 and 3 greenhouse gas emissions as well as various non-climate factors), and social and human rights and governance factors.
- **EU agrees reforms to its "cap and trade" scheme for regulating greenhouse gas emissions.** The reforms, which have been agreed by the Council of the EU and European Parliament, intend to reduce emissions in sectors covered by the EU Emissions Trading System by 62% by 2030 (compared to 2005 levels). A phased reduction in emissions allowances will take place until 2030 and free allowances will be phased out by 2036. A new and distinct Emissions Trading System II, which will create a market for emissions for fuel for road transport and buildings, is proposed to be introduced in 2027. Proceeds from the sale of allowances under ETS II will support a new EU-wide Social Climate Fund intended to address social impacts arising from the introduction of ETS II. In December, the Council and Parliament also reached a provisional agreement on the Carbon Border Adjustment Mechanism, which complements the ETS II by dis-incentivizing "carbon leakage".
- **International agreement on biodiversity action reached at COP15**. Governments participating in COP15 in December have adopted the Kunming-Montreal Global Biodiversity Framework, which includes the "30x30" pledge to effectively conserve and manage 30% of global terrestrial, inland water, and coastal and marine areas by 2030 and 22 other action-oriented global targets.

Legislative/ Regulatory Updates

1. *Global*

COP15 reaches international agreement to take action on biodiversity. The 15th meeting of the Conference of the Parties to the United Nations Convention on Biological Diversity took place between December 7 and 19 in Montreal, Canada. Participating governments adopted the Kunming-Montreal Global Biodiversity Framework. In order to achieve long-term biodiversity goals for 2050, the framework includes a wide-ranging package of 23 action-oriented global targets to be achieved by 2030. A flagship feature of the framework, supported by over 150 financial institutions, is the "30x30" pledge to effectively conserve and manage 30% of global terrestrial, inland water, and coastal and marine areas by 2030. Amongst other pledges, the framework includes targets to reduce

risks posed by pesticides and hazardous chemicals by half by 2030, raise international finance flows from developed to developing countries to $30 billion by 2030, and require large and transnational companies and financial institutions to regularly monitor, assess and transparently disclose their risks, dependencies, and impacts on biodiversity throughout their operations, supply and value chains and portfolios. Also at COP15, the International Sustainability Standards Board ("ISSB") announced that "sustainability" will be described in the forthcoming ISSB General Sustainability-related Disclosures Standard as "the ability for a company to sustainably maintain resources and relationships with and manage its dependencies and impacts within its whole business ecosystem over the short, medium and long term".

ISSB seeks to reduce the burden of disclosing data on Scope 3 greenhouse gas emissions. The ISSB has announced measures to facilitate the disclosure of Scope 3 GHG emissions under the sustainability disclosure standards being developed by the ISSB. Disclosure of Scope 3 emissions, which refers to emissions generated throughout a reporting company's value chain, will be required by the ISSB's Climate-related Disclosures Standard. However, the ISSB has agreed to set out a framework for the measurement of Scope 3 GHG emissions that would allow for estimation and require the use of reasonable and supportable information that is available without undue cost or effort. To further support companies, the ISSB also agreed to additional transitional measures, including allowances for a company to include information not aligned with its reporting period when that information comes from companies in its value chain with a different reporting cycle.

TCFD status report shows dramatic increase in provision of climate-related disclosures. The Task Force on Climate-related Financial Disclosures ("TCFD") released its 2022 TCFD Status Report, marking five years since it first provided its widely used framework for corporate climate disclosures. The status report noted that in 2021 over 80% of the public companies it surveyed provided information in accordance with at least one of the 11 recommended disclosures, although only 4% of reporting companies provided all the recommended disclosures. The report also indicated that over three-fourths of companies that are implementing TCFD disclosure requirements are doing so due to investor requests for information, while only one-fourth of companies implementing disclosures are doing so due to a legal obligation to provide such information.

