SULLIVAN & CROMWELL LLP

ESG Monthly Newsletter

November/December 2023

This memorandum highlights key recent developments in environmental, social and governance matters of relevance to 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**.

Key Developments

- **Policymakers intensify scrutiny of voluntary carbon markets.** In response to the increased global use of voluntary carbon credits by companies to offset their greenhouse gas (GHG) emissions, policymakers and market participants have expressed concerns that voluntary carbon markets lack transparency and standardization, making it difficult to differentiate high-quality credits from low-quality ones. Recent efforts seeking to regulate the voluntary carbon credit markets include:
    - A public consultation, which the board of the International Organization of Securities Commissions (IOSCO) announced at COP28, on a proposed set of "Good Practices" for the voluntary carbon markets, which are intended for consideration by regulators and other authorities or market participants to address vulnerabilities identified by IOSCO.
    - Proposed guidance from the U.S. Commodity Futures Trading Commission (CFTC) regarding the listing for trading, by CFTC-regulated derivatives exchanges, of voluntary carbon credit derivative contracts.
    - California's recently enacted Voluntary Carbon Markets Disclosure Act (AB 1305), which requires detailed disclosures from (1) business entities that market or sell voluntary carbon offsets within California and (2) entities operating in California that make, among other claims, claims regarding the achievement of net zero emissions or "carbon neutrality," including entities that purchase or use voluntary carbon offsets.

- **Corporate Sustainability Due Diligence Directive (CSDDD) may partially exclude the financial sector.** The European Parliament and European Council have announced a provisional agreement on the terms of the CSDDD, which would impose mandatory environmental and human rights due diligence requirements on certain large EU and non-EU companies. The provisional agreement, which will need to be endorsed and formally adopted by the two co-legislators, frames the scope of the directive, clarifies the liabilities for non-compliant companies, better defines the different penalties, and completes the list of rights and prohibitions that companies should respect. In particular, in a change from an initial proposal of the CSDDD, the provisional agreement temporarily excludes the financial sector from the scope of CSDDD obligations, but provides that there will be a review clause for a possible future inclusion of the financial sector's downstream obligations.

- **U.S. agencies release further guidance on clean energy tax credits.** The U.S. Department of Treasury (Treasury Department), Internal Revenue Service (IRS) and Department of Energy (DOE) have released additional proposed guidance on the advanced manufacturing, clean hydrogen and clean vehicle tax credits under the Inflation Reduction Act of 2022. The guidance has been long awaited and provides industry with clarity on eligibility for these credits. The DOE also announced up to $3.5 billion in grants to boost U.S. production of advanced batteries and battery materials, aiming to ensure that the U.S. has a competitive battery materials processing industry.

Legislative and Regulatory Updates

1. *Global*

Nearly 200 parties reach agreement to "transition away" from fossil fuels at 28th annual United Nations Climate Change Conference (COP28). COP28, which took place in Dubai from November 30 to December 12, concluded with the first "global stocktake" of progress against the Paris Climate Change Agreement goals. Recognizing a need to drive "deep, rapid and sustained reductions in greenhouse gas emissions" in line with limiting global warming to 1.5°C, nearly 200 countries and other parties agreed to the final COP28 text, which calls for "transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner, accelerating action in this critical decade, so as to achieve net zero by 2050 in keeping with the science." Although this is the first agreed COP text in which a transition away from fossil fuels has been explicitly included, the agreement is not legally binding on the parties and reflects concessions made from parties that called for a "phase-out" (rather than "phase-down") of fossil fuels. The agreement also called for tripling renewable energy capacity globally and doubling the global average annual rate of energy efficiency improvements by 2030. Among other key developments, parties agreed to operationalize the loss and damage fund and funding arrangements on the first day of the conference, with more than $700 million of commitments to the fund received by the end of the conference. In addition, oil and gas companies representing 40% of global oil production signed an agreement to reduce methane emissions to near zero by 2030 and to end flaring.

