SLAUGHTER AND MAY/

GOVERNANCE & SUSTAINABILITY

Part of the Horizon Scanning series

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THE LONG AND WINDING ROAD TO UK AUDIT AND CORPORATE GOVERNANCE REFORM

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It was Spring 2018 when, in the immediate aftermath of the failure of Carillion, Sir John Kingman was called upon to undertake an independent review of the UK's Financial Reporting Council (**FRC**), kicking off a whole series of reports, white papers and consultations on proposed reforms to various parts of the UK audit and corporate governance framework. Delays, a global pandemic and three prime ministers later, it seemed that changes to UK corporate governance may finally be falling into place for 2024, only for the journey's end to be once more obscured by a bend in the road in the second half of 2023 with the last minute withdrawal of the SRDR Regulations and consequent implications for the proposed changes to the UK Corporate Governance Code (**Code**).

The schematic on the following page sets out key steps along this long and winding road.

The Government published its response to the BEIS (as it was then) White Paper, "Restoring trust in audit and corporate governance" setting out its plans for reform in May 2022. This set a path to UK corporate governance reform through a combination of primary and secondary legislation and changes to the Code.

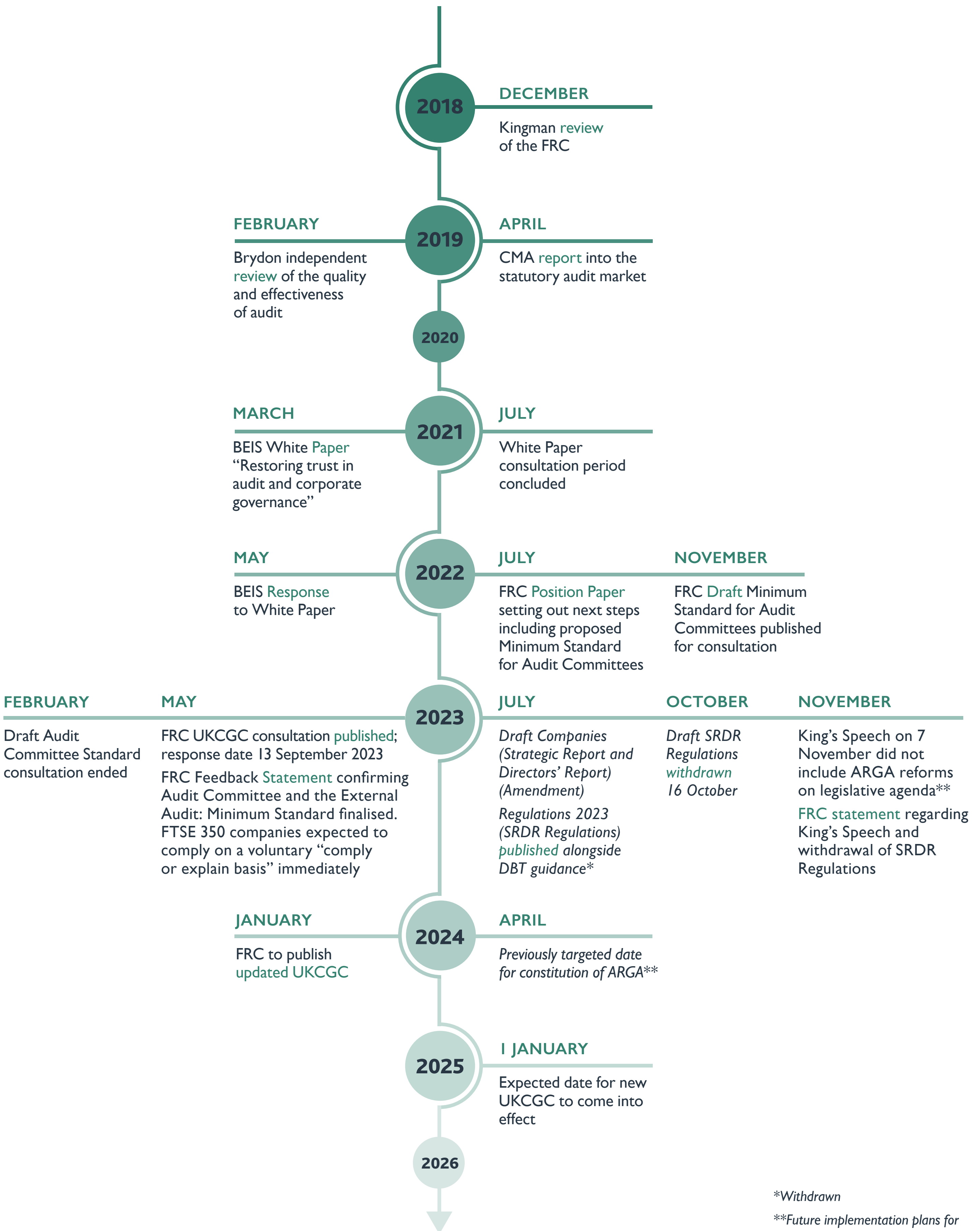
The FRC released a consultation in May 2023 setting out proposed changes to the Code, reflecting what the Government wanted the FRC to cover. New corporate reporting requirements were due to come into effect through the Companies (Strategic Report and Director's Report) (Amendment) Regulations 2023 (**SRDR Regulations**), published in July. As part of the implementation plan, primary legislation was needed to transition from the FRC to the new Audit, Reporting and Governance Authority (**ARGA**). That transition had provisionally been targeted for April 2024.