2. *United States*

'Anti-ESG' initiatives advance, primarily at state level. Multiple U.S. states continue to push back against the trend of companies and asset managers considering ESG factors in making investment and management decisions. Many of the proposed measures at the state legislative and executive level take aim at entities, such as asset managers and banks, that are pulling back from investing in or working with certain industries, such as carbon-intensive sectors. In addition, at the federal level, the minority Republican staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs released a report in December arguing that the "big three" asset managers use shareholder voting power to promote "liberal social goals known as ESG (environmental, social, and governance) and DEI (diversity, equity, and inclusion)" and raising questions about their compliance with federal securities and banking laws. Additionally, in November 2022, 13 state Attorneys General requested that the Federal Energy Regulatory Commission deny Vanguard's application to extend its authorization to invest in publicly traded utilities, arguing that, by making net-zero pledges, Vanguard "abandoned its status as a passive investor in public

utilities and adopted a motive consistent with managing the utility." Vanguard subsequently announced its decision to withdraw from the Net Zero Asset Managers Initiative on December 7. See S&C's memo on key ESG considerations for U.S. financial institutions in 2023 for more information. These state-level anti-ESG initiatives are likely to continue throughout 2023 and create uncertainties and challenges as companies, particularly asset managers and banks, navigate conflicting demands from various stakeholders.

SEC confirms expected timing of new ESG rules, including on climate disclosures. The SEC is expected to take final action on its proposed new climate-related disclosure rule in spring 2023, according to the Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions released by the Office of Management and Budget's Office of Information and Regulatory Affairs in January 2023 (the "Agenda"). The new rules, proposed in March 2022, would require expansive new disclosures from issuers on climate change and greenhouse gas emissions. The final rules were expected as early as October 2022 but were delayed, with SEC speakers declining to discuss the scope and timing of the final rules in recent remarks. According to the Agenda, the SEC is also expected to take action by fall 2023 on amendments related to ESG and the asset management industry, including proposed amendments to rules and reporting forms relating to the incorporation of ESG factors by registered investment companies and business development companies and separately proposed amendments to Rule 35d-1 under the Investment Company Act of 1940 (the "Names Rule") that would address the use by investment funds of names indicating that their investment decisions reflect ESG factors. Please see S&C's memos on the Names Rule and ESG disclosures for investment advisers and investment companies for more information.

FTC seeks comments on revisions to the Green Guides. On December 14, the Federal Trade Commission ("FTC") voted to approve a public consultation period on updates to its Guides for the Use of Environmental Marketing Claims, known as the "Green Guides." Established in 1992 and last revised in 2012, the Green Guides define and standardize the use of sustainability-related terms to prevent false or misleading advertising claims, known as "greenwashing." The FTC regularly cites the Green Guides in its enforcement cases, and states such as California have incorporated them into state law. Proposed updates could include the addition of guidance on how consumers interpret the term "sustainable" and further guidance on advertising related to carbon offsets or climate change.

3. *United Kingdom*

UK Government updates its green hydrogen strategy. The UK Government has published a December 2022 update to the UK Hydrogen Strategy. The update summarizes the activity taken across the UK Government, since the previous update last July, to develop new hydrogen policy at pace and to design and deliver funding support. It includes announcements on, amongst other things, shortlisted hydrogen projects in the carbon capture, usage and storage Cluster Sequencing Process, the launch of a consultation on hydrogen transport and storage infrastructure, the publication of heads of terms for the UK's Hydrogen Production Business Model contract for hydrogen producers, and an update on the ongoing first Electrolytic Hydrogen Allocation Round. (For information on recent hydrogen initiatives in the United States and the EU, see S&C's memos here and here.)

UK Government announces sustainable finance measures. As part of a wider set of reforms to UK financial services regulation announced on December 9, the UK Chancellor of the Exchequer, Jeremy Hunt, revealed two new measures designed to ensure the UK retains global leadership in sustainable finance. First, an updated Green Finance Strategy will be published in early 2023, revising the 2019 version of the Strategy. The Government has separately stated that the revised Strategy will include an update on its approach to developing a UK Green Taxonomy. Second, in Q1 2023 the Government will consult on bringing ESG ratings providers within the regulatory perimeter of the UK Financial Conduct Authority. Please see S&C's previous ESG Newsletter and memo for more information on the UK's regulation of ESG ratings providers.