IOSCO launches public consultation on "Good Practices" for the voluntary carbon markets. On December 3, IOSCO launched a 90-day public consultation (Consultation Report) outlining a set of "Good Practices" to promote the integrity and orderly functioning of the voluntary carbon markets (VCMs). The IOSCO board, which includes U.S. (including the CFTC and the U.S. Securities and Exchange Commission (SEC)), UK, European and other major securities regulatory bodies, announced the consultation at COP28. This proposed set of 21 "Good Practices," which relate to regulatory frameworks, primary market issuance, secondary market trading and use and disclosure of use of carbon credits, would not be legally binding. Instead, the "Good Practices" are intended to outline practices that relevant regulators and other authorities or market participants could consider in addressing vulnerabilities IOSCO has identified in the VCMs. The "Good Practices" are informed by feedback on IOSCO's 2022 discussion paper on VCMs, as well as existing good practices and principles for well-functioning markets, such as IOSCO's Objectives and Principles of Securities Regulation. IOSCO has asked for comments on or before March 3, 2024.

2. *United States*

Latest Office of Information and Regulatory Affairs agenda references April 2024 date for the SEC's final climate rule. In early December, the Office of Information and Regulatory Affairs released the Fall 2023 Unified Agenda of Regulatory and Deregulatory Actions, which sets forth expected timelines for the actions that administrative agencies, including the SEC, plan to take in the near and long term. The SEC's agenda sets forth an April 2024 date for the SEC's final rules on climate-related disclosures and ESG disclosures for investment advisers and investment companies (both previously scheduled for October 2023 in the Spring 2023 agenda). The SEC's agenda also includes an April 2024 date for proposing rule amendments on human capital management disclosures (previously scheduled for October 2023), as well as an October 2024 date for proposing rule amendments on board diversity (previously scheduled for April 2024). Although the agenda provides insights into the SEC's current rulemaking priorities, it is non-binding on the SEC and the indicated timelines are subject to change.

CFTC requests comment on guidance for carbon credit derivative markets. On December 4, the CFTC issued for public comment proposed guidance regarding the listing for trading, by CFTC regulated derivatives exchanges, of voluntary carbon credit (VCC) derivative contracts. The proposed guidance outlines factors that such derivative exchanges should consider when addressing certain requirements under the Commodity Exchange Act and CFTC regulations applicable to the listing of new contracts. The Proposed Guidance reflects the CFTC's interest in promoting the development of VCC derivative markets and in clarifying its role in connection with the underlying physical markets as well. Although certain VCC derivative contracts are currently listed and trading, the CFTC has not previously issued comprehensive guidance on the standards for the listing of such products. Comments on the proposed guidance are due by February 16, 2024. For additional information about the CFTC's proposal, please see S&C's client memo here.

Potential timing clarification for California AB 1305. California AB 1305, titled "Voluntary Carbon Market Disclosures," will impose website disclosure requirements on both (1) business entities that market or sell voluntary carbon offsets within California and (2) entities operating in California that make, among other claims, claims regarding the achievement of net zero emissions or "carbon neutrality," including entities that purchase or use voluntary carbon offsets. The statute provides that the required disclosures must be "updated no less than annually." Neither AB 1305 nor the legislative record addresses when the initial disclosures are required, leading to concerns that companies subject to the statute will need to make their initial website disclosures by January 1, 2024, the effective date of the statute. On December 6, a letter from the Assemblymember who authored AB 1305 to the Chief Clerk of the California Assembly was made public, in which the Assemblymember stated that his intent was that the first annual disclosure should be posted by January 1, 2025. The Assemblymember also stated in this letter that he intends to "submit a formal letter to the Assembly Daily Journal when the State Assembly reconvenes on January 3, 2024." The Assemblymember's recent letter does not have the force of law, but may provide some comfort that the Assembly, whether through a subsequent formal letter approved and published in the Assembly Daily Journal or other formal action, may clarify the timing required for initial disclosures under AB 1305. For additional information about AB 1305, see S&C's client memo here. For additional information about the potential timing clarification, see S&C's client memo here.

3. *European Union*

EU reaches provisional agreement on terms of CSDDD. On December 14, the European Parliament and European Council announced their provisional agreement on the text of the CSDDD. According to the press conference and accompanying press releases, the CSDDD's scope and core substantive requirements are as proposed by the European Commission in February 2022 (see S&C's client memo here). Compliance will be supervised by a network of national authorities, overseen by an EU body. Penalties will include "naming and shaming" disclosures and/or fines of up to 5% of net worldwide turnover, and a civil liability regime will be introduced. According to information released by the Parliament and Council about the terms of the provisional agreement, the financial sector will be temporarily excluded from the scope of the directive, but a review clause will be included that could allow for future inclusion of the financial sector's downstream obligations based on a sufficient impact assessment. The provisional agreement will next need to be formally approved by both the Parliament and Council before the CSDDD can enter into force.

