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Addressing ESG considerations in the M&A context

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Introduction

Environmental, Social and Governance ("**ESG**") considerations are now essential elements in deal-making. Taken together, ESG covers an extraordinarily broad scope, including but not limited to:

- **Environmental**: climate change and greenhouse gas emissions; energy efficiency; resource depletion, including water; hazardous waste; deforestation; and air, land and water pollution and waste management.
- **Social**: human rights; working conditions, including slavery and child labour; local and indigenous communities; conflict; health and safety; employee relations; and equality and diversity.
- **Governance**: bribery and corruption; tax; transparency; executive pay; political lobbying and donations; shareholder rights; board independence, diversity and structure; and ESG governance framework, including supply chain management and customer engagement.

Although individual elements of the "E", "S" and "G" have been present for decades, organisations are growing more conscious of the dual aims – and increasingly the related legal requirements – of building sustainable businesses and managing exposures to ESG risks.

This year has seen the ESG landscape become increasingly bifurcated, particularly in the United States. Individual states are passing "pro-ESG" and "anti-ESG" laws and regulations.

Some states and cities have sought to embed ESG considerations in law. For instance, California integrated ESG factors into its Public Employees' and Teachers' Retirement Systems. Illinois' Sustainable Investing Act (2020) states that "all public or government agencies involved in managing public funds...develop, publish, and implement sustainable investment policies". New York City announced plans to reach net-zero greenhouse gas emissions across its investment portfolios by 2040.

For other states and cities, there has been a growth in "anti-boycott" bills targeting financial institutions that "boycott" or "discriminate against" companies in certain sectors and "no ESG investment" bills prohibiting the use of state funds for the purpose of ESG or social investment. Under these Anti-ESG bills, states are prohibited from investing in strategies that consider ESG factors for any purpose outside of maximising financial returns. From 2020 to the date of this publication, 30 U.S. states have introduced 114 anti-ESG laws. Of these proposed laws, 56 are still pending, 40 have failed, and 18 have been enacted.

At the same time, legislators and regulators around the world increasingly focus on ESG considerations, and related initiatives in the private sector – particularly among institutional investors – have proliferated. Regulation has grown on multiple fronts, including new affirmative diligence and disclosure requirements. Cross-border and multinational deals will require purchasers in M&A transactions to be mindful of both, as they will be required under the laws of certain jurisdictions to follow mandatory diligence procedures and, in control transactions, to report on the operations of newly acquired businesses. This will become particularly relevant as an ever-increasing number of jurisdictions introduce ESG regulations with wide scopes and differing – and sometimes novel – due diligence and reporting obligations.

Furthermore, antitrust issues are increasingly coming to the attention of regulators and legislators, noting that ESG initiatives are subject to antitrust laws, as with all collaborations among industry participants.

This chapter focuses on current legal developments and market practice affecting ESG due diligence in M&A transactions. It begins by discussing ESG diligence requirements in selected markets, then highlights certain risk-management concerns, addresses benefits for businesses of robust ESG diligence and concludes with a consideration of ESG metrics and ratings agencies. As this is a limited survey in a rapidly evolving area, there is now, and surely will soon be, other national and super-national legislation that implicates these areas.

ESG: legislative and judicial action

<u>ESG regulations affecting buyers conducting due diligence</u>

Europe

- **European Union Corporate Sustainability Due Diligence Directive (the "CSDDD")**

Overview. In April 2020, the European Commissioner for Justice, Didier Reynders, announced that the European Commission would commit to introducing rules for mandatory environmental and human rights due diligence.[1] This was followed in February 2022 by the Commission publishing a proposal for a Directive on Corporate Sustainability Due Diligence as part of its sustainable corporate governance initiative. This draft CSDDD builds on the UN's Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises' Responsible Business Conduct Matters. The CSDDD would require both EU companies and non-EU companies operating within the EU to identify and, where necessary, prevent, end or mitigate their activities' adverse impacts on human rights and the environment. Companies could be held liable for harms committed at home or abroad by their subsidiaries, contractors and suppliers, and victims will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures.[2] EU Member States will be responsible for supervising compliance with these new rules and are required to develop rules on sanctions for non-compliance.[3]

These requirements will apply to all business relationships in the global value chain, not just the first tier, which contrasts with Germany's new due diligence law, as noted below.[4]

Primary objectives. The draft CSDDD outlines the following primary objectives: (*i*) to prevent and mitigate potential or actual adverse impacts on human rights, the environment and good governance in the value chain; (*ii*) to ensure that companies can be held accountable for such impact; and (*iii*) to provide anyone who has suffered harm caused by businesses' activities effective remedies in accordance with national law.[5] In addition, certain large companies will need to have a plan to ensure that their business strategy is compatible with limiting global warming to 1.5°C in line with the Paris Agreement.

Applicability. The Commission's proposal would apply to: (*i*) all large EU companies (defined as those with more than 500 employees and a net worldwide annual turnover of over EUR 150 million); (*ii*) high-risk medium-sized EU companies (defined as those with more than 250 employees and a net worldwide annual turnover of EUR 40 million, where at least 50% of this turnover was generated in a high-risk sector); (*iii*) non-EU companies that generate at least EUR 150 million in net turnover in the EU; and (*iv*) non-EU companies that generate at least EUR 40 million in net turnover in the EU, where at least 50% of the company's worldwide turnover was generated in a high-risk sector. High-risk sectors are defined as: (*i*) the manufacture and wholesale trade of textiles, leather and related products; (*ii*) agriculture, forestry, fisheries, food manufacturing and wholesale trade of agricultural raw materials, live animals, food and beverages; and (*iii*) mineral extraction, certain metal manufacturing and wholesale trade of certain mineral resources and products.[6] In December 2022, the EU Council agreed to a negotiating position (the so-called General Approach) on the CSDDD, and in April 2023, the European Parliament's Committee on Legal Affairs (the "**JURI**") agreed a number of final compromise amendments to the Commission's draft, which will be put to a vote in a Parliament plenary meeting in May/early June 2023. The drafts issued by the EU Council and the European Parliament's Legal Committee partially differ from the Commission's proposal and, for example, provide for different thresholds. One notable issue currently under discussion by the EU legislative bodies is the CSDDD's application to certain financial undertakings, including fund managers and investment funds.

