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INTERNATIONAL ESG REPORTING:

Why Americans Should Care

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2004: The Term “ESG” is Coined & Defined

In 2004, Paul Clements Hunt, the then head of the UN-convened network of banks, insurers and investors accelerating sustainable development is said to have coined the term “ESG”. It was intended as an acronym for environmental, societal and governance risks that a company controls that could impact the market value of a corporation or other reporting issuer.

The environmental risks may relate to such things as greenhouse gas emissions; biodiversity loss; deforestation and waste management. Societal risks are many include equity, diversity, and inclusion; privacy standards; labour standards; human rights violations; modern slavery (forced labour, child labour, human trafficking, debt bondage). Governance issues are also many and include diversity of the board of directors; board and committee structures; cyber security; privacy standards of the data maintained on behalf of employees and customers.

2017: The Real Birth of ESG Reporting

The term “ESG” was relatively unknown and unused until the signatories of the 2016 Paris Agreement on Climate Change moved to implement policy changes to achieve its goals. The central aim of that agreement is to strengthen the global response to the threat of climate change by keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. In short, the world must move away from its dependency on fossil fuels – it must decarbonize.

The finance ministers of the G-7 countries together with the chairs of the central banks of those countries realized that de-carbonization is both a liability and an opportunity for corporations. They were also acutely aware of the lessons learned from the 2008 financial collapse which emphasized that there must be accurate disclosure of financial risks to properly support capital valuation. These countries struck the TCFD – the Task Force on Climate Related Financial Disclosures – whose 2017 report released climate-related financial disclosure recommendations that are designed to help companies provide better information to support informed corporate valuations for the benefit of Investors, lenders, and insurance underwriters. The corporate world used Paul Hunt’s “ESG” as an acronym for the TCFD’s reporting metrics which also spoke of a requirement for sustainability reporting. Those reporting metrics apply to the “S” and “G” in the term ESG, but this paper will concentrate on the E – environmental impacts.

It is important to pause and understand how the changing environment impacts corporate valuations.

As outlined in the March 2023 Guideline to the B-15 directive (described in more detail below) that was published by the Office of the Superintendent of Financial Institutions of Canada, climate change and the global response to the threats it poses have the

potential to significantly impact the safety and soundness of financial institutions, public and private corporations and the financial system more broadly. These risks, also known as “climate-related risks”, are broadly categorized as physical and transition risks:

- “Physical risks” refer to the financial risks from the increasing severity and frequency of climate-related extremes and events (i.e., acute physical risks); longer-term gradual shifts of the climate (i.e., chronic physical risks); and indirect effects of climate change such as public health implications (e.g., morbidity and mortality impacts).
- “Transition risks” refer to the financial risks related to the process of adjustment towards a low-greenhouse gas (GHG) economy. These risks can emerge from current or future government policies, legislation, and regulation to limit GHG emissions, as well as technological advancements, and changes in market and customer sentiment towards a low-GHG economy.

Physical and transition risks can also lead to liability risks, such as the risk of climate-related claims under liability policies, as well as litigation and direct actions against financial institutions for failing to manage their climate-related risks.

Climate-related risks may manifest over varying time horizons, and are likely to intensify over time, especially if the global economy undergoes a disorderly transition. They can drive financial risks, such as credit, market, insurance, and liquidity risks. They can also lead to strategic, operational, and reputational risks. In severe instances, climate-related risks can threaten the long-term viability of a corporation’s business model.

Climate related physical and transition risks impact the market value of financial institutions and corporations generally. Investors, lenders, and underwriters require accurate reporting of these risks to properly evaluate the financial health of any given entity. Hence the need for ESG reporting.