European Securities and Markets Authority (ESMA) delays issuance of fund names guidance. On December 14, ESMA announced that it has postponed issuing guidelines for fund names containing sustainability-related terms until Q2 of 2024. ESMA postponed the adoption of the guidelines to fully consider the outcomes of the reviews of the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, which are expected to be published in the first half of 2024. In accordance with the provisional agreement resulting from the interinstitutional negotiations on the guidance, ESMA will require that a minimum of 80% of investments by funds with sustainability-linked names meet the requisite sustainability characteristics or objectives, up from 50% in the consultation paper, aligning its rule with the SEC's recent amendments to the Fund's Name Rule, after receiving feedback from Europe's largest asset managers. The updated guidance will also require funds that use sustainability terms in their names to apply the Paris-aligned Benchmark exclusions, and invest meaningfully in sustainable investments as defined in Article 2 of the Sustainable Finance Disclosure Regulation. In addition, ESMA announced that it is exploring including a new category for funds with names that include transition-related terms. The guidelines will take effect three months after the date of their publication in all official EU languages. Compliance deadlines will be staggered for new and existing funds.

4. *United Kingdom*

UK Financial Reporting Council (FRC) scales back UK Corporate Governance Code reform relating to audit, corporate reporting and governance. On November 7, the FRC published a policy update on forthcoming amendments to the UK Corporate Governance Code (Code). Following the UK Government's decision not to prioritize modernizing the regulation of audit, corporate reporting and governance this parliamentary session, the FRC will take forward only a small number of the 18 proposals for Code reform on which it originally consulted. Specifically, the FRC will take forward a small number of changes that streamline and reduce duplication in the Code, as well as a substantive change to how companies report on the effectiveness of their internal controls. The FRC intends to publish the revised Code in January 2024.

UK Financial Conduct Authority (FCA) makes final rules on greenwashing in UK financial services. On November 28, the FCA introduced a new regulatory regime designed to tackle greenwashing, including a general "anti-greenwashing rule" applicable to all FCA-regulated firms to ensure sustainability claims are fair, clear and not misleading. Rules applicable to FCA-regulated asset managers include: (i) rules governing the use of four voluntary labels for investment products seeking positive sustainability outcomes; (ii) rules restricting the use of sustainability-related terms in the naming and marketing of retail products that do not use the labels; and (iii) new sustainability-related disclosures, including consumer-facing, pre-contractual, ongoing product and entity level disclosures. Distributors will need to ensure the labels and consumer-facing disclosures are made available to retail investors. The regime will be phased in between May 31, 2024 and December 2, 2026, starting with the anti-greenwashing rule. The FCA has launched a consultation on guidance to underpin the anti-greenwashing rule, which closes on January 26, 2024.

Financial Institutions Updates

1. *Global*

Basel Committee on Banking Supervision requests comment on approach for Pillar 3 disclosure of climate-related financial risks. On November 29, the Basel Committee published a consultation paper seeking feedback from stakeholders on its "preliminary proposal" for qualitative and quantitative disclosure requirements on climate-related financial risks under Pillar 3. The proposal would require banks to make qualitative disclosures on governance, strategy, risk management and concentration risk, and quantitative disclosures on exposure by sector, financed GHG emissions by sector, and geographic exposure to physical risks. In addition, the proposal would require banks to make quantitative disclosures on bank-specific metrics, such as exposure by credit quality and maturity ladder and the bank's forecasts for future GHG emissions. Finally, the proposal would require disclosures, subject to jurisdictional discretion, on (i) real estate exposures in the mortgage portfolio by energy efficiency level; (ii) emission intensity per physical output; and (iii) facilitated emissions related to capital markets and financial advisory activities. The Basel Committee is seeking comment on the feasibility of a potential implementation date of January 1, 2026. Any comments should be submitted by February 29, 2024. The Basel Committee expects to publish a "revised or final proposal" in the second half of 2024.