However, a day before the SRDR Regulations were scheduled for parliamentary approval, the Government withdrew them, citing a need to "cut red tape" for business.

The decision of the Department of Business and Trade (DBT) to withdraw the SRDR Regulations encapsulates the current tension between a call from some sectors of Government to restore trust in audit and corporate governance (in the wake of perceived failings and the high-profile corporate collapses of Carillion and Thomas Cook), and the desire and focus in other quarters to (re-)position the UK, in general, and the London capital markets, in particular, internationally as a more attractive and efficient place to do business.

The SRDR Regulations contained several key reporting requirements that were part of the reform agenda. Companies in scope (public companies and private companies above certain employee and turnover thresholds) were to be subject to new annual reporting requirements, including amongst other things a "resilience statement" and annual distributable profits figure.

AUDIT AND CORPORATE GOVERNANCE REFORMS



*Withdrawn

**Future implementation plans for ARGA (if any) yet to be confirmed

The FRC's proposed amendments to the Code were mainly aimed at providing for a more robust framework of effective internal control and risk management (as requested by the Government in its response to the BEIS White Paper back in 2022). Arguably they went further than anticipated by extending audit committee responsibilities and other changes focusing on diversity, directors' time commitments and the quality of corporate governance reporting. Importantly, several of the proposed Code changes relied on the SRDR Regulations being in effect.

The withdrawal of the SRDR Regulations therefore had an inevitable knock-on effect on the FRC's proposals for updating the Code. On 7 November, the FRC announced that although it would still be targeting January 2024 for publication of the updated Code, it would be taking forward "only a small number" of its 18 original proposals – namely those aimed at reducing duplication across reporting standards and ensuring internal control standards are "targeted and proportionate". This aligns with the messaging from the DBT, which following a Call for Evidence in May 2023 looking at overlap and duplication in non-financial reporting requirements, has signalled that it intends to look into streamlining existing frameworks and eliminating duplicative requirements in companies' directors' and strategic reports (reinforcing the view that the focus on economic competitiveness is prevailing in Government for now).

Such pressing of the pause, if not the re-direct, button, was further evidenced in November by the absence of mention of the Audit Reform Bill in the King's Speech. The anticipated creation of ARGA next year will now not happen. The message from Government continues to be that the relevant legislation will happen 'when Parliamentary time allows'; however, that seems quite far away, despite the FRC gearing up for its change to ARGA for a number of years now.

The timing and extent of audit and corporate governance reform is therefore far from clear, though perhaps this should be of no surprise with the prospect of a generation-defining general election in the UK in 2024. The current appetite within the ruling Conservative Party is uncertain. The Labour Party has pledged support for the audit and corporate governance reform agenda, including the establishment of ARGA, but not as a priority action item. One thing that does appear certain is that it will take a back seat during the run-up to the UK general election. And it seems unlikely that any new, far-reaching reforms will be developed and implemented immediately following the election.

The journey that started in 2018 with Sir John Kingman to reform the FRC and the UK audit and corporate governance framework is therefore set to continue through 2024. Though that may cause concern and frustration for some, if a rethink and rebalancing of the proposed reforms leads the UK to a better door at the end, this long and winding road may well have been worth it.

