The Global Regulation Race*

* A Year of ESG Regulations in Review

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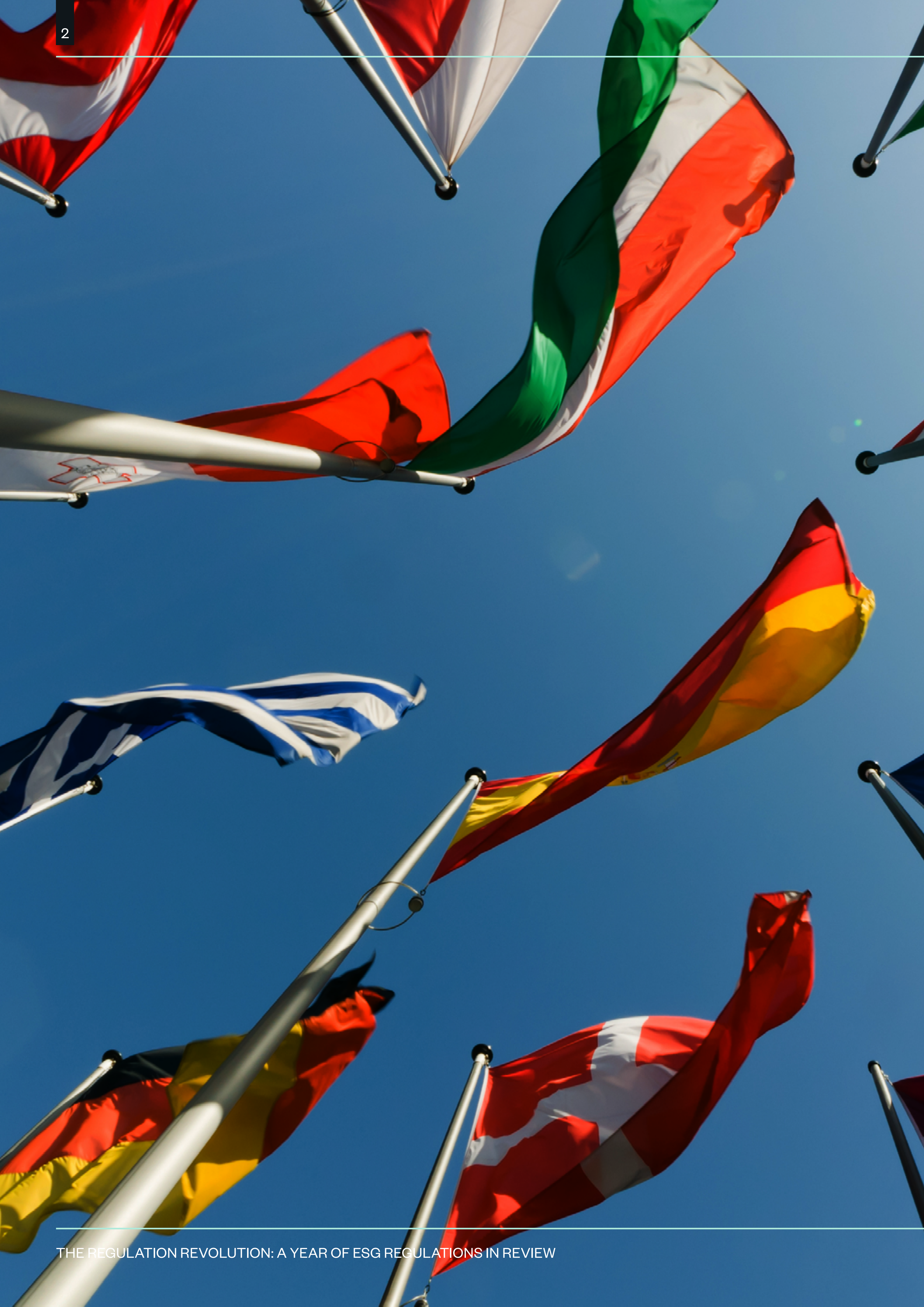
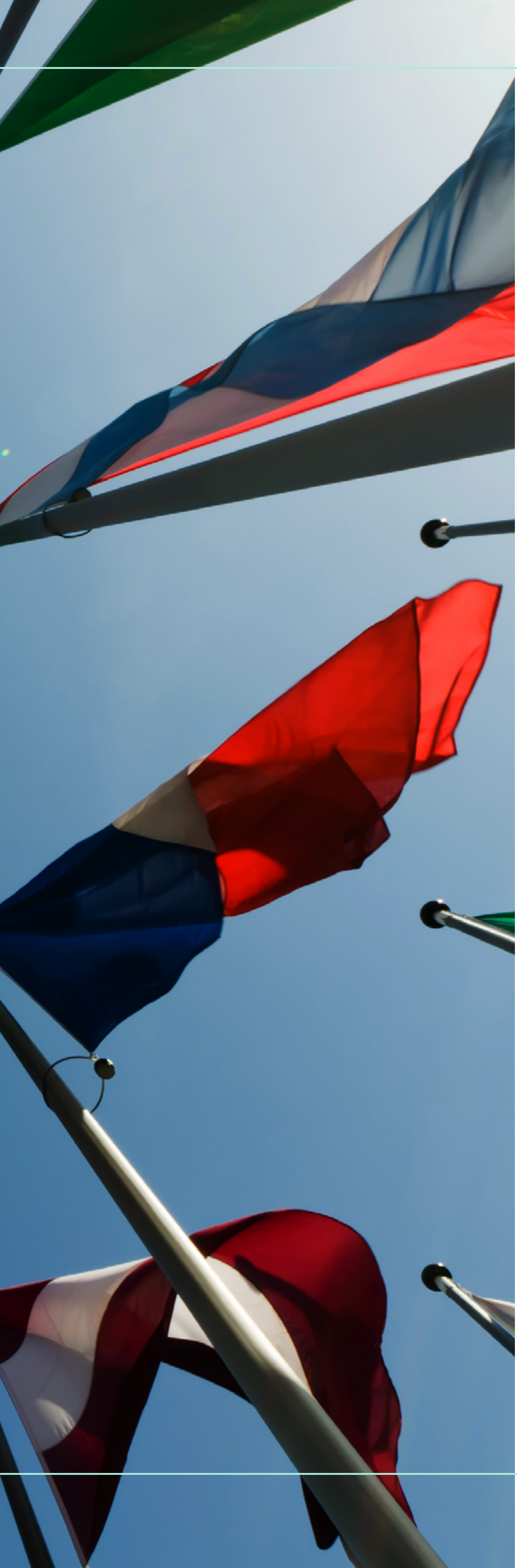
esgbook