2. *United States*

U.S. Federal Insurance Office (FIO) to proceed with data collection from insurers to assess climate-related financial risks. On November 1, the FIO announced its intention to proceed with collecting homeowners' insurance underwriting data to aid in assessment of climate-related financial risk to consumers. Based on feedback from the National Association of Insurance Commissioners and state insurance regulators, the FIO streamlined and refined its data collection request to reduce the estimated number of hours needed by insurance companies to comply with the request. The FIO's request for comment on the revised request closed on December 4. Also on November 1, Senator Sheldon Whitehouse, Chairman of the Senate Budget Committee, and Senator Ron Wyden sent letters to 40 insurance groups requesting documents and information related to these insurance groups' plans to address increased underwriting losses from climate disasters. Responses to these letters were due by November 17.

New York State Department of Financial Services (NYDFS) adopts climate risk guidance. On December 21, the NYDFS adopted guidance for New York State-regulated banking and mortgage institutions relating to management of material financial and operational risks from climate change. The guidance is designed to support such institutions' efforts to identify, measure, monitor, and control their material climate-related financial and operational risks in a manner consistent with current risk management principles. It addresses key components of prudent risk management, including corporate governance, internal control frameworks, risk management processes, data aggregation and reporting, and scenario analysis. The guidance is substantively similar to the proposed guidance issued by the NYDFS in December 2022, with certain targeted changes and clarifications, including (i) emphasizing the centrality of operational resiliency to an institution's safety and soundness, and (ii) clarifying the roles and responsibilities of the board versus management in addressing climate-related financial and operational risks. The NYFDS is not setting a timeline for implementation of the guidance at this time. The NYDFS notes in the guidance that it expects to issue a request for information (RFI) during 2024 to solicit from regulated institutions information on the steps they are taking, or plan to take, to assess and manage climate-related financial and operational risks. Individual institutions' responses to the RFI will not be made public, but data collected as part of the RFI will be factored into the NYDFS's determination of appropriate implementation timeline(s). The NYDFS further notes that as part of setting implementation timeline(s), it will coordinate with the relevant federal banking regulators to determine when and how to incorporate an assessment of a regulated institution's implementation of the guidance into supervisory examinations. In connection with the release of the guidance, the NYDFS has published available resources to assist organizations as they work to adopt measures that address their climate-related risk.

Shareholder and Proxy Adviser Updates

1. *Global*

Glass Lewis publishes benchmark guideline updates for 2024 shareholder meetings that include changes to environmental- and social-related policies. On November 16, proxy advisory firm Glass Lewis released its 2024 Benchmark Policy Guidelines for listed companies in different global markets. Among other changes, Glass Lewis has expanded its policy on board accountability for climate-related issues. In 2023, Glass Lewis's policy covered only significant emitters (such as those identified by Climate Action 100+); beginning in 2024, however, Glass Lewis will apply this policy to companies in the S&P 500 index (U.S.) and FTSE 100 (UK) operating in industries where the Sustainability Accounting Standards Board has determined that the companies' GHG emissions represent a financially material risk, as well as companies where it believes emissions or climate impacts, or stakeholder scrutiny thereof, represent an outsized, financially material risk. In determining its voting recommendations, Glass Lewis will assess whether such companies have produced disclosures in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), as well as whether they have disclosed explicit and clearly defined board-level oversight responsibilities for climate-related issues. In instances where Glass Lewis finds either of these disclosures to be absent or significantly lacking, it may recommend voting against responsible directors. For U.S. companies, Glass Lewis has also updated its guidelines to provide that board oversight of environmental issues should be formally codified in appropriate committee charters or other governing documents.

Although Glass Lewis has reiterated that it may recommend against the chair of the governance committee if a U.S. company has less than 30% gender diversity and no member of any underrepresented community on the board, the 2024 update has added a clarification that Glass Lewis will carefully review the company's disclosure and may refrain from making the negative recommendation if the board has provided a sufficient rationale or plan to address the lack of board diversity.

ISS's 2024 benchmark guidelines generally did not update policies on ESG-related issues. On December 19, proxy advisory firm ISS released its Global Proxy Voting Guidelines Updates for 2024, effective for shareholder meetings beginning in February 2024. With respect to ESG topics, the ISS benchmark guidelines are generally unchanged from 2023. Among other changes, ISS has codified a case-by-case approach when analyzing shareholder proposals requiring that executive severance arrangements or payments be submitted for shareholder ratification.