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THE ECONOMIC CRIME AND CORPORATE TRANSPARENCY ACT – WHAT YOU NEED TO KNOW

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CORPORATE CRIMINAL LIABILITY REFORM

The most important changes from a corporate criminal liability perspective are: an expanded identification principle – the test for attributing liability to a corporate for crimes with a mental element; and a new offence of failure to prevent fraud. These reforms create a powerful package, which should make it easier for corporates to be prosecuted for economic crimes in the UK.

New Identification Principle

Previously, a corporate could only be guilty of offences with a mental element where the offence was committed by someone considered to be the company's 'directing mind and will'. This was generally regarded as those at statutory board level.

The Act introduced a new test such that a corporate will now be liable if one of its 'senior managers', acting within the actual or apparent scope of their authority, commits an economic crime. This effectively lowers the threshold for the type of employee who can trigger criminal liability for a business.

The definition of 'senior manager' is loose and there is a lack of clarity around who will constitute a senior manager for these purposes. Assessment of whether an individual meets this test will need to focus on the extent of their decision-making power over the business in the context of the alleged offence.

This change is already in force, having come into effect on 26 December 2023. At present it only applies to economic crimes including, bribery, money laundering, sanctions offences and fraud. However, we may see a further expansion of the principle sometime in 2024 via a new Criminal Justice Bill. The Bill, which is currently before Parliament, proposes to expand the new senior manager test to all criminal offences, not just economic crimes. If this proposal becomes law, it will raise complex questions about the scope of senior managers' duties and whether certain offences such as sexual offences, if committed by a senior manager at work, could lead to corporate prosecution.

Failure to prevent fraud

Under the new 'failure to prevent' offence an organisation will be liable where a person associated with it (such as an employee, agent or subsidiary) commits a fraud with the intention of benefiting the organisation, or those to whom it provides services (eg. its customers or clients). It will

not be necessary to show that the organisation's leaders authorised, knew about, or even suspected the fraud. Importantly, an organisation will have a defence if it can prove it had reasonable procedures in place to prevent the fraud. These concepts of associated person and a reasonable (or adequate) procedures defence may be broadly familiar from the UK's Bribery Act 2010, but corporates should be aware that the new offence has some subtle differences in these concepts, as well as a different territorial scope.

The offence applies to 'large organisations' only (defined in line with the Companies Act 2006). This captures corporates that are themselves a large organisation and subsidiaries of a large organisation (even where the subsidiary alone does not meet the threshold). The result is that the vast majority of our clients will be in-scope of the new offence.

The offence is expected to come into force in mid-2024 after the Government issues guidance on the reasonable procedures defence.

EXPANDED POWERS FOR THE SFO

The SFO already has the power to compel information at the pre-investigation stage, but only in cases of suspected international bribery and corruption. Under the Act, this pre-investigation power is expanded to all SFO cases – capturing fraud and domestic bribery and corruption cases. This will likely result in an increase in the number of companies receiving pre-investigation compulsory notices from the SFO.

COMPANIES HOUSE

A large portion of the Act deals with reforms to Companies House, taking it from a passive repository of information to a more assertive regulator. The Act gives enhanced powers to the Registrar to query or remove information from the register, and introduces, amongst other things, new identity verification requirements and changes to company record keeping requirements. Implementation of many of these changes requires secondary legislation - which is expected over the next 12-24 months. Companies will need to do a significant amount of housekeeping and ensure their internal processes are ready for this new regime.

OTHER REFORMS

The Act also introduces a host of other significant changes including:

- **Information sharing provisions for regulated firms**: which will better enable firms to share customer information with each other for the purposes of preventing, investigating and detecting economic crime.
- **Cryptoassets**: new powers for enforcement agencies to freeze and seize cryptoassets which are the proceeds of crime or associated with illicit activity.
- **Reforms to limited partnerships**: including changes to the process for registration and additional transparency obligations.

The Act introduces sweeping reforms, only some of which are discussed here. The changes to the corporate criminal liability regime are particularly significant. The new director of the SFO, who has already made an assertive start to his tenure, may well feel pressure to use these new tools sooner rather than later. However, it remains to be seen whether these will be enough to turn the tide on the SFO's recent difficult history and make it a more formidable prosecutor of corporate crime.

