

QE Client Alert: The EU's Increasing ESG Regulation and its Implications for Business

The European Union (EU) is currently at the vanguard of environmental, social and governance (ESG) measures.

Two areas of development in particular are likely to have widespread repercussions for businesses: newly implemented obligations for ESG disclosures and likely forthcoming mandatory human rights, environmental and governance due diligence. These measures involve both new obligations of disclosure as well as, potentially, substantive obligations to address ESG issues connected to companies' businesses. Their implementation is likely to have significant effects for both companies domiciled in the EU as well as companies operating within the EU. Importantly, as well as compliance concerns, businesses will need to consider the attendant legal risks of publicly sharing human rights and environmental risks in their business operations and supply chain more widely.

ESG Disclosure: the Sustainable Finance Disclosure Regulation

The EU's regulation on sustainability-related disclosures in the financial services sector (the SFDR) was adopted by the European Parliament and European Council on 27 November 2019,ⁱ and applies to certain financial services sector firms from 10 March 2021. Broadly, the SFDR is aimed at ensuring asset managers, financial advisors, and other financial market participants take into account sustainability and ESG factors in their decision-making around investments and in the information provided about those investments.

The regulation is not focused on the investors themselves. Instead, the SFDR requires "financial market participants" (defined as investment firms carrying out portfolio management, certain insurance undertakings and qualifying venture capital funds, amongst others) and "financial advisers" to provide information about ESG matters in respect of their services and in the marketing of particular products. This approach is designed to promote investors' ability to investigate companies' approach to ESG, and to then act on the sustainability information provided.

At its core, the SFDR requires those market participants and advisers to identify and publish information about how they account for "sustainability risks" in their investment advice or decision-making.ⁱⁱ A sustainability risk is defined as an ESG event or condition which does or could negatively impact on the value of the investment. Possible ESG risks are extensive – taking exposure to climate change as an example, this could include companies whose supply chains rely on low-lying farmland or at the other end of the spectrum, companies who may face new regulation by governments, like those within the airline industry. Equally, social risks could extend to considering potential risks through not just a company's immediate operations but also its key supply chains, requiring knowledge of where its production takes place and the makeup of its workforces.

Article 4 of the SFDR requires financial market participants to publish on their websites a statement of how they take into account "principal adverse impacts" from ESG risks in their

investment decision-making and a statement on how they do the due diligence to understand those risks. While this obligation is slightly tempered for smaller companies, allowing them to *either* explain how they take these into account or if not, why they do not (so-called “comply or explain” measures) for larger companies of over 500 employees these obligations are fixed and in effect as of 30 June 2021. Financial advisers are also required to publish a statement explaining how they account for adverse impacts on sustainability factors in their investment advice or insurance advice, also on a “comply or explain” basis.ⁱⁱⁱ

Additional, more detailed periodic disclosure regimes are also set to come into place. The detailed nature of this guidance, and the expansive nature of the obligations it places on businesses, mean these rules are only proposed to be implemented on a rolling basis from 1 January 2022.^{iv} Again, the level of information proposed to be disclosed in the periodic disclosure is clearly going to require many companies who fall within the regulation to undertake significantly more investigations into the makeup of companies in their investment portfolio and their exposures.

For products, an additional set of obligations applies where they are marketed as “ESG” or “sustainable” products. The SFDR essentially breaks down products into three categories: (a) mainstream products, (b) products “promoting environmental or social characteristics” and (c) products promoting “sustainable investments”. For all products, the market participant or advisor must set out in pre-contractual disclosures how sustainability risks are factored into the investment or advice and provide an assessment of the impact of sustainability risks on returns.^v For financial market participants, they must also disclose how they have assessed the product’s principal adverse impacts on sustainability factors.^{vi} In each case, if this is not done a reasoned explanation must be provided. For categories (b) and (c), additional disclosures are required from financial market participants to show how those marketed objectives are met. As well as pre-contractual disclosures, there are obligations about providing that and similar information on company websites and in periodic reporting.^{vii}

While many ‘green’ or ‘sustainable’ investments and funds may already provide some of this information, the standardised nature of the SFDR is likely to make it easier to compare products and also potentially for consumers and advocacy groups to hold them to higher standards. Many advocacy groups have long been critical of “greenwashing” efforts, in which companies are seen as providing false or misleading information about their environmental and climate policies and impacts.^{viii} Disclosures may well also result in claims for compensation for alleged ESG violations being asserted against the investment companies themselves, as well as the company committing the alleged violation. The SFDR is likely to be a continued point of focus for campaigning groups to use and careful thought will need to be given to compliance to minimise the risk of being targeted either with litigation or damaging public campaigns.

