

ESG Around The World: European Union

By **Eva Monard, Charles Whiddington and Zanda Romata** (October 2, 2023)

ESG investing has recently become one of the most controversial policymaking issues in the U.S., dividing the country into pro- and anti-ESG states. But what does ESG legislation look like elsewhere? In this Expert Analysis series, attorneys across the globe tell us everything we need to know about the state of ESG in each of their countries or regions.

The European Union is committed to implementing the United Nations 2030 Agenda for Sustainable Development,[1] and has set out to achieve climate neutrality by 2050.

The policy initiatives are set out in the European Green Deal[2] and are further specified, just to name a few, in the Circular Economy Action Plan,[3] Chemicals Strategy for Sustainability,[4] European industrial strategy,[5] EU strategy on adaptation to climate change[6] and EU biodiversity strategy for 2030.[7]

As such, ESG-related policies are no longer just voluntary programs developed by forward-looking companies.

The EU legislative agenda related to these issues is unprecedented. It will affect all companies doing business in the EU — and that covers not just companies based in the EU but also third-country companies. This extraterritorial effect might be one of the most controversial aspects of these policies.

It is, however, a core driver thereof. The EU is genuinely committed to pursuing goals related to sustainability, human rights, the environment, climate change, etc., and those concerns evidently underlie these policies.

At the same time, however, many of the newly adopted and upcoming requirements are also a means to level the playing field and constitute novel types of trade barriers.

The EU imposes strict requirements on its own companies, but wants to mitigate the impact on their competitiveness, at least in the EU market.

Therefore, it is increasing the compliance costs for such non-EU competitors in the EU market.

Due Diligence and Reporting Requirements

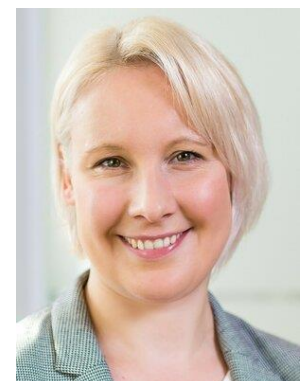
ESG-related due diligence and related reporting have become key focus points of recently adopted and proposed EU legislation.



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Of these, there are two broad instruments that apply to certain EU and non-EU companies operating in the EU.

The first is the Corporate Sustainability Reporting Directive,[8] adopted in January, which sets out disclosure requirements.

The CSRD amends the existing reporting requirements that had already been introduced by the Non-Financial Reporting Directive,[9] as it regards the disclosure of nonfinancial information by certain large undertakings and groups.

Under the CSRD, companies falling within its scope have to disclose information relating to the social and environmental impact of their activities.

Specifically, this covers environmental, social and governance factors, including climate change, biodiversity, circular economy, workforce, workers in the value chain, consumers, business conduct, etc.

There is a double materiality perspective, which not only concerns how sustainability issues affect companies' business, but also their own impact on people and the environment.

The second is the proposed Corporate Sustainability Due Diligence Directive, or CS3D,[10] which will lay down mandatory due diligence requirements for in-scope companies to address human rights and environmental — including climate change — concerns in their value chains.

The due diligence requirements of in-scope companies as proposed will be extensive, and include the obligation to monitor and mitigate actual, and potential, adverse impacts on human rights and the environment, spanning their own operations, those of their subsidiaries and the value chain operations carried out by entities with whom they have an established business relationship.

Noncompliance could result in fines, damages and director liability.

As a result of these instruments, and in particular the CS3D, in-scope companies will have to map and adequately audit their entire supply chains, and possibly value chains. There are also significant extraterritorial effects as in-scope companies include not only EU-incorporated entities but also non-EU entities with relevant EU business.

Moreover, in-scope companies will either have to impose obligations on their non-EU suppliers, or potentially disengage from them and find other suppliers.

Several of the EU's trading partners are concerned about this, especially in jurisdictions where there could be a realignment of supply chains because of these, and other, instruments.

