ESG Monthly Newsletter

October 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

- **California enacts new laws imposing climate reporting requirements on companies doing business in California, regardless of where headquartered or incorporated.** With the SEC's final climate disclosure rules pending and efforts continuing at the federal and state levels to limit the consideration of ESG, California has enacted three laws that impose new and sweeping climate-related reporting obligations on companies. These obligations, which include disclosure of Scope 1, 2 and 3 greenhouse gas (GHG) emissions, climate-related financial risk and details regarding a company's net-zero or GHG-reduction claims, as well as additional disclosures for sellers and buyers of voluntary carbon offsets, are, in many respects, broader and more prescriptive than the SEC's proposed climate disclosure rules. Thousands of companies are expected to fall under the scope of these laws, whether or not they are incorporated in California. Notably, unlike the SEC's pending rules, the California laws are not limited to public issuers.
- **EU sustainability reporting and due diligence directives face headwinds.** The European Commission is proposing to delay its deadline for adopting reporting standards under the Corporate Sustainability Reporting Directive (CSRD) with respect to (1) covered non-EU companies and (2) sector-specific reporting. The proposed delay, which would extend the standard-setting deadline from 2024 to 2026, comes amidst concerns from key stakeholders regarding the scope, timeline and implementability of the CSRD, in particular its double materiality requirement. Leading up to the second trilogue on the Corporate Sustainability Due Diligence Directive (CSDDD) in November, EU member states have also expressed disagreement on the scope of the proposed due diligence requirements, particularly whether and to what extent financial institutions should be covered.
- **Regulators, shareholders and other stakeholders focus on diversity and inclusion disclosures.** In October, a three-judge panel of the U.S. Court of Appeals for the Fifth Circuit upheld Nasdaq's board diversity rules. Board diversity has been an area of regulatory focus in the U.S., with the SEC's proposed rulemaking on the topic currently agendized for April 2024. Corporate disclosures on workplace, customer and supplier diversity have also become a focus area in the wake of the U.S. Supreme Court's affirmative action decision in *Students for Fair Admission* v. *Harvard*. U.S. groups (including organizations that frequently submit shareholder proposals) have begun to sue companies, citing diversity initiatives, targets and goals contained in public disclosures. Outside of the U.S., regulators in the UK and Canada continue efforts to increase disclosures around the diversity of directors and senior executives.

Legislative and Regulatory Updates

1. *United States*

California enacts expansive climate-related disclosure laws. On October 7, 2023, California enacted the Climate Corporate Data Accountability Act (SB 253), the Climate-Related Financial Risk Act (SB 261) and the Voluntary Carbon Market Disclosures Act (AB 1305):

- SB 253 requires any U.S. company with total annual revenues in excess of $1 billion that "does business in California" to publicly disclose all Scope 1 and 2 GHG emissions (beginning in 2026) and Scope 3 GHG emissions (beginning in 2027), in each case, on an annual basis. Under

SB 253, the California State Air Resources Board (CARB) will adopt regulations to implement the GHG emissions data reporting requirements on or before January 1, 2025, and will adopt regulations to impose penalties for violation of the statute (capped at $500,000 per year).

- SB 261 requires any U.S. company (other than insurance companies) with total annual revenues in excess of $500 million that "does business in California" to, on a biennial basis beginning in 2026, publicly disclose climate-related financial risk in accordance with the Task Force on Climate-Related Financial Disclosures (TCFD) framework. Under SB 261, CARB will adopt regulations to impose penalties for violation of the statute (capped at $50,000 per year).
- AB 1305, which will be effective on January 1, 2024, imposes disclosure requirements on both (1) business entities that market or sell voluntary carbon offsets within California and (2) entities that make certain claims, unless the entities "do not operate within" California or "do not make claims within" California. Specifically, under the latter requirements, companies (U.S. and non-U.S.) operating within California that make net zero, carbon neutral or significant GHG emission-reduction claims within California are required to publicly disclose how they determined the accuracy of those claims, how interim progress is measured, and whether third-party verification was obtained, and, if such companies purchase or use voluntary carbon offsets sold within California, detailed information on offsets purchased or used. Disclosures made pursuant to AB 1305 are required to be updated no less than annually. Notably, AB 1305 does not authorize any regulatory agency to issue implementing regulations, and empowers the California Attorney General, all district attorneys, all county attorneys and all city attorneys to enforce the law.