Effects. The draft CSDDD will force companies to understand the details and actors within their value chains, particularly where they may be at risk in the areas of: (*i*) human rights (e.g., charters and conventions relating to social rights, trade union activities and investment chains); (*ii*) environment (e.g., the impact on climate change, deforestation, water quality, use of sustainable resources, biodiversity and ecosystems); and (*iii*) good governance (e.g., bribery, anti-money laundering and tax compliance issues).[7]

The proposed legislation establishes a corporate due diligence obligation and requires in-scope companies to implement certain human rights and environmental due diligence measures. These include the following:

- integrating due diligence into corporate policies and implementing a due diligence policy;
- identifying actual and potential adverse human rights and environmental impacts arising from the company's operations or those of its subsidiaries and from its established business relationships;
- preventing or, where appropriate, mitigating potential adverse impacts, including implementing prevention action plans, seeking contractual assurances to ensure compliance, investing into management or production processes, providing targeted and proportionate support to enable small and medium-sized enterprises ("**SMEs**") to comply and, where relevant, collaborating with other entities to bring the adverse impact to an end;
- bringing actual adverse impacts to an end or minimising the extent of their impact by taking appropriate measures;
- establishing a complaints procedure that enables affected persons, trade unions and civil society organisations to submit complaints where they have legitimate concerns about the actual or potential human rights and environmental impacts of the company's operations; and
- monitoring the effectiveness of identification, prevention, mitigation, ending and minimisation of the adverse impacts by carrying out periodic assessments of the company's operations and measures.

Companies not already in scope of certain other reporting requirements must publish an annual statement on their websites reporting on matters in scope of the CSDDD. The specific content of this statement has not yet been set out; however, earlier drafts of the proposal indicate that these statements need to set out the company's due diligence strategy.[8]

The obligation of regulated financial entities to implement these due diligence measures is limited in two ways. First, regulated financial entities providing a credit, loan or other financial service need only identify actual or potential adverse impacts before providing such services. Second, they are not required to terminate a credit, loan or other financial service in order to prevent a potential adverse impact or bring to an end an actual adverse impact where doing so can reasonably be expected to cause substantial prejudice to the entity to whom that service is being provided. It is worth noting in this context, however, that the Council's proposal leaves it up to the EU Member States as to whether to include regulated financial undertakings, such as credit institutions, insurance undertakings and fund managers (AIFMs and UCITS management companies), within the scope of the CSDDD with regard to their provision of financial services to their business partners.

Civil liability. This proposed legislation is notable because companies will be held liable in accordance with national law for any violations arising out of adverse impacts on human rights, the environment and governance that either they or the subsidiaries under their control have caused or contributed to by acts or omissions. It remains to be seen whether the entire spectrum of stakeholders (as such term is used in the draft directive) will be afforded standing to bring claims under national liability regimes. The current form of the proposed legislation defines stakeholders as: (*i*) employees of the company or its subsidiaries; and (*ii*) groups, communities or entities whose rights or interests are or could be affected by the products, services or operations of the company and its subsidiaries.[9]

Furthermore, the Commission's and the Parliament's proposals extend a director's duties of care to act in the best interest of the company to encompass the short-, medium- and long-term consequences of their decisions on human rights, climate change and the environment. This follows from the requirement that directors put into place the due diligence measures mentioned above.

The result of this is that companies and their directors will no longer be able to protect themselves or investors from potential liability by simply performing basic due diligence.[10] Consequently, a need to expand ESG-related processes within companies or other investors, including private equity firms, is likely to arise for those with any business relationships with or within the EU in order to address the framework proposed by the EU.[11] The Council's proposal, in contrast, requires companies (rather than directors) to be responsible for implementing and monitoring their due diligence obligations and deletes the provision on directors' duties.

Areas of consideration. This is a draft of the legislation and is still subject to change. However, certain key principles have been part of the concept since its inception, including the breadth of the law. The Commission still needs to make a judgment as to how to hold companies liable for harm by means of private actions, while at the same time ensuring an acceptable degree of legal certainty. Furthermore, as discussed above, the Commission will be relying on national systems to enact liability; it therefore may encounter difficulties in ensuring consistency across national regimes.[12]

It is expected that companies will incur administrative and financial burdens in connection with changes required to implement the obligations imposed by the CSDDD, including engaging with potentially different tools to understand and track their value chains, though these measures are by and large directly proportionate to the level of risk contained in their value chains.

Other European due diligence regulations

French vigilance law

In 2017, France introduced into law a duty of vigilance requiring businesses to design, implement and publish a vigilance plan that includes due diligence measures to identify risks and forestall serious infringements of, or harm to, human rights and fundamental freedoms, personal health and safety and the environment.

In practice, the targeted companies are required to implement the following vigilance measures:

- risk mapping to identify, analyse and rank those risks;
- due diligence on all subsidiaries, subcontractors or suppliers with which a commercial relationship is established;
- appropriate actions to mitigate risks or prevent serious harm;
- the creation of a system to ensure alerts are raised over risks that eventuate; and
- a system to control the implementation of the above measures.

The law applies to any company having its head office in France that, at the end of two consecutive financial years, employs at least 5,000 employees by itself and in its direct or indirect subsidiaries whose head offices are also located in France, as well as to any company having its head office in France and employing at least 10,000 employees itself or in its direct or indirect subsidiaries, regardless of where their head offices are located.

The law therefore does not apply to parent companies governed by foreign law, since the text is included within the chapter of the French Commercial Code regarding joint-stock companies (*sociétés anonymes*) and also applies to simplified joint-stock companies (*sociétés par actions simplifiées*) governed by French law. However, it would also apply to their French subsidiaries that reach the relevant threshold.[13]

In March 2021, 11 non-governmental organisations ("**NGOs**") filed suit against the supermarket chain Casino Group under the vigilance law, alleging that it caused environmental and human rights abuses through involvement in the cattle industry in Brazil and Colombia.[14] In January 2023, Danone was sued under the vigilance law for allegations that, as one of the world's top 10 plastic polluters, it is not performing its duties because its vigilance plan is silent with respect to plastic consumption.[15] In February 2023, three environmental NGOs filed a suit against BNP Paribas, alleging that by continuing to provide both direct and indirect financing for new fossil fuel providers, the bank had violated its statutory duty of vigilance.[16]

That same month, a French court dismissed a case against TotalEnergies, alleging it failed to comply with its duties under the vigilance law on the basis that making a determination on TotalEnergies' alleged breach of duty would exceed the Tribunal's power.[17] The Tribunal determined that: (*i*) TotalEnergies had formally established a vigilance plan comprised of the five items required by law that was detailed enough to not be viewed as summary; (*ii*) there was contradictory evidence about the operations of the relevant oil development; and (*iii*) there is no regulation specifying the standard of a vigilant company. The Tribunal then concluded that an in-depth examination of the allegations against TotalEnergies must be carried out, but that this would exceed the powers of the Tribunal; only a judge examining the case in more depth could assess whether the accusations against TotalEnergies were founded, and then proceed to do an audit of operations on the ground. The case was therefore dismissed.