Implementation of ESG Reporting Requirements

Some of the countries that were signatories to the 2016 Paris Agreement have proceeded to mandate ESG reporting.

a) Hong Kong

Since 2016, the Hong Kong Exchanges and Clearing Limited (“HKEX”) has required all Hong Kong listed companies to issue ESG reports in accordance with its Environmental, Social and Governance Reporting Guide (“ESG Guide”). If listed companies do not comply with the “comply or explain” provisions set out in the ESG Guide, they must give considered reasons. Further, certain ESG disclosures have been upgraded to mandatory requirements since 2020.

b) The European Union

The Corporate Sustainability Reporting Directive (the CSRD) is European Union (EU) legislation, in effect since January 5, 2023, that requires EU businesses—including qualifying EU subsidiaries of non-EU companies—to report on the environmental and social impact of their business activities, and on the business impact of their environmental, social and governance (ESG) efforts and initiatives. This directive replaced the previous iteration of "ESG" reporting requirements that was known as the Non-Financial Reporting Directive (NFRD). The NFRD was first introduced in 2014 and amended several times thereafter. The reporting requirements under the NFRD will remain in place until all elements of the CSRD become effective.

Currently, CSRD reporting applies to entities with 250 employees or more, with assets of Euro 20 million or more, or a net turnover of Euro 40 million or more. EU subsidiaries of North American corporations or any other non-EU corporation with annual EU revenues of at least EUR 150 million in the most recent two years are subject to CSRD reporting.

An entity that is subject to the CSRD must disclose information on how its business activities affect the planet and its people, and how its sustainability goals, measures and risks impact the financial health of that business. For example, in addition to requiring an organization to report its energy usage and costs, CSRD requires them to report emissions metrics that detail how that energy use impacts the environment, targets for reducing that impact, and information on how achieving those targets will affect the organization's finances.

All CRSD disclosures are publicly available, and the CSRD mandates third-party auditing of all disclosures for accuracy and completeness. The reporting requirements are regulated and onerous but, broadly fall into the ESG reporting metrics that stem from the TCFD and are used elsewhere.

The CSRD requires EU member states to have an investigative and compliance entity in place to impose "effective, proportionate and dissuasive" penalties based on several factors, including the gravity and duration of the breach and the financial standing of the company.

New duties for the directors of the EU companies covered by the CSRD are imposed by this directive. Those duties include setting up and overseeing the implementation of the due diligence processes and integrating due diligence into the corporate strategy. Directors must consider the human rights, climate change and environmental consequences of their decisions when fulfilling their duty to act in the best interests of the company. This opens directors to personal liability on the basis that they breached a duty of care owed to the company to consider and mitigate the impact of climate change or other ESG related issues.

More regulations are expected in 2024.

c) The United Kingdom

On January 19, 2022, The Companies (Strategic Report) Climate-related Financial Disclosure Regulations 2022 were published which make climate-related financial disclosures mandatory for certain publicly traded companies, banks, insurance companies and large private companies. Those regulations came into effect in April of 2022. These regulations apply to:

- UK corporations and Limited Liability Partnerships (LLPs) with more than 500 employees or which are banks or insurance companies and trade on the UK stock exchanges;
- UK registered companies or LLPs whether public or private which have more than 500 employees and a turnover of more than £500 million (high turnover companies).

Amongst other things, these entities must describe how they identify climate risks; how those risks are integrated into the overall risk management plan; a carbon reduction plan; the key performance indicators to indicate compliance with its plan. The directors of the entities are liable for the contents of their reporting. If an untrue or misleading statement is reported, or a material fact is omitted, and a person disposes of shares in reliance on that information, the directors or LLP members would be liable to compensate the company against its liability for that loss if the directors or LLP members either knew or were reckless as to whether the statement was untrue or knew that the omission was a dishonest concealment of a material fact.

Non-UK companies that are not incorporated under the UK Companies Act are exempt from these regulations. However, their UK subsidiaries may be subject to the regulations if they were incorporated under the UK Companies Act.

A UK Company that is subject to the regulations must report on its global operations regardless of whether those operations are conducted outside the UK.

d) Canada

In the context of ESG reporting, 2023 is the watershed year for Canadian corporations --the year when everything changes.

At the end of the 2024 fiscal year, directive B-15 issued by the federal Office of the Superintendent of Financial Institutions (OSFI) comes into effect. Under that directive, most banks and insurers with Canadian head offices that are subject to federal regulation (about 350 entities) will become mandatory ESG reportees. All other federally regulated financial institutions will become subject to the directive in 2025.

