SULLIVAN & CROMWELL LLP

ESG Monthly Newsletter

September 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

- **U.S. and EU regulators focus on investment fund disclosure.** The U.S. Securities and Exchange Commission ("SEC") has adopted amendments to its rule on fund names that will bring funds whose names suggest they incorporate ESG factors in their investment decisions within the rule's scope. Meanwhile, the European Commission has launched an assessment of the Sustainable Finance Disclosure Regulation, which regulates certain disclosures by asset managers, to review its usability and ability to help tackle greenwashing.

- **California poised to require new corporate climate disclosures.** Two new bills passed by the state's legislature would require large entities doing business in the state to disclose emissions data and report on their climate-related risks. The new bills are not yet in effect but would require initial disclosures as soon as 2026 and impose disclosure obligations on companies that in certain respects exceed those previously proposed by the SEC.

- **Frameworks on nature-related financial risks continue to evolve.** The Taskforce on Nature-related Financial Disclosures has published its final recommendations for a voluntary framework for use by companies to identify, assess and disclose nature-related risks. In addition, the Network for Greening the Financial System, a group of central banks and supervisors, has released a conceptual framework to help central banks and financial supervisors identify and address nature-related financial risks that could affect financial stability or price stability.

In this Issue

Legislative and Regulatory Updates

1. *United States*

SEC imposes new rules on naming of ESG-focused funds. On September 20, the SEC adopted amendments expanding the scope of Rule 35d-1 (the "Names Rule") under the Investment Company Act of 1940. The Names Rule aims to ensure that the name of a registered investment company or business development company (each, a "fund") does not misrepresent the fund's investments and risks. The current Names Rule generally requires that, if a fund's name suggests a focus in a particular type of investment, or in investments in a particular industry, or geographic region, the fund must adopt a policy to invest at least 80% of the value of its assets in the type of investment, or in investments in the industry, country or geographic region, suggested by its name. The amendments broaden the scope of the current rule's 80% investment policy requirement to apply to any fund name with terms suggesting that the fund focuses in investments that have, or investments whose issuers have, particular characteristics, including names suggesting that the fund incorporates one or more ESG factors in its investment decisions. Under the final rules, funds will retain flexibility to define the parameters of the 80% investment policy requirement, to define the terms used in the policy, and to determine which investments are appropriate to include in the policy. Importantly, the final rule does not include proposed amendments that would have designated as materially deceptive and misleading the use of ESG terms in the names of integration funds. The amendments also include a new requirement that a fund review its portfolio assets' treatment under its 80% investment policy at least quarterly, and the amendments set time frames – generally 90 days – for a fund to resume compliance if it departs from its 80% investment policy. The amendments become effective 60 days after publication in the Federal Register. Fund groups with net assets of $1 billion or more will have 24 months to comply, while fund groups with net assets of less than $1 billion will have 30 months to comply.

California legislature approves climate disclosure bills. On September 12 and 13, California's state legislature passed two bills related to climate disclosures – SB 253 (*Climate Corporate Data Accountability Act*) and SB 261 (*Greenhouse gases: climate-related financial risk*). SB 253 would require U.S. entities with total annual revenues in excess of $1 billion that do business in California to disclose annually their Scope 1, 2 and 3 greenhouse gas emissions and obtain assurance of the disclosed emissions. SB 261 would require U.S. entities with total annual revenues in excess of $500 million that do business in California (except for insurance companies) to report biennially on their climate-related financial risks and measures adopted to reduce and adapt to such risks. Both bills require the California Air Resources Board to adopt implementing regulations and would require certain disclosures as early as 2026, with disclosure of Scope 3 emissions required from 2027. The bills await signature by the California governor and are not yet in force. The governor has indicated that he would sign the bills.

White House takes steps to account for climate change costs in certain agency decisions. On September 21, President Biden issued a new directive instructing federal agencies to account for climate change impacts in certain key agency decisions. The directive would expand how agencies account for the social cost of greenhouse gases ("SC-GHG"), which is a measure of known societal damages caused by emissions, when measuring the costs and benefits of their actions. Under the directive, agencies are instructed to consider the SC-GHG in budgeting, federal procurement processes and when conducting certain environmental reviews under the National Environmental Policy Act. The White House, in issuing the directive, noted that appropriate use of SC-GHG would facilitate comparison of the climate consequences of alternative options in budgeting, procurement and other agency decisions.