German Act on Corporate Due Diligence in Supply Chains

On 22 July 2021, the German Parliament adopted the Act on Corporate Due Diligence in Supply Chains. This human rights due diligence act aims to implement the 2016 "National

Action Plan for Business and Human Rights in the Federal Republic of Germany", which requires companies to appropriately identify, address and report on human rights risks in their supply and value chains, with reference to their size, sector and role within the supply chain, and enable persons to notify relevant risks and infringements by means of a complaints procedure or grievance mechanism. The basis of the Action Plan and the new national requirements is the due diligence standard of the 2011 UN Guiding Principles on Business and Human Rights.

The due diligence obligations along the supply chain extend to the company's own business operations and direct suppliers, and – in a weakened form – to indirect suppliers. As defined by the act, the "supply chain" thereby includes all steps, both domestically and internationally, required to manufacture a company's products and provide its services, starting with the extraction of raw materials and ending with delivery to the end customer. The actions required under the new act vary based on a number of factors, such as the nature and scope of the business, the in-scope company's ability to influence entities in their supply chain, the extent and expected severity of a violation, the possibility of reversing an error, and the probability of the reoccurrence of a violation.

This act applies not only to companies with their registered office or principal place of business in Germany but also to foreign companies that have a branch office in Germany and normally have at least 3,000 employees in Germany (not counting employees seconded to a foreign country).

The German act came into force on 1 January 2023, giving companies a transitional period to prepare for their new supply chain due diligence obligations by revising existing compliance management systems, establishing new processes and training employees accordingly. In particular, it applies to partnerships and corporations employing more than 3,000 employees domiciled in Germany from 2023 and will then apply to smaller businesses with more than 1,000 employees from 2024.[18]

If companies fail to comply with their legal obligations, fines can be imposed. These can amount to up to EUR 8 million or up to 2% of global annual sales, though the turnover-based fine framework only applies to companies with annual sales of more than EUR 400 million. Furthermore, if a fine is imposed above a certain minimum level, the company may be excluded from the award of public contracts.

*The Dutch Child Labour Due Diligence Act (the "**Child Labour Due Diligence Law**")*

The Child Labour Due Diligence Law applies to all companies that sell or supply goods or services to Dutch consumers, no matter where the company is based or registered, with no exemptions for legal form or size. Companies that fail to exercise child labour due diligence are subject to potential financial and legal enforcement actions, including multiple years of imprisonment. The Dutch government is currently developing implementing orders.[19]

The proposed Bill on Responsible and Sustainable International Business Conduct, tabled in March 2021 and still pending, could repeal the Child Labour Due Diligence Law. This new bill would establish a duty of care for companies registered in the Netherlands or that sell products or provide services in the Dutch market to prevent and mitigate adverse human rights and environmental impacts along their value chains and, where necessary, to enable remediation.[20]

The bill stipulates that companies engaging in activities outside the Netherlands and exceeding at least two of the following criteria – 250 employees, a total balance sheet of more than EUR 20 million and net revenues of more than EUR 40 million – would be subject to a due diligence obligation modelled along the lines of the six-step framework contained in the OECD's "Due Diligence Guidance for Responsible Business Conduct Guidelines".[21] The companies meeting the above criteria would be required to develop a policy commitment, draw up an action plan, monitor progress and annually report.

Additionally, the bill foresees administrative, civil and criminal liability. As far as enforcement is concerned, an independent public regulator would be empowered to issue binding instructions and impose financial sanctions but also to offer positive guidance.[22]

United Kingdom

The Environment Act 2021, a vehicle for delivering the UK government's 25-year environmental plan, had a significant impact on environmental governance in the United Kingdom. It requires the UK government to set out binding environmental targets and includes significant powers to make regulations that may translate into new obligations for private entities.[23]

United States

- **Dodd-Frank Act section 1502**

Section 1502 of the Dodd-Frank Act – implemented as a rule by the U.S. Securities and Exchange Commission (the "**SEC**") in 2012 – requires all publicly listed companies to disclose their use of tantalum, tin, gold or tungsten sourced from the Democratic Republic of the Congo and its neighbours, if "necessary to the functionality or production" of a product manufactured or contracted to be manufactured by the company.[24] While companies are not required or even encouraged to stop sourcing from the region, they must disclose due diligence efforts – including tracing and auditing – and other steps taken to ensure their purchasing is not funding armed groups or human rights abuses and to address identified risks.[25]

Under the rule, a company that uses any of the designated minerals must conduct a reasonable "country of origin" inquiry, performed in good faith and reasonably designed to determine the source of the material.[26] If the company either knows the mineral did not originate in the covered countries or has no reason to believe the minerals may have originated in the covered countries, then the company must disclose this determination along with a description of its inquiry.[27] If, on the other hand, the company knows or has reason to believe that the minerals may have originated in the covered countries, the company must undertake due diligence on the source and file a "Conflict Minerals Report" outlining the chain of custody of the mineral.[28] Both determinations must be made publicly available on the company's website.[29]

- **2010 California Transparency in Supply Chains Act**

The California Transparency in Supply Chains Act (the "**Supply Chains Act**") became effective in January 2012, making it the first supply chain disclosure act focused on consumers in the United States.[30] The Supply Chains Act requires all retailers and manufacturers doing business in California "and having annual worldwide gross receipts that exceed one hundred million dollars" to disclose "efforts to eradicate slavery and human trafficking from its direct supply chain for tangible goods offered for sale".[31]

More specifically, the disclosure must outline to what extent, if any, the retailer or manufacturer: (*i*) verifies, evaluates and addresses the risks of human trafficking and slavery in its product supply chain; (*ii*) audits suppliers to ensure compliance with company standards; (*iii*) requires direct suppliers to certify that the supply chains for all constituent parts comply with human trafficking prohibitions enshrined in domestic law where the part is produced; (*iv*) maintains internal accountability standards and procedures in case of violation; and (*v*) trains employees and managers with direct responsibility for supply chain management.[32] At a minimum, the Supply Chains Act requires disclosure on the company's website "with a conspicuous and easily understood link" or written disclosure within 30 days of having received a request for disclosure from a consumer.[33]

With this focus on disclosure, the Supply Chains Act is intended to provide consumers with the information they need to be "able to force the eradication of slavery and trafficking by way of their purchasing decisions", i.e., to reward companies with stronger practices and penalise those that fail to effectively monitor their supply chains.[34] Like other reporting statutes, the Supply Chains Act does not require that companies take steps to monitor their supply chains or eradicate forced labour, and it fails to outline what effective monitoring looks like or what adequate due diligence would entail. Thus, a company that states that it takes no efforts in any of the required reporting areas is still in compliance with the Supply Chains Act.