Indeed, as discussed in more detail below, several other proposed instruments also have due diligence requirements with extraterritorial effects.

Forced Labor

The European Commission has also proposed the forced labor regulation,[11] which would effectively ban the making available on the EU market, or exporting therefrom, any products made with forced labor.

This prohibition will apply to all companies, irrespective of their size or sector. Noncompliance can result in products being banned from the market, the destruction of products if already placed on the EU market and potential penalties.

In order to comply with the forced labor regulation, companies, especially those in at-risk sectors, will also have to map their entire supply chain all the way up to all raw materials and inputs used, in order to be able to show that there is no forced labor in their supply chains.

As a result, this proposed measure is likely to have strong extraterritorial effects.

Deforestation

The recently adopted deforestation regulation[12] prohibits the placing or making available on the EU market, or the export therefrom, of products that are not deforestation-free.

The regulation only applies to specific commodities, such as cattle, cocoa, coffee, oil palm, wood, etc., as well as products that contain, or have been fed or made with, these specific commodities.

Importantly, the deforestation regulation includes mandatory due diligence rules, also resulting in the mapping of supply chains with even mandatory geolocation requirements and extraterritorial effects.

For companies dealing with relevant commodities or products, this regulation will entail a significant compliance cost.

Carbon Border Adjustment Mechanism

Under the recently adopted carbon border adjustment mechanism, or CBAM,[13] EU importers of iron, steel, cement, aluminum, fertilizers, electricity and hydrogen will have to cover the carbon price that these products would have cost under EU emissions trading rules.

Until the end of 2025, the CBAM will apply only as a reporting obligation, while the full system will apply as of Jan. 1, 2026. The CBAM only applies to certain specific products, including iron and steel, cement, fertilizers, etc.

Under the key reporting obligations, importers will for every quarter have to submit a CBAM report including information on the in-scope goods they imported, and their embedded and indirect emissions. In order to be able to import goods into the EU, importers will have to be authorized as an authorized CBAM-declarant.

Starting from Jan. 1, 2026, the requirements become far more stringent, and the CBAM tax will be due. This will effectively price several imported products higher, by imposing the CBAM tax on importation.

Critical Raw Materials Act

Earlier this year, the commission proposed the Critical Raw Materials Act, or CRMA,[14] which aims to strengthen the EU's critical raw materials capacities across all stages of the value chain, diversify the EU's imports of raw materials, improve monitoring and risk

mitigation capacities, and improve the sustainability and circularity of critical raw materials.

Strategic raw materials include silicon metal, copper, lithium, nickel, tungsten and rare earth elements for magnets. The list of critical raw materials is larger, consisting of 34 raw materials.

The goal is to ensure that by 2030, not more than 65% of the EU's annual consumption of each strategic raw material at any relevant stage of processing comes from a single third country.

Of particular relevance in the present context, however, is that the proposed CRMA includes a requirement for large companies that manufacture strategic technologies using strategic raw materials to perform every two years an audit of their supply chain, including a mapping of where the strategic raw materials they use are extracted, processed or recycled, and a stress test of their supply chain of strategic raw materials, consisting of an assessment of its vulnerability to supply disruptions.

There are also certain sustainability and circularity requirements that would be imposed by the CRMA.

Importantly, the commission mentions in its proposal for the CRMA that it would complement the proposed CS3D, by adding the requirement for companies covered under the CSRD to produce information on the environmental footprint of critical raw materials.

In addition, according to the commission, the calculation of the environmental footprint of each material under the proposed CRMA could contribute to the effective implementation of a due diligence policy under the proposed CS3D.

Sustainable Product Policy Framework

The Circular Economy Action Plan highlights that sustainability principles in the product-design stage and circularity-in-production stage are key areas to address the negative life cycle environmental impacts of products.

By adopting appropriate legislative initiatives, the European Commission aims to foster sustainable product choices in the EU market.