The mandatory obligations in the SFDR also come with the risk of regulatory action, including fines. The SFDR envisages national financial market authorities investigating non-compliance with the EU law in each individual member state,^{ix} meaning the detail of possible fines or other action will vary. Although some member states have announced specific enforcement units focused on ESG issues,^x the majority of obligations in the SFDR are baked into existing disclosure obligations under other EU laws, such as the Directive 2011/61/EU on Alternative Investment Fund Managers and Directive 2014/65/EU on Markets in Financial Instruments. Enforcement of the

disclosure obligations in these existing regimes are also primarily at a national member state level and have resulted in significant fines being imposed.^{xi}

International Application

The SFDR clearly applies to companies within Europe. However, it may well reach into US businesses, and those located in other jurisdictions. The European Commission has not clarified its position on whether it applies to non-EU companies who operate in the EU or who market funds into the EU, although there has been a widespread assumption that it will.^{xii} Further, many large companies in Europe are owned by parent companies in the US,^{xiii} who may be affected even by a more limited EU-scope regulation, and internationally, companies who have EU-based investors are likely to face requests for their ESG data and other ESG information in order for those investors to comply with the regulation.

The SFDR should also be looked at as the ‘first mover’ amongst regulation of this kind. Similar type of regulations are being considered in the US and the UK. The UK has indicated that it will adopt the recommendations made by the Task Force for Climate-related Financial Disclosures (TCFD) to make climate-related financial disclosures mandatory for certain firms by 2025, positioning itself as a market leader in this area.^{xiv} On 24 March 2021, the Government launched consultation on mandating climate-related financial disclosures by publicly quoted companies, large private companies and Limited Liability Partnerships (LLPs).^{xv} The Financial Conduct Authority in the UK has already introduced a new listing rule on climate-related disclosure for commercial companies with a ‘premium listing’ on a UK stock exchange to require the provision of information on those companies’ exposure to climate change risks and opportunities.^{xvi} These efforts suggest UK regulations in this area could be extensive, and may well be guided by a desire to be seen as going beyond European standards.

In a similar vein in the US, the SEC has also signalled it is considering regulation around climate disclosures, and in particular, is interested in better policing of misleading information given about ESG investments and disclosures.^{xvii} Quinn’s Climate Change Litigation group has considered this in more detail in other briefings.^{xviii}

Mandatory Human Rights, Environmental and Governance Due Diligence

The second area of prospective regulation concerns mandatory “due diligence” measures for human rights, environmental and governance concerns – essentially equivalent to ESG. The idea of due diligence legislation is linked to the UN Guiding Principles on Business and Human Rights, in which “human rights due diligence” is used to refer to a process of assessing the actual and potential human rights impacts of a companies’ operations, integrating and acting upon the findings, tracking responses, and communicating how those impacts are addressed.^{xix} Centrally, these obligations are not limited to the companies own business operations but extend to those risks caused by, contributed to or directly linked to the business’ operations – incorporating businesses linked by relationship, and wider supply chains.

While there has been international discussion about creating a legal framework for the norms set out in the Guiding Principles, Europe has again been at the cutting edge in progressing a law

making such due diligence a mandatory requirement. After significant discussion, a proposal for a new directive covering mandatory due diligence is expected at the end of Q2 2021.^{xx} The commitment to a proposal builds on a wide range of discussions and reports at an EU level, including a public commitment by EU Commissioner Didier Reynders in April 2020.^{xxi} The major question since then has been the scope of the proposal. Here, the European Parliament has stepped in to the breach to push forward momentum for a comprehensive and wide-reaching initiative.

European Parliament Initiative

As a starting point, the European Parliament is not responsible for initiating legislation. It will be for the European Commission to specify the scope of the proposed directive. However, the European Parliament can put pressure on the Commission, and its draft Initiative indicates the current trends of discussion in Europe and given its landslide support in the Parliament (passing by a vote of 504-79)^{xxii} it may have some influence on the Commission's text.