The Supply Chains Act also does not create a private right of action but instead provides that the exclusive remedy for violation "shall be an action brought by the Attorney General for injunctive relief".[35] However, some consumers and their attorneys have begun to bring cases under California consumer protection statutes focused on unfair competition and false advertising.[36]

- **Uyghur Forced Labor Prevention Act (the "UFLPA")**

On 23 December 2021, President Biden signed into law the Uyghur Forced Labor Prevention Act, set to take effect no later than 21 June 2022.[37] The bill imposes various restrictions related to China's Xinjiang Autonomous region, including prohibiting certain imports from Xinjiang and imposing sanctions on actors responsible for human rights violations there.

Securities issuers required to file annual or quarterly reports with the SEC must disclose certain information related to such issuer's activities in Xinjiang, including certain details on: (1) the nature and extent of the activity; (2) the gross revenues and net profits attributable to the activity; and (3) whether the issuer or affiliate intends to continue the activity.[38] Such information would need to be disclosed in cases where the issuer knowingly engaged in activity with an entity engaged in building or running detention facilities or providing technology to create mass population surveillance systems in the Xinjiang Uyghur Autonomous Region of China, including any entity on the Department of Commerce's Entity List.[39] Additional circumstances requiring disclosure are outlined in the bill, including: (1) knowingly engaging in an activity with an entity or affiliate of an entity described in section 7(c)(I) of the Uyghur Forced Labor Prevention Act, including any entity engaged in the "pairing-assistance" programme that subsidises the establishment of manufacturing facilities in the Xinjiang Uyghur Autonomous Region or entities for which DHS has issued a "Withhold Release Order"; and (2) knowingly conducting any transaction or dealings with: (*i*) any person the property and interests in property of which were sanctioned by the Secretary of State for the detention or abuse of Uyghurs, Kazakhs, Kyrgyz or other members of Muslim minority groups in the Xinjiang Uyghur Autonomous Region; (*ii*) any person or the property and interests in property of which are sanctioned pursuant to the Global Magnitsky Human Rights Accountability Act (22 U.S.C. 2656); or (*iii*) any person or entity responsible for, or complicit in, committing atrocities in the Xinjiang Uyghur Autonomous Region.[40]

The scope of activities covered by the UFLPA could require companies to examine their supply chains. In particular, the Act extends to cover transactions with entities or affiliates of entities that are themselves engaging in activity in Xinjiang, even if the issuer itself is not engaging in such activity. The Department of Homeland Security conducted a request for comment ending March 2022, which included the following question: "What due diligence, effective supply chain tracing, and supply chain management measures can importers leverage to ensure that they do not import any goods mined, produced, or manufactured wholly or in part with forced labour from the People's Republic of China, especially from the Xinjiang Uyghur Autonomous Region?"[41] The Secretary of Homeland Security is tasked with developing and submitting to Congress a strategy to support enforcement of the provisions of the UFLPA.[42]

Accompanying the UFLPA is the Strategy to Prevent the Importation of Goods Mined, Produced, or Manufactured with Forced Labor in the People's Republic of China (the "**UFLPA Strategy**"), promulgated by the Forced Labor Enforcement Task Force of the Department of Homeland Security. The UFLPA Strategy provides guidance to importers on the nature of due diligence. It also discusses supply chain management controls expected of importers seeking to comply with the UFLPA, along with the types of evidence required to rebut the presumption.

- **New York Fashion Sustainability and Social Accountability Act (the "FSSAA")**

New York legislators introduced a bill that would require fashion retail sellers and manufacturers to disclose environmental and social due diligence policies, with the stated aims of targeting "fast fashion" and creating legislation to govern the fashion industry. Under the bill, fashion retailers doing business in the state and with global revenue of at least $100 million would be required to disclose various environmental and social impacts, diligence policies and outcomes.

Disclosures would include, at a minimum, the following:

(1) supply chain mapping and disclosure, including information on suppliers at all stages of production, from raw material to final production;
(2) due diligence disclosures, including social and environmental sustainability reports and identification of risk areas in the supply chains; and
(3) impact disclosures.

The introductory language contemplates that citizens may commence civil actions against a business in violation of the legislation. The bill would also amend the state finance law in order to establish a community benefit fund, which would allow the Department of Environmental Conservation to expend funds for implementing environmental benefit and environmental justice projects.

Senate Bill S7428 was introduced in October 2021 and was referred to the Consumer Protection Committee on 5 January 2022.[43] The Assembly version of the bill is similarly before the Consumer Affairs and Protection Committee.[44]

ESG regulations mandating ESG disclosure

Europe

- **Non-Financial Reporting Directive**

In 2014, the EU adopted the Non-Financial Reporting Directive (the "**NFRD**"), which requires large public interest entities to report on ESG information from 2018 onwards.[45] Large public interest entities include EU listed companies, banks, insurance companies and undertakings designated by EU Member States as public interest entities, subject to the threshold that the entity has more than 500 employees and a balance sheet of more than EUR 20 million or net turnover of more than EUR 40 million.

The NFRD aims to create greater transparency in relation to entities of a certain size across all sectors in all EU Member States, ensuring that investors and civil society organisations have adequate access to non-financial information. In particular, this directive identifies four sustainability issues: social responsibility and treatment of employees; respect for human rights; anti-corruption and bribery; and diversity on company boards. Entities in scope must disclose information about business models, policies, outcomes, risks and key performance indicators relevant to their business. The NFRD leaves flexibility in relation to the reporting standard and does not impose detailed disclosure requirements. Regarding climate change disclosure, the NFRD applies the recommendations of the Taskforce on Climate-Related Financial Disclosure (the "**TCFD**").