2022 was a make-or-break year for ESG – what was once a buzzword is now a siren signalling the end of business as usual. Regulators began the year with lofty aspirations that were put to the test amid turbulent geopolitical events.

As the attention of world leaders shifted to grappling with the consequences of the Russia-Ukraine military conflict, managing spiralling inflation and macroeconomic uncertainty, one could easily assume that topics such as sustainable development and climate change would be deprioritized. However, ESG emerged in the foreground of policymaking, as shown in our annual 2022 regulatory-wrap up. Regulators around the world were busier than ever in trying to introduce greater transparency and tackling greenwashing in financial markets.

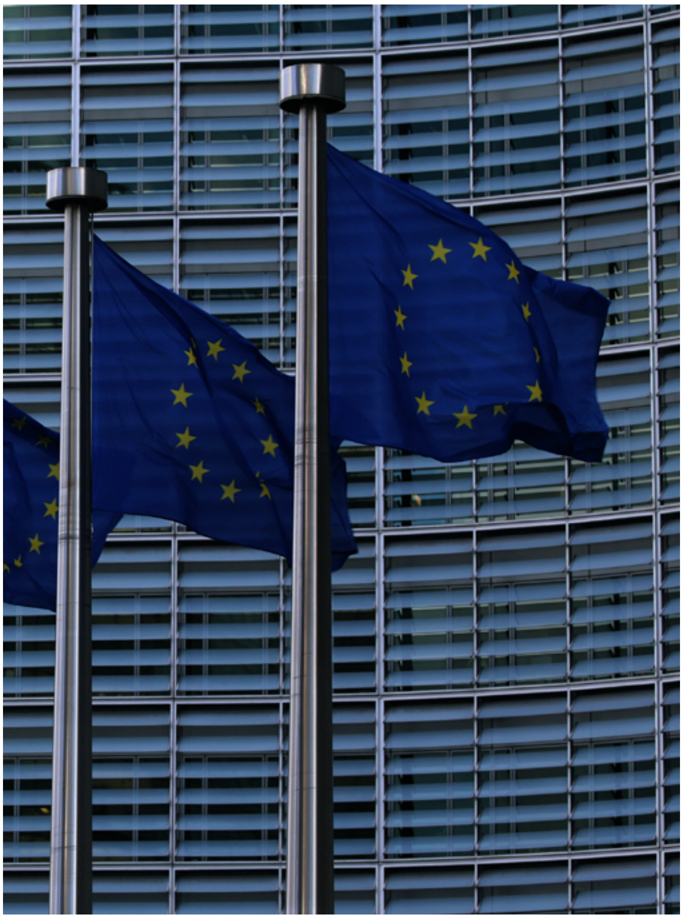
In this policy round-up paper we highlight the most noteworthy ESG regulatory developments that took place in 2022, segmented across global regions. We also outline the key deadlines to look out for in 2023 and beyond, so that our readers are well-prepared to proactively evaluate the impact of sustainable finance policy on their organizations.

Regional Highlights

European Union

The European Union continues to be the epicenter of ESG-related policymaking.

The rules-based approach adopted across the EU aims to accelerate action towards the implementation of the EU Sustainable Finance Action Plan and the Paris Climate Agreement. Ahead of the disclosure deadlines in 2023, regulators clarified the implementation of the Sustainable Finance Disclosure Regulation ("SFDR") and the EU Taxonomy for Sustainable Activities ("EU Taxonomy") by introducing additional regulatory screening criteria[1], further harmonizing the application of the two regulations. Additionally, European policymakers clarified that natural gas and nuclear energy can be considered sustainable[2], as long as they meet a defined set of key performance indicators, safety and emissions thresholds. Sustainable investing rules were further fleshed out under a new MiFID II obligation requiring discretionary fund managers to identify clients' sustainability preferences.



In another development, the proposal for an EU-wide Social Taxonomy was postponed indefinitely[3]. This regressive move was likely due to the difficulty of establishing a robust set of screening criteria for the more qualitative-driven social metrics and activities. Given the significance of the 'S' dimension in ESG, however, as well as the importance of meeting a set of rigorous Minimum Social Safeguards under the EU Taxonomy, regulators might well revisit the topic of a Social Activities Taxonomy in the future. Emphasizing the significance of social issues, in a step forward for gender board diversity, in June, the EU agreed to a 40% gender quota for corporate boards[4].

Zooming into the financial services sector, the European Central Bank ("ECB") introduced climate scores for portfolio management[5], and consequently, set deadlines for banks to adapt to climate risks. Regulators have underscored the importance of time-bound integration of adaptation strategy, despite the banking sector's temporary immunity from major EU sustainability rules. Furthermore, the European Securities and Markets Authority ("ESMA") launched a consultation on fund labelling proposals[6], focusing on a new set of ESG fund labelling guidelines, which would require any fund with a suggested sustainability/ESG focus to allocate at least 80% of their holdings accordingly. This follows similar initiatives by the Securities and Exchange Commission ("SEC") in the United States and the Financial Conduct Authority ("FCA") in the UK (see below).