FCA and FRC continue ongoing monitoring of climate-related financial disclosures. On December 12, the UK Financial Conduct Authority ("FCA") published Primary Market Bulletin No. 42 regarding compliance with TCFD disclosure requirements under the UK's Listing Rules. The Primary Market Bulletin reminded issuers of the FCA's existing guidance and identified a number of areas for improvement in listed companies' disclosure of forward-looking information. In addition, on December 16, the Financial Reporting Council announced that, following its thematic review of TCFD disclosures in 2022 (carried out in collaboration with the FCA), it will undertake a targeted follow-up in 2023 with a focus on the metrics and targets disclosures of companies from four relevant sectors (namely: travel, hospitality and leisure; retail and personal goods; construction and materials; and industrial transportation).

4. *European Union*

EU finalizes new ESG reporting requirements. The European Union has finalized the Corporate Sustainability Reporting Directive ("CSRD") that will introduce more detailed sustainability reporting requirements for EU companies, non-EU companies meeting various thresholds for net turnover in the EU and companies with securities listed on a regulated EU market. The scope of required reporting covers environmental, social and human rights and governance factors. Environmental factors include not only climate (including Scope 1, 2 and 3 greenhouse gas emissions) but also water/marine resources, circular economy, pollution and biodiversity. For more details on the CSRD, please see S&C's recent memo here.

EU reaches political agreement on reforming its Emissions Trading System, establishing a Social Climate Fund, and combating 'carbon leakage.' On December 17, the Council of the EU and the European Parliament reached political agreement on proposals to reform the EU Emissions Trading System ("ETS"), the EU's "cap and trade" scheme for regulating greenhouse gas emissions, and to establish a Social Climate Fund to support vulnerable households and others affected by the energy transition. The reforms to the ETS include one-off and annual reductions to the EU-wide quantity of allowances of CO2 equivalent emissions, with the goal of cutting emissions in sectors covered by the ETS by 62% by 2030 (compared to 2005 levels). The Social Climate Fund will be introduced in 2026, and aims to address any social impacts that arise from the expected launch in 2027 of a distinct emissions trading system covering fuel for road transport and buildings ("ETS II"). The Fund can finance temporary direct income support to address increased prices in road transport and heating fuel, as well as structural investments, including in buildings, infrastructure and public transport. Complementary to the ETS II, the Council and Parliament also reached a provisional agreement in December on the Carbon Border Adjustment Mechanism ("CBAM"). The CBAM would levy a tariff on

goods from specific carbon-intensive sectors imported into the EU in order to mitigate the outsourcing of carbon-intensive production to non-EU countries, known as "carbon leakage." Once formally adopted, the CBAM is expected to be phased-in from October 2023.

5. *Australia*

Australia plans mandatory climate reporting. On December 12, the Australian government released a consultation paper seeking views on the development of a mandatory climate-related financial disclosure framework. Disclosure on climate governance, strategy, risk management, and targets and metrics would be required, in alignment with the TCFD framework, with flexibility to accommodate future standards. This framework is part of a new push by the government to develop a comprehensive sustainable finance strategy that aims to address "opportunities presented by surging global momentum in sustainable finance" and follows the government's commitment in its October budget to introduce standardized and internationally aligned climate disclosure requirements. Among other matters, the consultation seeks feedback on questions dealing with the design, content, implementation and scope of the proposed regime. For instance, the consultation proposes reporting requirements that are initially aligned with the TCFD framework but with flexibility to accommodate the standards being developed by the International Sustainability Standards Board (ISSB), once finalized, and proposes that various requirements to disclose Scope 3 emissions will apply. The consultation also solicits feedback on the level and nature of assurances that should be required, liability matters, such as whether existing standards for forward-looking statements are appropriate, and consistency of reporting requirements. The consultation closes on February 17, 2023, though additional consultation on more detailed proposals is likely.

6. *New Zealand*

New Zealand climate reporting standards to take effect for the 2023 financial year. In December, the New Zealand External Reporting Board published the final climate-related disclosure standards under legislation, passed in October 2021, to mandate climate-related financial disclosure requirements for most issuers listed in New Zealand, large registered banks, licensed insurers and managers of investment schemes. Around 200 large financial institutions covered by the legislation will be required to start making climate-related disclosures for financial years commencing in 2023, with disclosures being made in 2024 at the earliest. The law requires companies to consider and disclose climate change risk via new annual "climate statements," based on standards issued by the External Reporting Board and developed in line with the recommendations of the TCFD.