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ESG IN 2024: MATURITY, CLARITY AND UNCERTAINTY

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Over the course of 2023, the concepts of ESG, and sustainability more broadly, evolved to reflect and anticipate developments in society, governmental policy and corporate decision-making and strategy.

We expect 2024 to be no different. The world's view of ESG will likely be tested against the backdrop of the anti-ESG movement in the United States, U-turns in UK governmental policy in the context of the cost-of-living crisis and the ongoing conflicts in the Middle East and Ukraine.

Yet, these developments are unlikely to slow down the pressure from investors, lenders, regulators, and sectors of society that see ESG as a priority. For this reason, in 2024 expectations on companies to create adaptable strategies and ensure that they deliver on their ESG commitments will be even higher, and many have already demonstrated resilience in meeting their commitments.

The current focus is on listed companies, public interest entities and the finance sector, but private companies (particularly large private companies) are under increasing pressure to re-evaluate their businesses, disclose more information and revisit their governance structures accordingly to cater for the risks and opportunities presented by the sustainability agenda.

To help businesses make sense of the various challenges and opportunities presented by ESG, in 2024 we have collected our thoughts around three key themes: **maturity**, **clarity** and **uncertainty**.

MATURITY

We have sensed from conversations with our clients a marked shift towards implementation and operationalisation of ESG, regardless of political and economic uncertainties and ongoing regulatory evolution. Whilst the political environment fluctuates (particularly with significant elections coming this year, including in the United States) stakeholder expectations are no longer focused solely on whether businesses must transition, but rather how to transition and how fast.

Those businesses plotting a path for their transition most successfully often start with their purpose, strategy and commercial proposition in mind (i.e. a sophisticated view of sustainability, opportunity and risk). They understand this will require increasingly focused sustainability leadership from the board and the senior management team. The Transition Plan Taskforce's (**TPT**) framing of Ambition, Action and Accountability (see further below) captures the zeitgeist. Businesses that get ahead of the regulation on transition plans will have the prospect of differentiating themselves positively.

It is likely that 2024 will see a new language of corporate communication emerge, reflecting a focus on delivery and achievement beyond the mere articulation of ambition. This will be driven by the increasing expectation of assurance, the spotlight on delivery and the widespread focus on, and increasing negative consequences of, greenwashing.

Our sense is that, once the current suite of contemplated UK regulatory initiatives are consulted on and implementation processes are commenced (notably endorsement of the International Sustainability Standards Board (**ISSB**) standards, TPT, TNFD (defined below), Sustainability Disclosure Requirements and a UK Green Taxonomy), the stock of domestic transparency and reporting regulations will stabilise. The UK Government's pillars of strategic action for green finance, being 'greening finance' and 'financing green' have been furthered, with measures to ensure that market participants have the information and data that they need to manage risks and allocate capital where there are opportunities. Climate finance, and in particular the private sector's role in providing such finance, was also a key theme of **COP28**: **Discussion points for business from week 1**, **Impacts for business** . Good market practice will continue to develop, with a collaborative approach from regulators and amongst businesses.

2023 saw a consistent voice from multiple business sources, trade associations and stakeholder platforms for more meaningful regulatory intervention, ranging from calls for a comprehensive industrial strategy, to better support for particular energy transition technologies, to a more ambitious regulatory framework to incentivise transition. We expect this to continue as businesses see the opportunity that sustainability presents, the need to progress their transition and the demands of their stakeholders to do so.

CLARITY

Corporate ESG reporting frameworks will continue to evolve in 2024 and will benefit from greater clarity from regulators, albeit that it is unlikely that full clarity will emerge by the end of the year.

Regimes like the Taskforce on Climate-related Financial Disclosures (**TCFD**) will merge into more prescribed regulatory content via the European Sustainability Reporting Standards (**ESRS**), the ISSB standards, the TPT framework and such like. Despite imperfect interoperability, each new framework calls for improved transparency through more detailed disclosure requirements (including in respect of scope 3 emissions, the subject of a UK Government call for evidence that closed at the end of 2023), assurance processes and materiality assessments.