Following public consultations, commentators identified several deficiencies relating to the NFRD's implementation, finding that the disclosures have not led to relevant public information on the impact of non-financial issues on companies or the other way around, and caused companies to incur unnecessary costs.[46]

- **Corporate Sustainability Reporting Directive**

In November 2022, the European Parliament formally adopted the Corporate Sustainability Reporting Directive (the "**CSRD**"), which will supersede the prior Non-Financial Reporting Directive as of fiscal year 2023.[47] The CSRD is a sustainability reporting framework that extends the NFRD's scope to all EU "large" companies (that meet two of the following criteria: balance sheets greater than EUR 20 million; net turnover greater than EUR 40 million; or more than 250 employees) and all EU listed companies (including SMEs, but excluding micro-enterprises). EU subsidiaries or branches of non-EU parent companies are also in scope of the CSRD to the extent that the non-EU parent company generates turnover of more than EUR 150 million in the EU, and the subsidiary is a large or listed company or a significant EU branch (generating more than EUR 40 million in turnover). The CSRD also introduces more detailed reporting requirements in accordance with the EU sustainability reporting standards (detailed in the following section). Reporting requirements under the CSRD will apply on a phased basis, as follows: from 1 January 2024, for large public interest companies with over 500 employees that are already subject to the NFRD; from 1 January 2025, for large companies not currently subject to the NFRD (over 250 employees and/or EUR 40 million in net turnover and/or EUR 20 million on its balance sheet); and from 1 January 2026, for listed small and medium-sized enterprises ("**SMEs**"). SMEs can opt out until 2028.[48]

- **Sustainable Finance Disclosure Regulation and Taxonomy Regulation**

In December 2019, the Sustainable Finance Disclosure Regulation (the "**SFDR**") entered into force, requiring all EU financial market participants and financial advisors (including non-EU firms marketing in the EU) to make ESG disclosures in relation to their financial products, sustainability risks and adverse sustainability impacts, in their investment processes. The level of disclosure and obligations depends on the level of integration of ESG considerations within the financial product. Products promoting environmental or social characteristics (Article 8 products) and products having sustainable investments as their objective (Article 9 products) are subject to pre-contractual and ongoing disclosures on sustainability indicators used to monitor performance.[49]

The SFDR's Level 1 requirements have applied since March 2021. These Level 1 disclosures are entity-level and product-level disclosures, which require fund managers to: (*i*) assess the potential for ESG factors to negatively impact the returns of funds under management; and (*ii*) disclose the outcome of that assessment to investors both in the funds' prospectus documents and on the firm's website. The Level 1 disclosures also require in-scope firms to publish an adverse impacts statement on their website. Firms with 500 employees or more have been required to publish a statement describing the due diligence policies that are applied by the firm to identify the adverse impacts of investment decisions on sustainability factors; firms with fewer than 500 employees have the option either to publish a statement or clearly state that adverse impacts are not taken into account as long as they detail why they do not and, where relevant, whether they intend to do so in the future.[50]

The Level 2 disclosures were published in April 2022 and applied from January 2023. These Level 2 disclosures provide regulatory technical standards specifying the details of the Level 1 disclosures, notably including the disclosure templates for Article 8 and Article 9 products.

Alongside the SFDR, the European Union adopted the Taxonomy Regulation, to apply from 1 January 2022.[51] The Taxonomy Regulation puts forward a common set of technical screening criteria to test and measure to what extent an economic activity qualifies as environmentally sustainable. It applies where financial market participants make available products that promote specific environmental characteristics or products that have sustainable investment as an objective. The Taxonomy Regulation (and associated technical screening criteria) initially focused on climate change issues, with the Taxonomy Regulation applying from 1 January 2022 in respect of the two climate change objectives, and on 1 January 2024 for the other environmental objectives.[52]

Together with the SFDR, the Taxonomy Regulation ensures that investors investing in financial products in scope will obtain adequate information about the alignment of their portfolios to the Taxonomy. Moreover, together with the CSRD, the Taxonomy Regulation ensures that companies falling under the scope of the CSRD disclose information about a company's Taxonomy-aligned economic activities.

The European Union has also adopted the Low Carbon Benchmark Regulation, which seeks to ensure that low-carbon benchmarks comply with a standard methodology to limit the possibility of presenting outcomes without a proper basis (otherwise known as greenwashing).[53]

- **Corporate Sustainability Due Diligence Directive**

The draft CSDDD provides an obligation for in-scope companies that are not subject to the reporting obligation under the EU Accounting Directive (Directive 2013/34/EU of the European Parliament and of the Council) to publish an annual statement on their compliance with the requirements under the CSDDD on their website. The statement shall be published by 30 April each year, covering the previous calendar year.

Germany

- **German Act on Corporate Due Diligence in Supply Chains**

The German Act on Corporate Due Diligence in Supply Chains requires in-scope companies to continuously document the compliance with due diligence requirements and prepare an annual report thereon, which must be made publicly available on the company's website and electronically transmitted to the German Federal Office of Economics and Export Control (the "**BAFA**").

United Kingdom

- **UK Modern Slavery Act 2015 (the "MSA")**

The United Kingdom implemented the MSA in 2015, one of the first global modern slavery regulations. The MSA requires large businesses to produce a statement each financial year stating the steps the organisation has taken during that year to ensure that slavery and human trafficking is not taking place in any part of its own business or any of its supply chains, or a statement that the organisation has taken no such steps. This requirement applies to all commercial organisations (wherever formed) that carry on a business (or part of a business) in any part of the United Kingdom that supply goods or services and have an annual turnover of at least GBP 36 million (calculated on a group-consolidated basis).[54]

The statement may include information about the organisation's policies regarding slavery and human trafficking, its due diligence processes in relation to slavery and human trafficking in its business and supply chains, and its effectiveness in ensuring that slavery and human trafficking are not taking place in its business or supply chains. The statement must be approved by the board and signed by a director. The organisation must publish this statement on its website and include a link to the statement in a prominent place on the homepage.[55]

In March 2021, the UK government created a central registry for publishing MSA statements and announced the creation of a government watchdog to protect the rights of UK workers. Additionally, two bills to amend the MSA are currently before the House of Lords: one aims to strengthen enforcing obligations under section 54 of the MSA; and the other aims to support victims of modern slavery. While both bills had their first reading in late 2021, neither has had its second reading scheduled.[56] It is therefore unclear whether these amendments will be enacted and, if so, when.

- **TFCD**

The United Kingdom has implemented legislation to make the voluntary disclosure framework under the TCFD mandatory for UK companies, UK asset managers and types of regulated investors, in each case subject to a size threshold. This requires entities in scope to publish detailed TCFD reports that cover their approach to climate risks (the impact of climate change) and opportunities (the transition to a lower-carbon economy) in terms of governance, strategy and risk management. Entities in scope will also need to collect and disclose data on carbon emissions and climate-related targets.