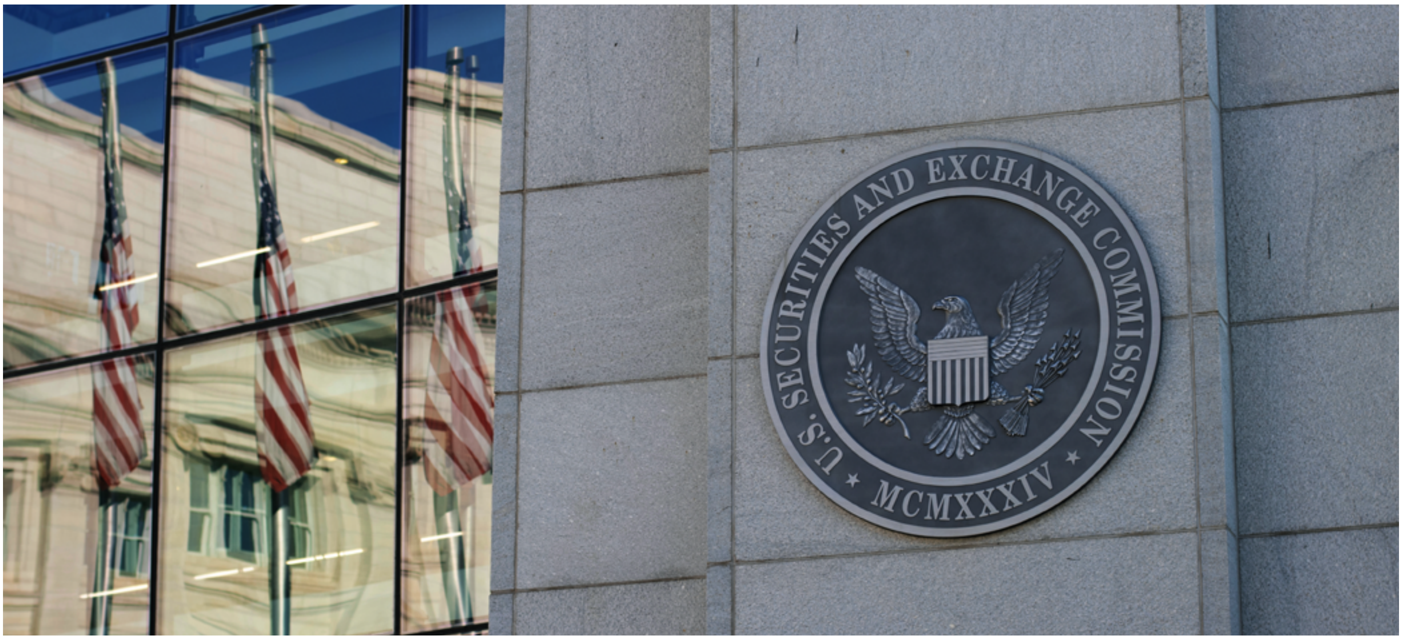
In November 2022, lawmakers made important changes to the corporate reporting landscape by adopting the Corporate Sustainability Reporting Directive ("CSRD")[7]. The new legislation significantly expands mandatory sustainability disclosure requirements for companies operating in the EU and will replace the current Non-Financial Reporting Directive ("NFRD"). After being signed by the President of the European Parliament and the

President of the Council, it will be published in the Official Journal of the European Union and enter into force 20 days afterwards. The new rules will need to be implemented by member states 18 months later. More recently, European regulators reconsidered the applicability of CSRD following political backlash. Several member states advocated in favour of granting exemptions to the financial services sector from the rule, at least temporarily.