The ISSB has published its sustainability and climate change disclosure standards, which may become the global baseline for sustainability reporting in many jurisdictions, including in Brazil, Japan, South Africa and the UK. The EU has gone a step further, adopting a "double materiality" approach via the Corporate Sustainability Reporting Directive and ESRS, requiring disclosures about the impact a business has on people and planet, not just what is financially material. The US Securities and Exchange Commission (**SEC**) is yet to publish its climate rules. Reporting on biodiversity is also expected to develop, as companies get to grips with the recommendations of the Taskforce on Nature-related Financial Disclosures (**TNFD**), published in September. Human rights and supply chain integrity will also go up the reporting agenda.

Finally, disclosure of transition plans is likely to see major growth in 2024. The UK's TPT has published its "gold standard" sector-neutral transition plan disclosure framework, which offers businesses a better sense of how wider stakeholder expectations are likely to be set, and how to satisfy or exceed them. The TPT's guidance on legal considerations for transition plans preparers (to which Slaughter and May contributed) also offers guidance on how to account for directors' duties and competition law when making transition plan disclosures. This will be supplemented by sector specific guidance, following closure of a consultation at the end of 2023.

We expect to see greater clarity with respect to regulating greenwashing as well. In the US, regulators including the SEC have been cracking down on greenwashing and strengthening their rules. In the UK, whilst the Advertising Standards Authority continues to closely police misleading green claims in advertising, we anticipate further guidance from the Competition and Markets Authority arising out of its sector-by-sector review of greenwashing in consumer-facing businesses and many will be closely watching how the Financial Conduct Authority enforces its newly released anti-greenwashing rule and implements its guidance (currently out for consultation) when issued.

Companies wanting to play a role in helping formulate UK ESG policy are invited to participate in various governmental and regulatory consultations, with the key upcoming consultations summarised in Table 1.

UNCERTAINTY

Given the breadth of sustainability, there are still areas of great uncertainty and we expect this theme to continue into 2024, best illustrated by the case of the EU's Corporate Sustainability Due Diligence Directive (**CS3D**).

The directive is ambitious, and in-scope entities need to gear up for its implementation by mapping their value chains and embedding processes into their operations to cater for the level of oversight and assurance that is needed.

There will inevitably be tensions and complexities around how different member states address the directive, and indeed how different players impose requirements across their business relationships. See more detail on the CS3D on page 26.

In the field of ligation, we are continuing to see cases against corporates and financial institutions, and expect this to continue through 2024. For example, the scope of companies' and their boards' duties in an ESG context remains a live issue for companies to watch closely. In 2023, in two separate climate-related derivative claims brought by shareholders against company boards (**ClientEarth v Shell** (in which Slaughter and May acted for Shell and its directors) and **McGaughey v USSL**), the English courts emphasised their reluctance to wade into the reasonable commercial decision-making of boards, even in a climate change context. We expect these issues to play out further in 2024, with boards' ESG strategy and decision-making staying under the spotlight, and that the use of derivative actions will remain in the playbooks of some shareholders with ESG goals.

Elsewhere, we are seeing attempts to **use the courts to** impose direct obligations on companies with respect to their CO2 emissions, such as in the on-going cases *Lliuya v RWE* in Germany and *Milieudefensie v Shell* in the Netherlands. We are yet to see these types of cases before the English courts, where other routes such as threatened **securities claims (sections 90 and 90A/Schedule 10A FSMA)** for misleading statements or omissions in ESG material published by UK listed companies are gaining traction.

Table 1: Key upcoming ESG policy consultations in the UK

Body	Subject matter	Focus of consultation / call for evidence	Status
UK Government	Transition plans disclosures for largest companies	The introduction of requirements for the UK's largest companies (public and private) to disclose their transition plans if they have them, similar to what the FCA is doing (see below).	Was planned to be launched in "Autumn/ Winter 2023" (not yet launched)
UK Government	UK Green Taxonomy	The draft UK Green Taxonomy, designed to be a tool to provide investors with definitions of which economic activities should be labelled as 'green'.	Was planned to be launched in "Autumn 2023" (not yet launched)
FCA	Anti-greenwashing rule	Consultation on the FCA's newly-announced anti-greenwashing rule. **GC23/3: Guidance on the anti-greenwashing rule | FCA**	Closes 26 January 2024
FCA	ISSB	Updating TCFD-aligned disclosure rules for listed companies to refer to UK-endorsed ISSB standards, and the appropriate scope and design for the new regime. New requirements would apply from 2026 (in respect of accounting periods beginning on or after 1 January 2025). The FCA also expect to consult on moving from the current comply-or-explain compliance basis to mandatory disclosures for listed issuers. **Primary Market Bulletin 45 | FCA**	First half of 2024
FCA	Transition plans	Developing guidance setting out the FCA's expectations for listed companies' transition plan disclosures (at the same time as consulting on the ISSB standards). Under the FCA's rules, companies only have to disclose their transition plans if they have one, and this is not expected to change. **Primary Market Bulletin 45 | FCA**	First half of 2024