While more initiatives are yet to come, there is already a lot for the market players to digest and prepare for.

For example, the commission's proposal for ecodesign for sustainable products regulation, or ESPR,[15] will set a framework that will allow extending the previous scope of electronic products to all products, including intermediate products. The products will be subject to new rules once specific delegated acts by the commission are adopted.

These acts will specify the requirements per product or product groups, and will cover criteria such as product durability, reliability, reusability and use of substances of concern, as well as labeling and digital passport requirements.

While the proposal is still going through the legislative process, it has already been identified that textiles, chemicals, iron, steel, aluminum and some other commonly used product groups will be the first ones to have specific requirements.

Textiles and their destruction will not only be addressed under the ESPR, but there is also a proposal[16] to revise the Waste Framework Directive[17] to increase the environmental sustainability of the textiles sector by introducing mandatory extended producer responsibility schemes — that allow covering the costs of collection of used and waste textile, and the specified textile-related and footwear products — and a producer register.

As another example, the legislators recently adopted the new batteries regulation,[18] which will apply from Feb. 18, 2024. It applies to all batteries[19] placed on the EU market, and it establishes end-of-life requirements, including collection targets and obligations, targets for the recovery of materials, and extended producer responsibility.

The batteries regulation also introduces a due diligence obligation for economic operators similar to those described above.

As the majority of products are supplied already packaged, it is unsurprising that the regulatory framework for packaging and packaging waste is also revised in order to achieve the sustainability and circular economy goals of the Green Deal and the Circular Economy Action Plan.

The proposed[20] regulation by the European Commission aims to reduce the negative environmental impacts by setting the essential requirements for packaging design and composition, introducing harmonized criteria for extended producer responsibility schemes, and setting out packaging collection and recycling targets.

The proposal specifies that all packaging will have to be designed for recycling by Jan. 1, 2030, and be recycled at scale five years later.

Green Claims

The EU legislative framework regulates not only different aspects of the product life cycle but also what companies say about their products.

For example, the European Commission has published a proposal for a directive on the substantiation and communication of explicit environmental claims.[21] This proposal will regulate voluntary environmental/green claims[22] — i.e., claims not covered by other existing EU legislation — made in business-to-consumer commercial practices.

Any voluntary environmental claims made will have to be substantiated, verified by a third party and communicated together with information on the substantiation, in physical form, on a website or via a QR code.

The proposal will require member states to ensure that national legal systems allow natural or legal persons or organizations to make substantiated complaints and challenge any decision before the courts or other independent public bodies.

Antitrust

Following years of criticism for not having clear guidance from the commission on how environmental or sustainability cooperation agreements will be addressed for competition law compliance, we finally have the new Chapter 9 of the revised horizontal guidelines.[23]

It is welcomed by many, as some of the above-identified legislative initiatives call for wider

industry cooperation in achieving the sustainability goals and meeting the due diligence obligations. The commission has:

- Identified several types of agreements that are unlikely to breach EU competition rules;
- Provided a soft safe harbor for sustainability standardization agreements; and
- Indicated how consumer nonmonetary benefits will be taken into account to outweigh competition concerns in sustainability agreements.

The companies should also take advantage of obtaining additional guidance on novel and unresolved questions regarding their sustainability agreements from the commission through its informal guidance notice.[24][25]

Conclusion

The above provides a high-level overview of some of the key ESG-related evolutions taking place in the EU regulatory sphere.

EU companies, as well as third-country companies doing business in the EU, will face significant compliance costs for these ESG-related requirements and trade barriers.

Many of those companies are only starting to come to grips with this evolution, and some of them have not yet realized the EU regulatory tsunami that may hit them soon.

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[1] Available at: <https://sdgs.un.org/2030agenda>.

[2] Available at: https://commission.europa.eu/document/download/daef3e5c-a456-4fbb-a067-8f1cbe8d9c78_en.