7. *Japan*

Finalization of Code of Conduct for ESG evaluation and data providers. On December 15, Japan's Financial Services Agency ("FSA") finalized a voluntary code of conduct for ESG evaluation and data providers (the "Code"). Consistent with the International Organization of Securities Commission's final report on ESG ratings and data product providers, published in November 2021, the Code sets out specific principles and guidelines to improve the quality and transparency of services, including internal controls ensuring independence and management of conflicts of interest, disclosure of methodologies and processes, and steps for communication with companies subject to evaluation. The Code takes a principles-based approach, and organizations that endorse the Code are encouraged to publicly apply the Code on a "comply or explain" basis. The

FSA intends to publish an update on the status of endorsement by evaluation providers by June 2023, with an update on endorsements by data providers to follow by June 2024.

Financial Institutions Developments

1. *Global*

Basel Committee issues climate-related FAQs. On December 8, the Basel Committee on Banking Supervision (the "Basel Committee") issued responses to frequently asked questions ("FAQs") to clarify how climate-related financial risks may be captured in existing Pillar 1 standards. The FAQs are intended to facilitate consistent interpretation of existing standards given the unique features of climate-related financial risks and should not interpreted as changes to the standards. The FAQs discuss how climate-related financial risks may be captured in the following Basel standards: CRE – Calculation of RWA for credit risk; OPE – Calculation of RWA for operational risk; MAR – Calculation of RWA for market risk; and LCR – Liquidity Coverage Ratio. The Basel Committee has stated that the FAQs are consistent with its Principles for the effective management and supervision of climate-related financial risks (2022).

2. *United States*

Fed requests comment on draft principles for climate-related financial risk management. The Board of Governors of the Federal Reserve System (the "Board") is requesting comment on draft Principles for Climate-Related Financial Risk Management for Large Financial Institutions, published December 8. The draft principles aim to provide a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the risk management frameworks described in the Board's existing rules and guidance. The draft principles are intended for Board-supervised financial institutions with over $100 billion in assets and are consistent with the principles previously proposed by the FDIC and OCC. Comments on the draft principles must reach the Board on or before February 6, 2023. See S&C's memo on key ESG considerations for U.S. financial institutions in 2023 for more information.

New York banking regulator releases new guidance on climate-related financial risks. On December 21, the New York State Department of Financial Services ("DFS") released new proposed guidance to support efforts by New York State-regulated organizations, including banking organizations and mortgage servicers, in assessing and managing their material climate-related financial risks. The guidance intends to address such risks in the context of risk assessment, risk management and risk appetite setting. The DFS noted that the guidance is not intended to tell regulated entities how credit or investment decisions might evolve to account for climate-related financial risks.

Sustainable Finance Updates

Update on sustainable debt market. 2022 saw a reduction in global sustainable debt issuances compared to 2021. According to Bloomberg reporting, in 2022 issuances of sustainable finance bonds amounted to $863 billion, from $1.1 trillion in 2021. Last year thus broke a recent trend of year-on-year growth in sustainable debt; by contrast, issuances doubled between 2020 and 2021. However the decline has not been universal, with issuances continuing to grow in Asia. Bloomberg also reported that green bond sales in China have jumped to $90 billion this year from about $68 billion in 2021 and that yen-denominated ESG bonds from Japanese borrowers have risen about 50% to around $23 billion in 2022.

EU Commission calls on EBA for advice on green loans and mortgages. As part of the EU's 2018 Action Plan on Financing Sustainable Growth, the EU Commission issued a call for advice from the European Banking Authority ("EBA") on measures to increase the uptake of sustainable financing by households and Small and Medium Enterprises ("SMEs") through green loans and mortgages. Advice is requested on whether to include SME exposures in credit institutions' disclosures under the EU Taxonomy, of credit institutions and how to facilitate use of green loans by retail borrowers while protecting against potential risks. The request for advice runs until December 29, 2023.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 900 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.