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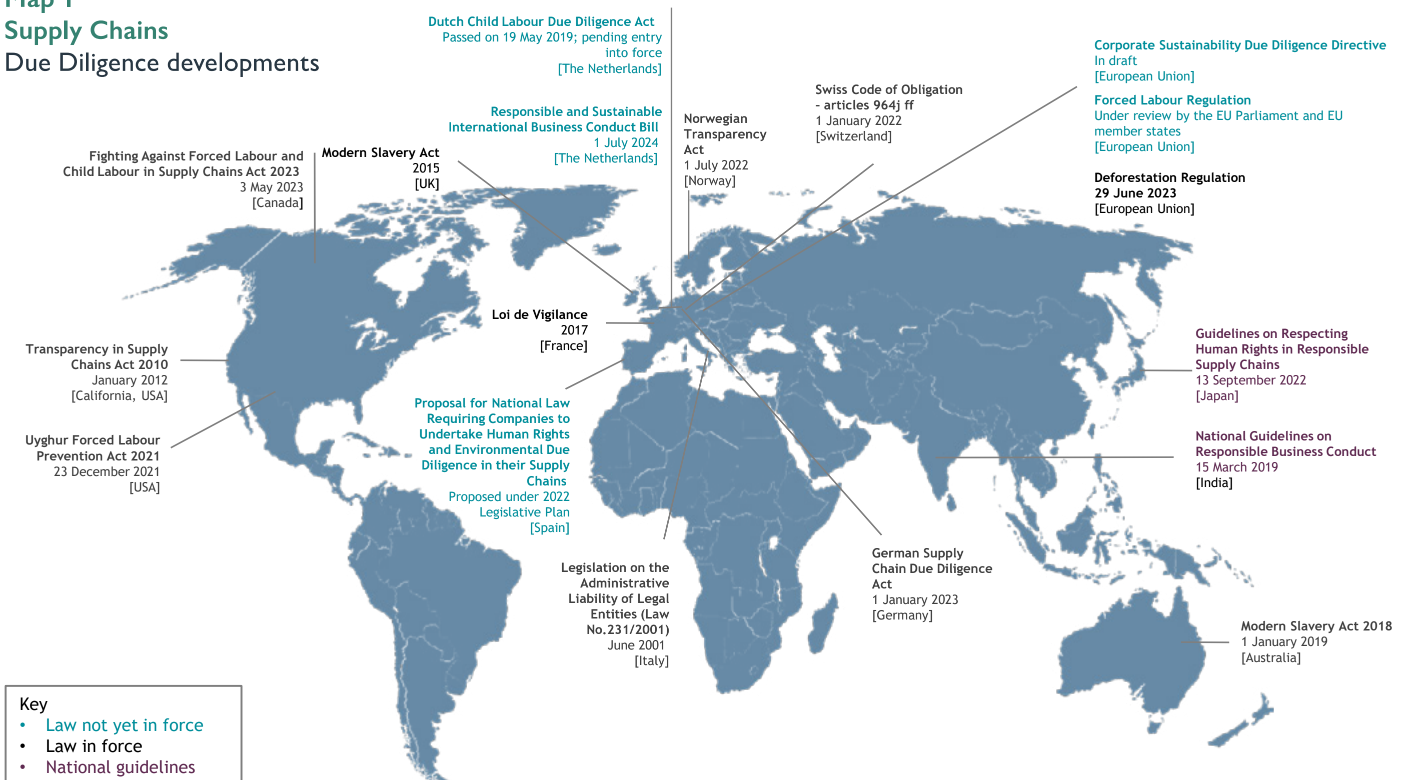
SETTING THE SCENE: BUSINESS AND HUMAN RIGHTS

Human rights have meteorically risen up the corporate sustainability agenda, propelled by stakeholder pressure, civil society and customer expectations of companies, increasing regulation and the risk of litigation. This article discusses the current expectations on businesses to address their human rights impacts, and issues on the horizon.