Regulations from CARB implementing SB 253 and SB 261 could provide clarity on, among other areas, (1) whether these reporting requirements will differ from, or be required in addition to, other applicable requirements, such as the pending SEC climate disclosure rules and the EU's Corporate Sustainability Reporting Directive; (2) what "doing business" in California means (although the legislative materials include a reference to an existing definition in California's tax code, the term is not defined in the statute), and (3) how the requirements will apply to U.S. subsidiaries of non-U.S. headquartered companies. California has estimated that thousands of U.S. companies (including private companies) will be subject to SB 253 and SB 261. It is difficult to estimate the number of companies that may fall under AB 1305, given the large and continually growing number of companies that make some type of claim about achieving net zero, carbon neutrality or GHG emissions reduction. See S&C's memos for a summary of the three California laws and for a discussion of AB 1305 in the broader context of recent legal developments on voluntary carbon credits.

House Republicans introduce legislation to limit consideration of ESG factors in ERISA plans. On September 26, 2023, the House Education and Workforce Committee advanced several bills to amend the Employee Retirement Income Security Act of 1974 (ERISA), including the following three bills intended to limit ESG considerations in ERISA plans:

- H.R. 5339, which uses language similar to the Trump-Administration Department of Labor rule that was reversed by the Biden Administration, would require plan fiduciaries to base investment decisions on pecuniary factors. A fiduciary would only be permitted to use non-pecuniary factors as the deciding factor if it documents, among

other information, why pecuniary factors were not sufficient and how the non-pecuniary factors are consistent with "the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan."

- H.R. 5337 would require plan fiduciaries to vote proxies and otherwise exercise shareholder rights "solely in accordance with the economic interest of the plan and its participants and beneficiaries," without subordinating "the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any non-pecuniary objective" or promoting goals unrelated to those financial interests. Plan fiduciaries would also need to monitor the proxy voting activities of investment managers and proxy advisors to determine compliance with these requirements.
- H.R. 5338 would require decisions regarding the selection, monitoring, and retention of any fiduciary, counsel, employee, or service provider of ERISA plans to be made without regard to race, color, religion, sex, or national origin.

These bills, particularly H.R. 5339 and 5337, resemble laws recently adopted in several states that would limit or prohibit the consideration of non-pecuniary factors by financial institutions that manage state funds. Although these state laws typically include a "fiduciary" exception similar to H.R. 5339, lawmakers in states such as Oklahoma are considering eliminating or narrowing the application of the exception.

SEC releases 2024 examination priorities. On October 16, 2023, the SEC's Division of Examinations released its 2024 priorities. In addition to listing priorities for various market participants, the SEC's Examination Priorities include a description of certain risk areas that market participants may be impacted by, which include (1) information security and operational resilience, (2) crypto assets, (3) regulation systems compliance and integrity and (4) anti-money laundering. Notably, the SEC's 2024 examination priorities do not include a direct reference to ESG topics, representing a departure from the examination priorities reports for the past three years.

Fifth Circuit upholds Nasdaq board diversity rules. On October 18, 2023, a three-judge panel of the U.S. Court of Appeals for the Fifth Circuit upheld Nasdaq's board diversity rules. Nasdaq's full proposal included two parts: (1) a board diversity disclosure rule and (2) a board recruiting service rule. The board diversity disclosure rule, proposed by Nasdaq in December 2020, would require listed companies to have at least one director who self-identifies as female and at least one director who self-identifies as an underrepresented minority, or explain the lack of such directors (see our memo for more information). The board recruiting service rule proposes to provide certain Nasdaq-listed companies with one year of complimentary access for two users to a board recruiting service that would provide a network of board-ready diverse candidates for companies to identify and evaluate. After the SEC approved the rules in August 2021, the Alliance for Fair Board Recruitment, an organization led by the lawyer who brought the Harvard case, and the National Center for Public Policy Research (NCPPR), an entity that frequently submits shareholder proposals, sued Nasdaq and the SEC. The court rejected the argument that Nasdaq is a "state actor" subject to the constitutional restraints on state actions that discriminate on the basis of race or sex. The court also rejected arguments that the SEC lacked statutory authority to approve the Nasdaq rules and that the Commission violated the Administrative Procedure Act. On October 23,

2023, the Alliance and NCPPR filed a petition for an en banc hearing by the Fifth Circuit.