Premium-listed companies have been required to publish TCFD reports for financial years beginning on or after 1 January 2021, and large UK occupational pension schemes will first need to publish information for scheme years ending on or after 1 October 2021. From 6 April 2022, "large" UK companies (those with a turnover above GBP 500 million *per annum*) and LLPs in scope must include TCFD-aligned disclosures in their strategic reports. Furthermore, large UK asset managers (those with GBP 50 billion in assets under management) and standard listed companies must make TCFD-aligned disclosures at an entity level and a product level for accounting periods commencing on or after 1 January 2022.[57] Other firms with assets under management greater than GBP 5 billion are subject to the new rules from 1 January 2023, with reports due by 30 June 2024.[58]

- **Transition Plan Taskforce**

The UK government also confirmed in November 2021 that it would require certain companies to publish climate-transition plans to set out how they would decarbonise by 2050. A Transition Plan Taskforce was launched to determine the "gold standard" for transition plans, and it published a draft Disclosure Framework and Implementation Guidance in November 2022, with final versions expected in summer or autumn 2023.[59]

United States

Historically, the SEC generally has taken a principles-based approach to ESG disclosure, focusing on materiality relative to each company's results. However, in spring 2021, the SEC released its rulemaking list, including several proposed regulations that would bolster ESG disclosure in the areas of climate change, board diversity, human capital management and cybersecurity risk governance.[60] Then, in March 2022, as detailed below, the SEC released its long-awaited proposed rules for enhanced climate change disclosures.[61]

Indeed, since 2021, the SEC has taken a number of steps towards regulating ESG issues. In March of that year, the SEC launched a Climate and ESG Task Force in the Enforcement Division with a mandate to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules";[62] the Division of Examinations also announced climate-related risks as one of its 2021 examination priorities.[63] On 7 July 2021, the SEC's Asset Management Advisory Committee adopted recommendations to the SEC regarding disclosures of material ESG matters by issuers and ESG investment product disclosures.[64]

In addition, on 3 November 2021, the SEC issued a Staff Legal Bulletin that would make it easier for shareholder proposals related to ESG issues to remain on the agenda.[65] Staff Legal Bulletin No. 14L (CF) stated the following: (1) shareholder proposals related to emissions limits or targets will not *per se* fall under the micromanagement exception; (2) the SEC staff will focus more on the social policy significance of an issue, as opposed to the nexus between a policy issue and the company, in determining whether the significant social policy exception applies; and (3) whether an issue is "too complex" under the micromanagement exception must be judged in light of the sophistication of investors and the robustness of public discussion.[66] Looking ahead to the 2022 proxy season, there has been a significant increase in the number of environmental- or social-related shareholder proposals, and the SEC has also rejected a significant number of company requests to exclude such shareholder proposals.[67]

On 21 March 2022, the SEC released its proposed rules on the "Enhancement and Standardization of Climate-Related Disclosures for Investors" (the "**climate disclosure rule for investors**"), which is intended to require "consistent, comparable, and decision-useful information" on climate-related disclosures.[68] These proposed rules would add new, often prescriptive climate-related disclosure requirements to Regulation S-K, which primarily governs qualitative disclosures, and Regulation S-X, which governs financial statements. In general, these disclosures would address various climate-related risks to the registrant's business, operations and financial condition, including disclosure of a registrant's greenhouse gas emissions.[69] The proposed rules would require domestic and foreign registrants to include information related to greenhouse gas emissions, climate-related risks, corporate governance, public climate goals (if any) and transition plans.[70] The SEC public comment period for the proposed rules closed on 17 June 2022.[71] We currently expect to see a final rule this year, subject to potential litigation.[72]

On 7 February 2023, the SEC announced its 2023 examination priorities, which included a focus on ESG-related advisory services and strategies that incorporate certain ESG criteria, including whether funds are operating in the manner set forth in their disclosures.[73] This is the second year in a row that the SEC has prioritised ESG-related products and services, including preventing greenwashing.[74] In line with these priorities, on 25 May 2022, the SEC proposed an amendment to the funds Names Rule, which would expand its 80% requirement to include ESG fund names.[75] The SEC also issued a proposed rule related to ESG disclosures of funds and fund managers (the "**climate disclosure rule for funds**").[76] If adopted, the rule would create additional disclosure requirements in a number of areas – including fund prospectuses, annual reports and adviser brochures – for entities that consider ESG factors in their investment processes. The proposed rule applies to certain registered investment advisers, advisers exempt from registration, registered investment companies and business development companies. Looking ahead, the SEC is likely to continue its heightened focus on ESG factors in investment and company disclosures.

In parallel, and up until Republicans took control of the House in 2022, the U.S. Congress under Democratic control passed significant ESG-related legislation. On 16 June 2021, the U.S. House of Representatives passed legislation that would impose new ESG due diligence and disclosure requirements on publicly traded companies. H.R. 1187, the ESG Disclosure Simplification Act of 2021 (the "**ESG Disclosure Simplification Act**"), would require publicly traded companies to disclose their efforts to ensure that ESG standards are reflected in their operations, activities and supply chains based on metrics established by the SEC. The ESG Disclosure Simplification Act would also allow the SEC to incorporate any internationally recognised, independent, multi-stakeholder ESG disclosure standards in defining ESG metrics and the disclosure process.

H.R. 1187 would also establish the Sustainable Finance Advisory Committee (the "**SFAC**"), a permanent body with no more than 20 members that would advise the SEC on ESG metrics, standards and disclosure, as well as sustainable finance issues more broadly. Section 4 of the Act would require that the SFAC submit to the SEC recommendations regarding which ESG metrics the SEC should require companies to disclose. Within 18 months after the SFAC's first meeting, the body would be required to issue a report that identifies challenges and opportunities for investors associated with sustainable finance and to recommend policy changes that facilitate the flow of capital towards environmentally sustainable investments.