In large measure, directive B-15 follows the reporting guidelines set out in in the 2017 report of the Task Force on Climate-Related Financial Disclosures and therefore they

are very similar to the UK regulations. Amongst other things, the regulation requires reporting on the Institution's board of directors' oversight of climate-related risks and opportunities; the Institution's climate transition plan; and the resilience of the Institution's strategy; the Institution's processes for managing climate-related risks; and, certain metrics and targets to measure with its carbon reduction plan.

There will be non-compliance penalties.

There are a number of ESG reporting requirements for those Canadian entities that are not subject to Canadian federal regulation. They are:

- **Canadian Securities Administrators (CSA)** Corporate ESG Reporting and Disclosure - The Canadian Securities Administrators is an umbrella organization of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate, and harmonize regulation of the Canadian capital market. The CSA can be compared with counterpart organizations in the U.S. such as the Securities and Exchange Commission (SEC) or FINRA. The directives of the CSA are only applicable to Canadian public traded corporations.

  In November 2022, the CSA issued a notice on ESG reporting by issuers where the agency shared guidance designed to discourage "greenwashing" and unsubstantiated ESG claims. The CSA's view is all ESG claims, and disclosures should be factual, balanced, and substantiated.

  At the time of writing, the CSA does not currently require any mandatory ESG disclosure from issuers. It is anticipated that the CSA will require reporting but it is waiting to see what its American counterpart does in this space before issuing any directives.

- **CSA ESG Investment Fund Disclosure** - In 2022, the CSA also outlined ESG disclosure guidance for investment funds. This guidance applies to all investment funds that either (a) focus on ESG as a core strategy or investment objective, or (b) consider ESG investment risk and opportunity factors as part of their investment process.

- **Supplier ESG Disclosure for Large Federal Contractors** - Large suppliers to the Government of Canada are required to disclose their greenhouse gas (GHG) emissions and set targets to reduce them, starting April 1, 2023, according to new the new "Standard on the Disclosure of Greenhouse Gas Emissions and the Setting of Reduction Targets" rule. This rule applies to federal procurements greater than $25 million.

Bottomline for American Public Issuers

The many, similar but different international ESG disclosure regulations and directives could result in unexpected liability for companies whose securities are traded in the U.S.

Many of these regulations and directives have extraterritorial application. Most certainly the UK and EU requirements have that effect. US listed corporations with a significant presence in the EU and the UK will have to closely determine if their global reporting meets the stringent requirements of these regulations and directives. Note that the requirements in Hong Long, the EU and the UK (and shortly, Canada) may be similar, but they may not align.

A September 2023 article, posted to the Harvard Law School Forum on Corporate Governance[1] outlines the risks that American public issuers face arising from international ESG reporting requirements.

The starting premise is that ESG disclosures wherever and however made can create a liability risk for the corporation's directors and the corporation itself if they are not carefully reviewed to ensure that they are accurate and that there are no material omissions.

American corporations that are subject to both the American securities laws and the EU CSRD (for example) may make different disclosures in each jurisdiction. A U.S.- listed company may publish global, group-wide ESG information only on its website or in an ESG report — primarily to comply with the CSRD — but does not include the same granular information in the company's SEC filings. The less detailed filing made in the United States may result in an American or an SEC enforcement action because the more detailed information was not disclosed in the U.S. filing. There is no easy solution. The American issuer must weigh the risks of providing different levels of detail for subsidiaries in different countries or choosing to report according to one regime for all subsidiaries and affiliates with supplemental information as required.

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[1] Raquel Fox, Simon Toms, and Jeongu Gim, Skadden, Arps, Slate, Meagher & Flom LLP*, The EU's New ESG Disclosure Rules Could Spark Securities Litigation in the US, September 23, 2023,* https://corpgov.law.harvard.edu/2023/09/23/the-eus-new-esg-disclosure-rules-could-spark-securities-litigation-in-the-us/