2. *United Kingdom*

UK regulators focus on diversity and inclusion disclosures for financial institutions. On September 25, 2023, the Financial Regulation Authority (FCA) and Prudential Regulation Authority (PRA) launched consultations on proposals to improve diversity and inclusion in the UK financial services sector. The wide-ranging proposals include strengthened conduct rules, as well as requirements on FCA or PRA regulated firms to: (1) develop and publish a diversity and inclusion strategy setting out how they will meet their diversity and inclusion objectives and goals, (2) collect, report and disclose data against a wide range of demographic characteristics and inclusion metrics, and (3) set and disclose targets to address under-representation at board, senior leadership and/or all employees level. The proposals would apply to regulated firms individually (rather than on a group basis), with most applying only to firms with 251 or more UK-based employees. The consultations close on December 18, 2023. The regulators will then review feedback and develop final policies, with rules expected to enter into force in 2025.

FCA endorses framework for transition plan disclosure. On October 9, 2023, the UK's Transition Plan Taskforce (TPT) published its final, sector-neutral climate transition plan disclosure framework. The TPT was established by the UK government in April 2022 with a two-year mandate to develop the "gold standard" for climate transition plans. The TPT framework is designed around five elements: (1) foundations (including strategic ambition, business model and value chain), (2) implementation strategy, (3) engagement strategy, (4) metrics and targets, and (5) governance. The TPT has published implementation guidance, as well as technical mapping documents to assist on alignment with the TCFD framework, the climate disclosure standards finalized by the International Sustainability Standard Board (ISSB) and the European Sustainability Reporting Standards (ESRS).

On the same day, the FCA confirmed its intention to draw on the final outputs of the TPT framework as part of its consultation on mandatory disclosure requirements for UK-listed companies. The FCA previously announced that it intends to launch its consultation in H1 2024 and intends for the new requirements to enter into force with respect to accounting periods beginning on or after January 1, 2025 (with first reporting in 2026).

3. *European Union*

European Commission proposes to delay sustainability reporting standards for non-EU companies and specific sectors. On October 18, 2023, the European Commission proposed to postpone its deadlines for adopting two sets of standards under the CSRD from June 30, 2024 to June 30, 2026. Specifically, the Commission proposed to delay its adoption deadline for (a) sector-specific ESRS and (b) standards that specify reporting obligations for large non-EU companies operating in the EU. The Commission stated that its proposed postponement will allow companies "to focus on the implementation of the first set of ESRS[,] ensure that EFRAG has time to develop sectoral ESRS that are efficient, and limit reporting requirements to the minimum necessary." Public consultation on the Commission's proposal is open through December 19, 2023.

Member states focus on CSDDD's inclusion of finance companies in advance of second trilogue. Trilogues (the negotiation process for resolving disagreements among EU member states) are ongoing with respect to the

CSDDD, which would impose mandatory environmental and human rights due diligence requirements on companies (including large non-EU companies). The first of the trilogues began in September 2023, and the next set of trilogues are scheduled to begin in mid-November. Negotiations are expected to conclude in 2024, and EU member states are expected to incorporate the CSDDD into domestic laws within two years after the CSDDD is officially adopted. A key focus area of current debates among EU members states is whether the CSDDD should (1) not cover finance companies, (2) cover only financial institutions that have direct business relationships with corporations (e.g., banks and insurers), or (3) extend to the full financial sector (including asset managers).

Shareholder Engagement and Proxy Advisory Updates

1. ***United States***

SEC Adopts Rule Amendments to Beneficial Ownership Reporting. On October 10, 2023, the SEC voted to adopt certain amendments to Regulation 13D-G and Regulation S-T that will, among other changes, accelerate the filing deadline for Schedule 13D beneficial ownership reports from 10 days to five business days and mandate that amendments be filed within two business days after a material change. Because the amendments will also accelerate the deadline for "Qualified Institutional Investors" to file Schedule 13G beneficial ownership reports from 45 days after year-end to 45 days after quarter-end, Qualified Institutional Investors will need to create systems to monitor new reportable holdings at the end of each quarter to comply with the amended requirements, which will become effective September 30, 2024. See S&C's memo for a summary of the amendments.

SEC updates format of 14a-8 no-action submissions. Recently, the SEC's Division of Corporate Finance updated its process for submitting no-action requests with respect to Rule 14a-8 proposals. All no-action requests and supplemental correspondence must now be submitted to the Division using an online Shareholder Proposal Form, rather than via email.