The Parliament's proposal involves both an obligation to conduct due diligence and a liability provision for companies which fail to do so.

In terms of the due diligence obligation, the Parliament has proposed that it would apply to all large companies operating in the EU and to any publicly listed or "high risk" small and medium enterprises.^{xxiii} This would explicitly catch internationally domiciled businesses. As well as the obligation to actually carry out due diligence, the obligations on these companies would include creating a due diligence strategy and publishing a mapping of their entire value chain which (taking into account commercial confidentiality), "*which may include names, locations, types of products and services supplied, and other relevant information concerning subsidiaries, suppliers and business partners in its value chain*". Value chains covers all business activities as well as direct or indirect business relationship, upstream and downstream, making this an extensive exercise, particularly as it is to be carried out yearly and is just one aspect of the due diligence strategy. Other aspects include obligations to ensure companies' business relationships in turn have human rights standards and policies in place, including throughout their linked supply chains. The Initiative also envisages that companies will provide internal grievance mechanisms (consistent with current obligations under the UN Guiding Principles).

Alongside these very extensive obligations would sit mechanisms for providing remedies for any harms arising from human rights, environmental or good governance failures. Again, the Initiative is ambitious in scope providing that companies "*harm arising out of potential or actual adverse impacts ... that they, or undertakings under their control, have caused or contributed to by acts or omissions*" unless the company can prove that it acted with due care and took all reasonable measures to prevent such harm. That carve out in essence creates a type of safe harbour provision for companies who undertake due diligence in line with the proposals.

However, there may still be a teething period while what constitutes reasonable compliance is worked out, as the various ways human rights, environmental and governance harms can emerge throughout different companies' value chains will differ immensely meaning due diligence strategies will also validly differ in scope and focus. For companies who are only "directly linked" to harms, they are obliged to cooperate with the remediation process to the best of its abilities.

The schema of differentiating between causing, contributing and being directly linked to ESG harms is directly drawn from the UN Guiding Principles, and has not always been straightforward to apply. This would be monitored by member states, and there are various provisions for investigations, supervision and penalties for companies.

Implications

Although many of the details of a due diligence law in Europe are still up in the air, the Parliament's proposal provides the latest indication of the possible stringency of these rules. The mood in Europe is clearly toward a relatively rigid due diligence law, unlike previous human rights in supply chain laws like California's Transparency in Supply Chains Act or the UK's Modern Slavery Act, which (in a similar vein to the SFDR) focused much more on disclosure. Instead, the due diligence laws in Europe are likely to require both extensive reporting and specific action to address risks within businesses. In tandem with increased investor interest in ESG risks, businesses will need to engage substantively on ESG issues in their own operations and to have good insight into risks in their wider supply chains. As an example of increasing attention to ESG issues, investor group BlackRock has recently published guidelines on its approach to engaging with companies on their human rights impacts, noting these human rights impacts as potential investment issues and setting out clear expectations for compliance with the UN Guiding Principles.^{xxiv} Aside from the wide scope of companies who may be directly regulated by the EU, these type of moves from major investors also suggests ESG risk should be at the forefront of business decision-making and long-term planning.

Conclusion

The SFDR and mandatory due diligence measures coming out of Europe are likely to significantly affect how businesses approach ESG issues. The SFDR is part of a particular wave of consumer-focused regulation around ESG issues. Rather than directly requiring businesses to change the way they work, the objective is for the transparency obligations to promote changes in business practices and to promote accountability (for sustainability claims in particular). Those disclosures are likely to lead to increased scrutiny of businesses decision-making around ESG issues, with implications for both legal risk and reputational risk. The best way for businesses to address these concerns – as well as to future proof against upcoming due diligence legislation – is to take action to address ESG concerns and to comply with guidance such as the UN Guiding Principles on Business and Human Rights.

Quinn is at the forefront of ESG matters, with particular experience in both business and human rights and in climate change litigation. Our team is led by partner Julianne Hughes-Jennett, who is Chambers-ranked in business and human rights disputes and described as an “expert” in the field. This practical experience covers both advisory work and, uniquely amongst other firms, actual direct experience of litigation claims in these areas. In our advisory work, we have worked across a wide-range of sectors and issues, from minimising legal risks for products with complex actual and potential supply chains to international businesses working in high risk jurisdictions. Quinn Emanuel's Julianne Hughes-Jennett has also co-authored a leading publication considering how such a ‘failure to prevent’ law might feasibly be implemented,^{xxv} a legal structure . We are well-placed to advise on compliance with new European regulations as well on achieving compliance with ESG standards more generally, with particular experience with the UN Guiding Principles on Business and Human Rights.