The Act was drafted by the House Financial Services Committee. When the Committee came under Democratic control in 2019, it spearheaded a parcel of legislative initiatives focused on increasing accountability and social responsibility within the corporate sector. In championing the legislation, the Financial Services Committee noted that: (*i*) the SEC does not currently require companies to disclose information related to their ESG commitments or to adhere to standards for disclosing such information; (*ii*) investors have reported that voluntary disclosures of ESG metrics are inadequate; (*iii*) statutes and regulations requiring reporting and standardisation of ESG disclosures are in the interest of investors; and (*iv*) ESG standards are "material to investors" such that the SEC is obligated to establish standards for disclosure of such matters.[77]

Since Republicans took control of the House in 2022, Congress has seen a marked shift towards anti-ESG initiatives. In February 2023, Chairman of the Financial Services Committee Patrick McHenry announced the formation of a Republican working group to "combat the threat to our capital markets posed by those on the far-left pushing environment, social, and governance proposals".[78] The working group's threefold mandate includes "rein[ing] in the SEC's regulatory overreach", "reinforc[ing] the materiality standard as a pillar of our disclosure regime" and "hold[ing] to account market participants who misuse the proxy process or their outsized influence to impose ideological preferences in ways that circumvent democratic lawmaking".[79] Moreover, in a February 2023 letter to SEC Chair Gensler, Chairman McHenry and two other Republican Committee members demanded information on the SEC proposed climate disclosure rule for investors, which they alleged "exceeds the SEC's mission, expertise, and authority and, if finalised in any form, will unnecessarily harm consumers, workers, and the U.S. economy".[80] The authors alleged that, under Chair Gensler's leadership, the "SEC has shifted away from its principles-based disclosure regime to a partisan, activist, and prescriptive approach" with an impermissible "climate agenda".[81]

Despite the promised legal challenges from House Republicans, further SEC regulations on ESG disclosures are likely forthcoming. The then-Acting Chair Allison Lee directed the Division of Corporate Finance to "enhance its focus on climate-related disclosure in public company filings", with the ultimate aim of revising the Commission's 2010 Climate Change Guidance.[82] Towards that revision, the SEC solicited input from the public[83] and received over 5,000 comments.[84] In March 2021, the SEC launched a Climate and ESG Task Force in the Enforcement Division with a mandate to "identify any material gaps or misstatements in issuers' disclosure of climate risks under existing rules";[85] the Division of Examinations also announced climate-related risks as one of its 2021 examination priorities.[86] On 7 July 2021, the SEC's Asset Management Advisory Committee adopted recommendations to the SEC regarding disclosures of material ESG matters by issuers and ESG investment product disclosures.[87] Looking ahead, the current SEC Chair Gary Gensler's agenda includes a commitment to expanding ESG disclosures.[88]

<u>ESG: executive action</u>

United States

- **Inflation Reduction Act**

The Inflation Reduction Act (the "**IRA**") was signed into law by President Biden in August 2022. The U.S. Environmental Protection Agency described the IRA as the most ambitious climate-related legislation in the United States' history.[89] Most of the Act's provisions came into effect on 1 January 2023. The IRA introduced reduced renewable energy costs for "Green Power Partners", a voluntary programme that encourages businesses, non-profits, educational institutions, and state, local, and tribal organisations to buy green energy. The IRA's provisions include: clean energy tax credits, which allow taxpayers to deduct a percentage of the cost of renewable energy systems from their federal taxes; an emphasis on application to disadvantaged populations and communities with environmental justice concerns; and a range of options for tax credit monetisation. In particular, the IRA promises a near-USD 370 billion investment into disadvantaged communities, with an emphasis on projects that repurpose old fossil fuel infrastructure for green initiatives and employ displaced workers. The IRA also supports projects that facilitate the use of electric vehicles and allots funds towards climate resilience efforts and green power infrastructure. The impact of the IRA on the United States' transition towards green energy will be evaluated in the years to come.

Benefits of robust ESG due diligence

According to one 2022 survey, four out of five dealmakers consider ESG factors in their M&A activities, with nearly half of the respondents stating that, going forwards, deals are expected to involve ESG due diligence. The same survey noted that two-thirds of respondents would pay a premium for a target that demonstrates a high level of ESG maturity in areas that align with their own ESG priorities. Close to half of all respondents put the premium at somewhere between 1% and 5%, and one in five respondents would pay a premium of 5% or more.[90]

There is strong evidence that ESG integration into business and investment, and the robust due diligence required to ensure that this is done successfully, has a positive financial effect. A 2023 joint study by Bain & Company and EcoVadis assessed the ESG activities and outcomes of 100,000 companies. The study found that ESG activities correlate with stronger financial profitability and growth for private companies. For example, companies that rank in the top quartile of their industry for gender diversity in their executive teams enjoy annual revenue growth approximately 2% above companies in the bottom quartile. The study also found a positive correlation between renewable energy usage and higher EBITDA margins in carbon-intensive industries, and assessed that companies focusing on ethics, environmental and labour practices in their supply chains are 3% to 4% more profitable than those companies that do not consider their suppliers' ESG credentials.[91]

Furthermore, there is evidence of positive ESG-related debt issuance. Although the issuance of green bonds fell by 25.6% globally in 2022 compared to 2021, certain experts attributed this to the broader decline in corporate bond issuance rather than a lack of desire from companies to issue the bonds or low investor demand. Some analysts have forecasted a rebound in 2023 thanks to supportive policies such as the United States' IRA (above).[92] A 2022 study of a global panel of green and conventional bonds found that, on average, green bonds have a yield spread of eight basis points lower relative to conventional bonds.[93] Green bonds also garner institutional support from international actors. For example, the UN Development Programme has promoted and assisted with the issuance of green bonds in numerous countries in the recent past, including Mexico's EUR 1.25 billion SDG bond issued in July 2021 and Indonesia's EUR 500 million SDG bond issued in September 2021.

Gains through the establishment of a level playing field. The legal framework described in the section "ESG: Legislative and Judicial Action" above goes a significant way in ensuring that businesses are provided legal certainty and clarity, at both national and supra-national levels, in an area of the law that has often been filled with many, sometimes confusing, non-mandatory codes, principles and guidelines as to best practices.

Gains from improved governance. A study by the *Financial Times* Moral Money Forum found that a long-term approach to corporate governance could have a positive effect on corporate and financial performance and long-term productivity. Such effects are competitive advantages that could make companies more attractive to investors and more successful in the long run.[94]

Valuation gains. One FactSet study[95] suggested that companies under the Ethical Sustainability Index Europe and the MSCI Global Environment Index trade at about 12× the EV/EBITDA enterprise multiple, compared to 10× EV/EBITDA for the Stoxx Europe 600. A McKinsey survey of investment professionals suggested that the majority would be willing to pay a premium of about 10% to acquire a company with a positive ESG profile compared to a negative one.[96] Similarly, a survey of private equity partners found that 54% had reduced a bid price after ESG due diligence, while 32% had increased the bid price.[97] Other surveys have cast doubt on the extent to which market participants might in fact be willing to pay a premium for acceptable ESG performance, but suggest that the vast majority have reduced the valuation of an acquisition target or abandoned a deal because of poor performance on ESG factors.[98]