2. *European Union*

European Commission launches comprehensive assessment of SFDR. The European Commission launched on September 14 consultations on the effectiveness and functioning of the Sustainable Finance Disclosure Regulation ("SFDR"), which sets out rules for how asset managers, among others, communicate sustainability information to investors. The consultations seek stakeholder views to facilitate the Commission's assessment of the SFDR, focusing on legal certainty, the usability of the regulation in practice and its ability to help tackle greenwashing. In launching the consultations, the Commission has noted that the SFDR is "not entirely working as intended." As part of its assessment, the Commission is also hosting an online workshop on October 10 to discuss current challenges of the SFDR and possible ways forward for sustainability disclosures in the EU, including how to ensure better coherence between the SFDR and other parts of the EU's sustainable finance framework. The deadline for participating in the consultations is December 15.

EU moves to ban greenwashing advertisements. The European Parliament and European Council on September 19 announced they had reached a provisional agreement on a new directive to prohibit companies from making misleading statements about their sustainability practices and to require them to provide consumers with more information about the durability of their products. The amendments, first proposed last year, intend to tackle greenwashing by restricting practices such as making generic environmental claims without proof of recognized excellent environmental performance relevant to the claim, using sustainability labels not based on approved certifications or established by public authorities, and making claims about environmental impact based on use of emission offsets. Following final approval from EU legislators, expected later this year, EU member states will have 24 months to implement the directive into domestic law.

3. *United Kingdom*

UK Government relaxes net-zero policies. Amid increasing political debate in the UK over the government's green policies, on September 20, the UK's Prime Minister announced changes to certain previously announced policies intended to help the UK meet its statutory target to achieve net zero greenhouse gas emissions by 2050. The changes include: delaying the ban on the sale of new gas and diesel vehicles from 2030 to 2035; delaying the ban on the installation of new off-grid oil-fired and liquid petroleum gas boilers from 2026 to 2035, with a complete exemption from the ban for low-income households; and abolishing planned requirements for homeowners and landlords to improve the energy efficiency of dwellings. The Prime Minister intends to set out the next stage of the UK government's environmental agenda in the coming weeks, ahead of the opening of the COP28 climate change conference on November 30.

4. *Global*

Taskforce on Nature-related Financial Disclosures publishes final recommendations. On September 18, the TNFD published its final recommendations for a voluntary risk management and disclosure framework for companies, including financial institutions, to identify, assess, manage and, where appropriate, disclose nature-related issues. The TNFD also provided implementation guidance for the new framework. The recommendations comprise 14 recommended disclosures addressing nature-related dependencies, impacts, risks and opportunities. The recommended disclosures are arranged under four pillars familiar from the Task Force on Climate-related Financial Disclosures ("TCFD") framework – namely, governance, strategy, risk and impact management, and metrics and targets. Whether and how governments and regulators will incorporate the TNFD recommendations into mandatory disclosure frameworks remains to be seen.

Accounting body IASB to review reporting of climate-related uncertainties in financial statements. On September 20, the International Accounting Standards Board ("IASB"), which develops the IFRS accounting standards, announced an initiative to improve the reporting of climate-related and other uncertainties in financial statements. The outcomes of the project could include targeted amendments to IFRS Accounting Standards to improve application of existing requirements, as well as development of educational materials. The initiative follows feedback received by the IASB that entities may be disclosing insufficient information in their financial statements about climate-related risks.

Financial Institutions Updates

Central bank-led network focuses on management of nature-related financial risks. On September 7, the Network for Greening the Financial System ("NGFS"), a group of central banks and supervisors, published a conceptual framework to help central banks and financial supervisors assess and address nature-related financial risks. The NGFS notes that the framework is designed to help guide central banks' and supervisors' policies and actions in respect of nature-related financial risks by drawing attention to considerations that are most likely to be material from a microprudential, macroprudential or macroeconomic perspective and that could therefore affect financial stability or price stability. The NGFS further notes that the framework marks a new milestone in the NGFS' efforts to help "mainstream the consideration of nature-related risks."

U.S. Treasury releases voluntary principles on net-zero financing and investment by financial institutions. On September 19, the U.S. Department of the Treasury released a voluntary guide, entitled Principles for Net-Zero Financing & Investment, to highlight best practices for net-zero financing and investment by financial institutions. The Principles focus on "Scope 3" financed and facilitated greenhouse gas emissions (i.e., indirect emissions included in a company's value chain) and advocate that financial institutions making credible net-zero commitments should develop transition plans with clear practices, targets and metrics, and should support their clients and portfolio companies adopting their own transition plans. Although voluntary, financial institutions that have made net-zero commitments – or are considering making net-zero commitments – should consider reviewing the Principles to better understand how Treasury is approaching issues related to net-zero commitments and climate change more generally. For more information on the Principles, see S&C's memo here.