European legislators also kept a strong focus on sustainable supply chains. The European Supply Chain Human Rights Due Diligence ("HRDD") law and its German counterpart: the Lieferkettengesetz[8] made strides, supplemented by specific action by the EU authorities on preventing forced labour and more effectively tackling deforestation. These regulatory initiatives underscore the COP15 agenda to establish a post-2020 global biodiversity framework for achieving positive social and environmental objectives. Correspondingly, in December, the EU passed legislation banning the sale of products linked to deforestation activities[9]. Several groups have criticized regulators for temporarily exempting banks from this rule and not considering the protection of other ecosystems. Despite the recurring trend of banks escaping the remit of EU sustainability rules, the Basel Committee is signalling the importance of integrating climate risk in the banking sector. The Committee has responded to a set of FAQs[10] related to best practices for judging exposure of assets and credit risk ratings based on climate risks.

As instructed by the EU Council, the European Insurance and Occupational Pensions Authority ("EIOPA") is assessing whether considering ESG-related risks is "warranted" under Solvency II[11]– an EU directive for the prudential treatment of insurance-related risks. Solidifying action against greenwashing, in November 2022, the European Supervisory Authorities ("ESAs") launched a joint call for evidence on greenwashing[12]. The exercise is intended to gather input from stakeholders on how to understand the key features, drivers and risks associated with greenwashing and collect examples of potential greenwashing practices. The Swiss government is also preparing to tackle greenwashing by introducing its own ESG-fund labelling rule[13]. This underscores the interconnectedness between economies, as regulators across the UK, EU and US are working simultaneously to formalize policies that protect financiers from being misled by exaggerated ESG-related claims. Unsurprisingly, different versions of the same rule are being announced to increase transparency and ease of comparability between financial products.

These are some of the snapshots of sustainable regulatory initiatives that took place across Europe in 2022. Now we will turn our attention to North America.



United States and Canada

The SEC started the year by releasing the Proposed Rule to Enhance and Standardize Climate-related Disclosures for Investors.[14]

Republican lawmakers and state treasuries vehemently opposed the logic of regulating the flow of capital based on non-financial factors. However, this did not stop the SEC from becoming the harbinger of progressive rulemaking. Soon after, the agency proposed an update to an existing rule that requires 80% of holdings to be invested in accordance with the fund's suggested focus. The SEC developed a fund-classification proposal[15] that accounts for the integration and consideration of sustainable objectives in investment strategies. The SEC carefully designed the two regulatory proposals to ensure consistent interpretation of rules and achieve the end objective of protecting investors through standardized disclosures.

Additionally, both chambers of Congress managed to pass the Inflation Reduction Act[16] after addressing political concerns on both sides of the aisle. A special provision in the law expedites the availability of energy efficiency and clean energy tax credits.

Reinforcing US policymakers' progressive agenda, in November, US Department of Labor ("DOL") authorized retirement plan fiduciaries to consider climate risks for investment decisions. Furthermore, the Biden-Harris Administration proposed a plan to protect Federal supply chains from climate-related risks[17]. Also in November, the White House unveiled a new plan which would require all federal contractors to disclose their greenhouse gas (GHG) emissions. Further north, Canada announced plans to impose mandatory climate disclosures on banks and insurers.[18] The Canadian budget[19] has also added a special provision that will require banks and insurers to provide climate disclosures in line with the TCFD framework.

In 2022 it became clear that despite a heavily politicized partisan agenda and the backlash against ESG and 'woke' capitalism in some key American States, the momentum behind introducing greater transparency and coherence in the sustainable finance market, is unstoppable.

United Kingdom

Looking across the pond, in January 2022, the UK FCA climate related disclosure regime[20] came into effect, introducing climate-related reporting requirements in line with the Taskforce on Climate-related Financial Disclosures ("TCFD") from April 2022.

The FCA also required UK listed companies to disclose their board and executive diversity targets[21] from financial period starting 1 April 2022. Following in the US SEC's footsteps, in October, the FCA made strides to combat greenwashing with its own ESG fund label proposal.[22] The proposed rule includes a set of three fund labels to tell apart forms of "green" investing and imposing the next burden on corporations to again up advertising with proof.