Litigation and Enforcement Developments

1. *United States*

U.S. Federal Trade Commission (FTC) Chair reiterates position on ESG commitments in antitrust enforcement. On November 10, FTC Chair Lina Khan stated that the FTC "firmly reject[s]" the idea that companies can move forward with otherwise problematic mergers by making certain ESG commitments. Chair Khan reiterated, "[w]e've tried to make clear that firms should not come to us with those types of non-statutory commitments." The remarks come nearly a year after Chair Khan's September 2022 congressional testimony, where Chair Khan stated that merger approvals are not conditioned on the adoption of a particular set of ESG policies, and illegal mergers cannot be remedied by corporate promises to make ESG commitments.

2. *United Kingdom*

UK Advertising Standards Authority (ASA) bans airlines advertisements for making misleading environmental claims. On December 6, the ASA, UK's advertising regulator, banned online advertisements from three airlines, ruling that the advertisements breached the UK Code of non-Broadcast Advertising and Direct & Promotional Marketing (CAP Code), including provisions requiring that the basis of environmental claims must be clear and that unqualified claims could mislead if they omit significant information. All three advertisements were identified for investigation by an ASA system that uses artificial intelligence to proactively search for online ads that might break the rules. The ASA's action follows the release on November 28 of updated guidance to help marketers and advertising agencies interpret the rules of the CAP Code and the UK Code of Broadcast Advertising that concern environmental-related advertising issues. The updated guidance now includes a section on green disposal claims, including the use of terms such as "recyclable," "biodegradable" and "compostable."

Energy Transition Updates

1. *United States*

DOE announces new grants to boost domestic battery industry. Pursuant to the Bipartisan Infrastructure Law (BIL), the DOE has announced up to $3.5 billion in grants to boost U.S. production of advanced batteries and battery materials. The funding will support new, retrofitted, and/or expanded U.S. facilities for battery-grade processed critical minerals (such as lithium, nickel, cobalt, manganese, and others), battery precursor materials (such as aluminum), battery components, and cell and pack manufacturing. For additional information about the DOE's grant-making process, please see S&C's Energy Transition Insights memo here.

DOE announces key definition for determining EV tax credit and battery grant eligibility. On December 1, the DOE released a notice of its proposed interpretation of the definition of "foreign entity of concern" (FEOC) under the Bipartisan Infrastructure Law and a request for public comment on its proposed interpretation. The deadline for comments is January 3, 2024. The proposed text would provide that, among other criteria, a non-U.S. entity is defined as an FEOC if it is "owned by, controlled by, or subject to the jurisdiction or direction of a government of a foreign country that is a covered nation." Covered nations include North Korea, China, Russia and Iran. The DOE's Battery Materials Processing and Manufacturing grant program prioritizes applicants that will not use battery material supplied by or originating from an FEOC. In addition, the U.S. federal tax credit for new EVs is not available to vehicles whose battery contains components or critical minerals from an FEOC. For additional information about the proposed interpretation, please see S&C's Energy Transition Insights memo here.

The Treasury Department and IRS issue proposed regulations for the advanced manufacturing production credit and clean hydrogen production credit. On December 14, the Treasury Department and the IRS released a notice of proposed regulations regarding the advanced manufacturing production credit under section 45X of the Internal Revenue Code. A week later, on December 22, the Treasury Department and the IRS released a notice of proposed regulations regarding the production tax credit for clean hydrogen under section 45V of the Internal Revenue Code. Both sets of proposed regulations provide much-needed guidance on certain definitions and requirements to be eligible for the credits. S&C's Energy Transition Insights memos will be forthcoming on additional information about the proposed regulations.

2. *European Union*

EU agrees on gas and hydrogen sector reform. On December 8, the European Council and the European Parliament reached a provisional agreement to adopt new rules to decarbonize the EU gas market and create a hydrogen market. Key features include the establishment of the European Network of Network Operators for Hydrogen to promote a dedicated hydrogen infrastructure; consumer protection measures to facilitate switching between gas suppliers, limiting long-term contracts for unabated fossil fuels beyond 2049; a mechanism allowing Member States to limit upfront bidding for natural gas or LNG from Russia and Belarus, the establishment of a voluntary mechanism for demand aggregation and joint purchasing for natural gas and a five-year pilot project to bring together demand and supply of hydrogen and create market transparency under the European Hydrogen Bank. The measures also provide for increased coordination between national network development plans for hydrogen, electricity and natural gas. The new rules will enter into force after being formally adopted by the relevant EU institutions.

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.