Litigation and Enforcement Developments

UK High Court orders environmental NGO to pay Shell plc's costs in climate risks suit and refuses permission to appeal. On August 31, the UK High Court published a judgment ordering ClientEarth, an environmental law NGO, to pay the costs incurred by Shell plc in defending an application to continue a derivative claim against Shell's directors that had alleged that their purported failure to manage climate risks constituted a breach of their statutory duties. For additional background to ClientEarth's claim, see S&C's May ESG newsletter. In awarding costs to Shell, the High Court declined to derogate from the general rule in the courts of England and Wales that the unsuccessful party will be ordered to pay the successful party's costs. ClientEarth unsuccessfully sought to rely on Practice Direction 19A to the UK's Civil Procedure Rules, which provides that the company in respect of which permission to continue a derivative claim is sought will not "normally" be allowed any costs of submissions or attendances volunteered without invitation from the court. The judge found that the case was "far from the norm for many reasons," including (in brief) the degree of media interest and potential adverse impact on Shell of a decision granting ClientEarth permission to continue the claim, the seriousness of the alleged breaches by Shell's directors, the unusual relief sought by ClientEarth, the small number of shares in Shell held by ClientEarth, and the lack of support for ClientEarth's course of action from other shareholders. The High Court also refused permission for ClientEarth to appeal the dismissal of the claim.

European Commission highlights importance of sustainability in merger reviews. The European Commission on September 26 published a new "Merger Brief" discussion paper showcasing what it described as the "clear trend" towards sustainability-related aspects becoming increasingly important when it considers mergers' competitive impact under the EU Merger Regulation. The Commission noted that sustainability considerations now permeate all aspects of the merger review: they could affect how it defines the relevant product market, by raising considerations such as whether customers would switch from fair-trade to non-fair-trade coffee, and how it conducts the competitive assessment, by raising questions on whether the merger would hamper green innovation. The Commission also discussed how sustainability considerations could affect potential remedies offered by deal participants in transactions, such as whether a purchaser of a divested business would continue to advance net-zero targets. The discussion paper also warns that "'green' killer acquisitions," where a "green innovator" target with low or no EU turnover shows high competitive potential, may be subject to scrutiny by the Commission under Article 22 of the EU Merger Regulation even if the acquisition would not otherwise meet the EU notification thresholds. Although the Commission acknowledges that it has no mandate to intervene in mergers for environmental reasons alone in the absence of harm to competition, the Merger Brief suggests that environmental and sustainability aspects of mergers will play an increasingly key role in EU merger reviews.

Sustainable Finance Updates

International organizations release guidance on 'blue' bonds. A group of development banks, United Nations' initiatives and the International Capital Market Association ("ICMA") have released a guide for issuance of sustainable bonds focused on the use of coastal and marine resources. The guide builds on the existing market standards developed by ICMA for sustainable use of proceeds bonds and sustainability-linked bonds and provides thematic guidance to issuers, investors and underwriters on how to apply those standards to debt issuances focused on marine sustainability.

Energy Transition Updates

IRS publishes guidance on U.S. clean energy tax credits. On August 30, the Internal Revenue Service ("IRS") published a Notice of Proposed Rulemaking relating to prevailing wage and registered apprenticeship requirements for domestic clean energy projects which, if met, can achieve substantial increases in the quantum of U.S. tax incentives that a project could benefit from under the U.S. Inflation Reduction Act of 2022 (the "IRA"). In total, 11 tax credits and one tax deduction in the IRA have provisions that increase the credit or deduction by five-fold when these requirements are met. The potential uplift in credits/deductions can benefit new solar, wind, hydrogen, carbon sequestration and nuclear projects, along with energy storage facilities. For more details on the IRS's proposal, please see S&C's recent Energy Transitions Insights memo here.

European Hydrogen Bank launches pilot auction on European hydrogen production. On August 29, the European Commission published the terms and conditions of an €800 million pilot auction under the Innovation Fund of the European Hydrogen Bank (the "EHB"). The auction will subsidize hydrogen projects located in the European Economic Area by granting a fixed premium in €/kg of renewable hydrogen produced over 10 years. The auction forms part of the EHB's first proposal to create a domestic market for hydrogen by reducing the cost gap between renewable and fossil fuel hydrogen production, facilitating price discovery, leveraging private capital to de-risk hydrogen projects, and mitigating administrative burdens. The EU has announced a total budget for the EHB of €3 billion thus far. For more details about the pilot auction, please see S&C's Energy Transition Insights memo here.

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