Additionally, in October the UK Green Taxonomy Advisory Group (GTAG) tasked with forging the UK's environmental Taxonomy system issued its first recommendations for the integration of technical screening criteria and developing guidance for the consideration of the 'do no significant harm' principle within a local context. Although efforts to further flesh out the UK's Green Taxonomy criteria were put on hold in December 2022, work on this topic is expected to resume throughout 2023.

Moreover, in November 2022, the UK FCA launched a working group[23] focused on the creation of a voluntary code of conduct for ESG data and ratings providers. This builds up on other initiatives such as the 2021 IOSCO call for oversight of ESG Ratings and Data Product Providers and the ESMA Call for Evidence on ESG ratings, which concluded in June 2022. Regulators in the UK are trailing behind post-Brexit and will try to fill the consequent policy vacuum in 2023. In 2023, the UK government is expected to release a new green finance strategy and launch a consultation on the oversight of ESG data and ratings providers.

APAC and Rest of the World

Building upon the IOSCO recommendations, in January 2022, the Securities and Exchange Board of India (SEBI) published draft rules to regulate ESG ratings providers.[24]

In April, India's financial regulatory authority announced that it will require the country's top 1000 companies by market capitalization to disclose a Business Responsibility and Sustainability Report (BRSR)[25] along with annual stock exchange filings. In June, China moved forward with the issuance of the country's first ESG disclosure standard.The China Enterprise Reform and Development Society (CERDS), Ping An Insurance Company of China and dozens of other companies in the country launched its first environmental, social and governance (ESG) disclosure standards,[26] which came into effect on June 1, 2022. In September, China issued a plan to establish a carbon emission statistical accounting system.[27]

In a noteworthy development, Japan announced its code of conduct for ESG data providers and published Guidelines on Respect for Human Rights in Responsible Supply Chains.[28] Mirroring growing fund label disclosure requirements globally, in July, Singapore's financial regulatory authority MAS has declared that any ESG labelled fund will have to provide evidence of compliance in accordance with its recently published reporting and disclosure guidelines.[29]

Furthermore, Australia's Financial Services Council issued climate disclosure standards for asset owners,[30] followed by the passing of a landmark Climate Bill[31] to achieve net zero emissions by 2050.

In the autumn, the Australian Government announced that it is seeking feedback[32] from the public on the implementation of the Modern Slavery Act over the past three years.

Deadlines to look out for in 2023

2023 promises to be another eventful year that solidifies momentum in sustainability policy regimes. Some key deadlines to look out for include:

01 JANUARY 2023

SFDR RTS Level 2 comes into effect, including additional disclosures on adverse sustainability impact at fund level and further reporting on all Taxonomy environmental objectives per fund.

JANUARY 2023 & ONWARDS

Corporates across the EU make their first full Taxonomy alignment disclosures.

APRIL 2023

SEC to finalize Climate Disclosure Rule: first disclosures required in 2024, covering climate data for fiscal year 2023.

30 JUNE 2023

Financial market participants subject to SFDR issue their first Principal Adverse Impact (PAI) statement under the SFDR Regulatory Technical Standards (RTS).

JUNE 2023

CSRD standards for the 2023 reporting year published, including 2 conceptual guidelines, cross-cutting standards and 'core' topical standards.

OCTOBER 2023

SEC to finalize amendments to Fund Names Rule.

Conclusion

In 2022, policy became a vehicle to reorient capital flows through multiple routes, at different levels – international and domestic. The convergence of standards and frameworks created direct links between a variety of actors in sustainable finance. Despite geopolitical turmoil and shadowy economic forecasts, regulators are pursuing the objective of more sustainable and transparent financial markets through timely and fortuitous interventions. With the beginning of the New Year, policymakers and practitioners will embark on an endeavour to create more consistent global sustainability reporting rules. Though many challenges and pitfalls lie ahead, 2023 promises to be a substantial year characterized by increasing investment in climate change adaptation and social sustainability.

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