Financial incentives and disincentives. There have also been a number of recent efforts to link ESG performance with financial incentives (or disincentives). Examples include the following:

- Close to half of the **FTSE 100 companies** including an ESG target in the annual bonus, the Long-Term Incentive Plan, or both.[99]
- 73% of **S&P 500 companies** tying executive compensation to some form of ESG performance as of 2021.[100]
- The **Net Zero Banking Alliance**, representing over 40% of global banking assets, committing to align the group's lending and investment portfolios with net-zero emissions by 2050.[101]
- **Nordea** committing to facilitate over EUR 200 billion in green and sustainable financing by 2025.[102]
- **BlackRock's** USD 4.4 billion lending facility linking borrowing costs to staff diversity targets.[103]
- **WSP Global's** USD 1.2 billion syndicated revolving credit facility with borrowing costs linked to greenhouse gas emissions, "green revenues" and the proportion of women in management positions.[104]

- **Enerplus's** USD 900 million bank credit facility where borrowing costs vary by plus or minus five basis points according to performance against targets on greenhouse gas emissions, water management and health and safety.[105]
- **Gibson Energy's** USD 750 million revolving credit facility with borrowing costs linked to the diversity of its board and workforce.
- **Bridgestone's** USD 1.1 billion credit facility with an interest rate based on its ESG risk rating as determined by independent ratings providers Sustainalytics and FTSE Russell.
- **Carlyle Group's** USD 4.1 billion credit facility linked to achieving 30% diversity on the boards of the companies it controls within two years of ownership.[106]

ESG metrics

When conducting ESG due diligence in an M&A context, it is important to understand how the buyer intends to account for and potentially disclose ESG information. For example, diligence conducted for an impact-focused fund will likely serve as the baseline from which the fund will measure and report ESG changes during its period of ownership. Similarly, a social impact fund aimed at improving financial inclusion will want to know the number of "unbanked" people currently served by a target company so that it can measure the shift in access to financial services during the life of its investment.

As discussed above, some regulators have mandated ESG-related reporting on specific matters, such as supply chain or climate risks. Beyond those legally mandated, various systems of ESG reporting standards have arisen over the last few years. Most notable is that of the International Sustainability Standards Board (the "**ISSB**"). Launched during the 2021 COP26 summit in Glasgow, the ISSB is in the final stages of developing international sustainability standards, with the aim of creating a "high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets".[107] The ISSB enjoys global support from coalitions such as the G7, the G20, the International Organization of Securities Commissions and the Financial Stability Board.[108] The ISSB comment period closed July 2022.[109] At its most recent meeting in Montreal in February 2023, the ISSB completed all final decisions on the technical elements of the proposed standards, and unanimously approved entering the drafting and balloting process of the standards.[110] The ISSB expects to issue the standards in June 2023.[111]

Other recent examples of ESG reporting standards include the Value Reporting Framework (the product from the merger of the Sustainability Account Standards Board (the "**SASB**") and the International Integrated Reporting Council) and the Global Reporting Initiative (the "**GRI**"). The SASB's set of 77 Industry Standards identifies "the minimal set of financially material sustainability topics and their associated metrics for the typical company by an industry".[112] The GRI Standards are divided by topic: the three universal Standards are used by every organisation that prepares a sustainability report; and the remainder are chosen by an organisation from topic-specific Standards.[113]

Efforts are currently underway to harmonise these standards to allow better direct comparisons of ESG reporting (see, for example, the discussion above regarding the Taxonomy Regulations). Certain sustainability accounting standards are designed to be aligned with other ESG projects, such as the Climate Disclosure Standards Board Framework, which has been explicitly designed to be aligned with TCFD recommendations. Others seek to provide a high-level reporting framework to improve harmonisation across the board, such as the International Integrated Reporting Council Framework or the Institutional Limited Partners Association ESG Data Convergence Project.

There are also public and private efforts to create resources by which investors can incorporate ESG into their activities and reporting, as well as compare different investments according to ESG performance. For instance, the UN Principles for Responsible Investment are aimed at investors seeking to incorporate ESG issues into their investment decision-making. The Impact Management Project is a collaboration among environmental accounting standards organisations, impact organisations and investment managers to create norms to measure ESG impacts, against which companies and investors can assess their impact performance.

ESG ratings

As sustainable investment has continued to become more integrated into the financial ecosystem, investors have increasingly come to rely on ESG ratings agencies to provide data points that allow a comparison of companies' ESG credentials. ESG ratings are used more often to both validate the ESG characteristics of financial products or companies and indicate the ESG risk-exposure of an equity or debt issuer. The Big Three credit ratings agencies – namely Standard & Poor's, Moody's and Fitch Ratings – all provide ESG-rating services. Specialised ESG ratings agencies have also been gaining in popularity, including Sustainalytics and the Carbon Disclosure Project.

In 2022, there were increasing calls in the United States for government regulation of the ESG ratings industry, though this has not translated into government action.[114]

In the United Kingdom, the Financial Conduct Authority is looking to provide greater oversight through regulation to bring ESG data and rating providers within its purview. It also suggested that a globally consistent regulatory approach should be adopted, which is in line with the International Organization of Securities Commissions' recommendations on ESG data and ratings.[115] Furthermore, HM Treasury launched a consultation in March 2023, proposing a requirement that ESG ratings providers must know who is accessing their services and how they are being used.[116]

As part of the European Commission's 2021 consultation on its renewed sustainable finance strategy, stakeholders were asked for their views on the quality and relevance of ESG ratings to their investment decisions, the degree of concentration in the market and the need for regulation and action at the EU level.[117] The Commission went on to undertake a targeted consultation on ESG ratings and sustainability factors in credit ratings that will directly feed into an impact assessment evaluating the impacts, costs and options of a possible EU intervention in the ratings space.[118] In parallel, a call to evidence was issued by ESMA in February 2022, aimed at mapping rating providers operating within the EU and assessing the possible costs of supervision.[119]

Final thoughts

ESG due diligence can prove instrumental in evaluating both the value and appropriateness of a particular transaction. Especially given unavoidable resource and other constraints in the M&A context, successful execution of such due diligence requires carefully identifying and assessing the key ESG exposures and related mitigation efforts.

In this regard, the ever-increasing legal requirements around ESG due diligence should help level the playing field among businesses as the momentum shifts from voluntary due diligence and self-regulation towards mandatory diligence and disclosure along the lines discussed above. As the ESG landscape continues to evolve, there are significant opportunities for businesses to reap the rewards of more stringent due diligence, including through gains in valuations, improvements in governance and in value chains, and incentive-based deal-making.

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