Financial Institutions Updates

1. ***United States***

Federal banking regulators finalize interagency principles for climate-related financial risk management for large financial institutions. On October 24, 2023, the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) jointly issued the final interagency guidance on principles for climate-related financial risk management for large financial institutions (Principles). The Principles are substantively similar to the draft principles issued individually by the agencies in 2021 and 2022, but include targeted changes and clarifications to address commenter feedback. The Principles, which apply to regulated financial institutions with $100 billion or more in total consolidated assets, cover six areas: (1) governance, (2) policies, procedures, and limits, (3) strategic planning, (4) risk management, (5) data, risk measurement and reporting, and (6) scenario analysis. In addition, they describe how climate-related financial risks can be addressed in the management of six traditional risk areas: (1) credit risk, (2) liquidity risk, (3) other financial risk, (4) operational risk, (5) legal and compliance risk, and (6) other nonfinancial risk. Federal Reserve Governors Bowman and Waller, FDIC Vice Chairman Hill, and FDIC Director McKernan dissented. See our memo for additional information.

2. *European Union*

European Banking Authority recommends integrating ESG risk in capital requirement framework. On October 12, 2023, the European Banking Authority (EBA) published a report on the "Role Of Environmental and Social Risks in the Prudential Framework for Banks and Investment Firms" (Report). The Report is preceded by an EBA discussion paper published in May 2022, which addressed whether and how to incorporate environmental risks into the Pillar 1 framework of Basel III (which defines banks' minimum capital requirements). The Report includes a number of short-term and medium- to long-term actions to accelerate integration of environmental and social risks across the Pillar 1. The recommendations include, among other things, requiring institutions to consider environmental and social risks as part of stress testing programs and competent authorities to verify that due diligence requirements explicitly integrate environmental aspects. The Report also notes that the EBA will continue to consider how scenario analysis could be used to enhance forward-looking elements of the prudential framework.

Energy Transition Updates

1. *European Union*

EU formally adopts new renewable energy targets. On October 9, 2023, the EU formally adopted the Renewables Energy Directive, which aims to raise the share of renewable energy in the EU's overall energy consumption from 32% to 42.5%. The directive is part of the EU's "Fit for 55" package of proposals to reach at least 55% GHG emissions reduction by 2030. The directive introduces new sector-specific sub-targets, including: (1) the choice between a binding target of 14.5% reduction in GHG intensity in transport from use of renewables by 2030, or a binding share of at least 29% share of renewables within final consumption of energy in the transport sector by 2030, (2) 42% of hydrogen used in industry to come from renewable fuels of non-biological original by 2030 (and 60% by 2035), and (3) an indicative target of at least 49% of renewable energy share in buildings by 2030, with a renewable target of heating and cooling to increase 0.8% per year until 2026 and 1.1% from 2026 to 2023. The directive will come into force on November 20, 2023, following which EU Member States will have 18 months to implement the provisions into national legislation.

EU's Carbon Border Adjustment Mechanism Enters First Phase of Operation. On October 1, 2023, the Carbon Border Adjustment Mechanism (CBAM), the EU's regulatory instrument to address carbon leakage, entered into application in its transitional phase. CBAM will initially apply to imports of certain carbon-intensive goods in six sectors that are at most significant risk of carbon leakage (i.e., cement, iron & steel, aluminum, fertilizers, electricity and hydrogen). Importers across the six sectors will have to submit reports covering direct and indirect GHG emissions embedded in their imports for the last quarter of 2023 to be reported by the end of January 2024. During the transitional period, companies may elect to report (1) with full reporting according to the EU's new methodology, (2) based on an equivalent method, or (3) based on default reference values. After January 1, 2025, the EU will only accept reports following the EU's reporting methodology. See S&C's memo for additional information on CBAM and key considerations for companies importing goods into the EU.

Sustainable Finance Updates

1. *Global*

LMA publishes updated best practice guide to sustainability-linked leveraged loans ("SLLLs"). On October 5, 2023, the Loan Market Association (LMA), in conjunction with the European Leveraged Finance Association (ELFA), published an updated Best Practice Guide to Sustainability-Linked

Leveraged Loans (Guide). The Guide was originally published in June 2021, and is being updated in light of significant growth in the sustainability-linked loan market. The Guide is intended for use in the leveraged loan market on the portfolio company level, rather than the sponsor or fund level. It offers practical guidance on the application, in the context of leveraged loans, of the Sustainability-Linked Loan Principles and its five core components: (1) the selection key performance indicators, (2) calibration of sustainability performance targets, (3) loan characteristics, (4) reporting, and (5) verification.

2. *European Union*

EU Parliament votes in favor of green bond label. On October 5, 2023, European Parliament voted in favor of the voluntary standard for use of a "European Green Bond" label. Issuers that comply with the standard are able to use the designation "European green bond" or "EuGB" when marketing a bond. The European Parliament reported that the EU issued 51% of the global volume of green bonds in 2020. Companies that choose to adopt the standard will be required to disclose information about how the bond's proceeds will be used and how the investments feed into the company's transition plans.

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