[3] Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1583933814386&uri=COM:2020:98:FIN>.

[4] Available at: <https://circabc.europa.eu/ui/group/8ee3c69a-bccb-4f22-89ca-277e35de7c63/library/dd074f3d-0cc9-4df2-b056-dabcacfc99b6/details?download=true>.

[5] Available at; https://commission.europa.eu/system/files/2021-05/communication-industrial-strategy-update-2020_en.pdf.

[6] Available at: https://ec.europa.eu/commission/presscorner/api/files/document/print/en/ip_21_663/IP_21_663_EN.pdf.

[7] Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52020DC0380>.

[8] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (OJ L 322, 16.12.2022, p. 15–80).

[9] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (OJ L 330, 15.11.2014, p. 1–9), as amended.

[10] Available at: https://commission.europa.eu/publications/proposal-directive-corporate-sustainability-due-diligence-and-annex_en.

[11] Available at: https://single-market-economy.ec.europa.eu/document/download/785da6ff-abe3-43f7-a693-1185c96e930e_en?filename=COM-2022-453_en.pdf.

[12] Regulation (EU) 2023/1115 of the European Parliament and of the Council of 31 May 2023 on the making available on the Union market and the export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010 (OJ L 150, 9.6.2023, p. 206–247).

[13] Regulation (EU) 2023/956 of the European Parliament and of the Council of 10 May 2023 establishing a carbon border adjustment mechanism (OJ L 130, 16.5.2023, p. 52–104).

[14] Available at: https://single-market-economy.ec.europa.eu/publications/european-critical-raw-materials-act_en.

[15] Available at: https://environment.ec.europa.eu/document/download/11246a52-4be4-4266-95b1-a15dbf145f51_en.

[16] Available at: https://environment.ec.europa.eu/system/files/2023-07/Proposal%20for%20a%20DIRECTIVE%20OF%20THE%20EUROPEAN%20PARLIAMENT%20AND%20OF%20THE%20COUNCIL%20amending%20Directive%20200898EC%20on%20waste%20COM_2023_420.pdf.

[17] Directive 2008/98/EC of the European Parliament and of the Council of 19 November 2008 on waste and repealing certain Directives OJ L 312 22.11.2008, p. 3), as amended.

[18] Regulation (EU) 2023/1542 of the European Parliament and of the Council of 12 July 2023 concerning batteries and waste batteries, amending Directive 2008/98/EC and Regulation (EU) 2019/1020 and repealing Directive 2006/66/EC (OJ L 191, 28.7.2023, p. 1–117).

[19] Batteries are defined as "any device delivering electrical energy generated by direct

conversion of chemical energy, having internal or external storage, and consisting of one or more non-rechargeable or rechargeable battery cells, modules or of packs of them, and includes a battery that has been subject to preparation for re-use, preparation for repurposing, repurposing or remanufacturing" (Article 3.1(1) of the Batteries Regulation).

[20] Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022PC0677>.

[21] Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023PC0166&from=EN>.

[22] It has been proposed to define environmental claims as "any message or representation, which is not mandatory under Union law or national law, including text, pictorial, graphic or symbolic representation, in any form, including labels, brand names, company names or product names, in the context of a commercial communication, which states or implies that a product or trader has a positive or no impact on the environment or is less damaging to the environment than other products or traders, respectively, or has improved their impact over time."

[23] Available at: https://competition-policy.ec.europa.eu/document/download/fd641c1e-7415-4e60-ac21-7ab3e72045d2_en?filename=2023_revised_horizontal_guidelines_en.pdf.

[24] Available at: https://competition-policy.ec.europa.eu/system/files/2022-10/coronavirus_informal_guidance_notice_antitrust_2022.pdf.

[25] See our previous analysis here: <https://www.law360.com/articles/1702180/us-antitrust-approach-toward-esg-clashes-with-eu-stance>.