If you have any questions about the issues addressed above, please do not hesitate to contact us:

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- i Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.
 - ii Article 3.
 - iii Article 4(5)
 - iv See Final Report on draft Regulatory Technical Standards (2 February 2021), available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2021/962778/JC%202021%2003%20-%20Joint%20ESAs%20Final%20Report%20on%20RTS%20under%20SFDR.pdf
 - v Article 6.
 - vi Article 7.
 - vii Article 11.
 - viii See, for example, recent complaints made about BP’s clean energy advertising: <https://www.clientearth.org/latest/latest-updates/news/bp-greenwashing-complaint-sets-precedent-for-action-on-misleading-ad-campaigns/campaign> [last accessed 29 March 2021]
 - ix Article 14.
 - x See Lene Andersen, AMWatch, “Danish FSA takes action against greenwashing investment products” (15 March 2021) Available at: <https://amwatch.dk/AMNews/Ethics/article12832770.ece> [accessed 1 April 2021].
 - xi See, for example, the European Security and Markets Authority, Report: Sanctions and measures imposed under MiFID II in 2019 (13 July 2020), available at: <https://www.esma.europa.eu/press-news/esma-news/esma-issues-second-report-sanctions-under-mifid-ii> [last accessed 1 April 2021].
 - xii There has as at the date of writing been no response to a letter to the EU Commission (7 January 2021) seeking clarification of this point. See letter at: https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relatig_to_sfdr_application.pdf
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 - xv Department for Business, Energy & Industrial Strategy, Consultation: Mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs (24 March 2021) <https://www.gov.uk/government/consultations/mandatory-climate-related-financial-disclosures-by-publicly-quoted-companies-large-private-companies-and-llps> [last accessed 29 March 2021].

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- xvi Financial Conduct Authority, Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations (December 2020) available at: <https://www.fca.org.uk/publication/policy/ps20-17.pdf> [last accessed 29 March 2021].
- xvii See for example SEC, “SEC Responds to Investor Demand by Bringing Together Agency Information About Climate and ESG Issues” (22 March 2021), <https://www.sec.gov/news/press-release/2021-52> and SEC, “SEC Announces Enforcement Task Force Focused on Climate and ESG Issues” (4 March 2021) <https://www.sec.gov/news/press-release/2021-42> [last accessed 29 March 2021].
- xviii Quinn Emanuel, Climate Change SEC Financial Disclosures: Will New Rules Come With A New President?, available at: <https://www.quinnemanuel.com/the-firm/publications/climate-change-sec-financial-disclosures-will-new-rules-come-with-a-new-president/> [last accessed 29 March 2021].
- xix UN Guiding Principles, Principle 17.
- xx See European Commission, Sustainable corporate governance consultation <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance> [last accessed 29 March 2021].
- xxi Responsible Business Conduct, European Commission Promises Mandatory Due Diligence Legislation in 2021 (30 April 2020). See webinar: <https://responsiblebusinessconduct.eu/wp/2020/04/30/european-commission-promises-mandatory-due-diligence-legislation-in-2021> [last accessed 29 March 2021].
- xxii European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability, available at https://www.europarl.europa.eu/doceo/document/TA-9-2021-0073_EN.html [last accessed 29 March 2021].
- xxiii Draft Directive, Article 2.
- xxiv Blackrock, Our approach to engagement with companies on their human rights impacts (March 2021), available at: <https://www.blackrock.com/corporate/literature/publication/blk-commentary-engagement-on-human-rights.pdf> [last accessed 29 March 2021].
- xxv Peter Hood, Julianne Hughes-Jennett, Dr Irene Pietropaoli, Lise Smit, A UK Failure to Prevent Mechanism for Corporate Human Rights Harms (11 February 2021), <https://www.biicl.org/publications/a-uk-failure-to-prevent-mechanism-for-corporate-human-rights-harms> [last accessed 29 March 2021].