Human rights: the intersection with business

The requirement for companies to consider the relevance of human rights to their business activities is relatively recent. The 1948 Universal Declaration of Human Rights set the foundation for states' responsibilities to protect and fulfil human rights. It was not until 2011, when the Human Rights Council endorsed the UN Guiding Principles on Business and Human Rights (**UNGPs**), that the expectation for business to respect human rights was formally articulated.

Map 1
Supply Chains
Due Diligence developments



Over time, businesses have recognised that a failure to respect human rights can have significant consequences. In addition to reputational impacts, various mechanisms have been used to hold companies to account, whether through the complaints mechanism under the OECD Guidelines for Multinational Enterprises (**OECD Guidelines**), or through innovative cases brought in the courts. To add to the mix, in recent years there has been an expansion, especially in the EU, of laws requiring companies to undertake human rights and environmental due diligence (**HREDD**) in addition to laws already requiring disclosure of human rights impacts (Map 1).

Moreover, in an increasingly socially conscious society accompanied by social media channels, some companies are marketing their 'good human rights records' to attract customers and obtain financing.

WHAT'S COMING IN 2024?

2024 will be a busy year for businesses and human rights. We expect developments to include:

1. entry into force of the **EU Corporate Sustainability Due Diligence Directive** (**CS3D**) which will require companies to conduct human rights and environmental due diligence following the European Parliament and Council recently reaching a provisional agreement;
2. a greater focus on **corporate disclosures** relating to businesses' human rights impacts, their verification and accuracy in light of underlying processes;
3. further, **deeper integration of human rights considerations in business processes**, such as in supply chain management, due diligence when entering and exiting markets, in M&A activity and in risk management systems (with risk assessment of both the impacts of human rights on the business, and the impact of the business on human rights – the **double materiality approach**);
4. an increased business **focus on the rights of vulnerable or marginalised** people (such as children and indigenous communities), socioeconomic rights (e.g. the right to a living wage) and rights at risk when operating in conflict-affected regions;
5. maturing understanding of companies' **responsibility** for **delivering remedies** for human rights violations associated with their operations;
6. continuing **challenges for multinationals navigating differing ESG approaches** across markets, for example, the US vs. EU approach, and any divergence of the CS3D from the UNGPs and OECD Guidelines;
7. **increased pressure on SMEs** to meet stretching human rights compliance requirements if they are part of the value chain of companies with obligations under the new HREDD laws; and
8. continued **claimant-led litigation** seeking to use (and expand) existing legal mechanisms to hold companies to account for alleged human rights violations.

We deep dive into two of these developments – mandatory human rights due diligence under the CS3D and continued claimant-led litigation – below.

Mandatory human rights due diligence

The CS3D aims to bring about a fundamental shift in corporate responsibility by mandating policies and processes for effective HREDD. This initiative strives to enhance corporate accountability and increase available data on human rights impacts, addressing issues such as child labour, slavery, deforestation and pollution. Prescribed actions will range from establishing a due diligence policy to identifying adverse impacts and taking steps to prevent, cease or remedy them.

Following negotiations between the EU institutions since June, on 14 December 2023, the European Parliament and Council reached a provisional deal on the CS3D. This deal finalises the position on points of disagreement between the EU bodies, but leaves some details to be finalised in the ensuing drafting process. The negotiations were focussed on, among other things, the employee number and turnover thresholds for application, directors' obligations and civil liability. The final text is still to be finalised and formally adopted (expected 2026 or 2027), after which member states will have two years to transpose the CS3D into national law. As always, member state legislatures can add to or strengthen the CS3D in the transposition process, but cannot fall below its standards.

The agreement reached between the European Parliament and Council settles the scope of the CS3D to include large EU companies that have more than 500 employees and a net worldwide turnover of €150 million. Those with over 250 employees and a turnover of more than €40 million will also be in scope if at least €20 million of that turnover is generated in designated high-risk sectors (e.g. textiles, agriculture and mineral trading). Non-EU companies and parent companies with equivalent turnover in the EU will also be in scope but they are expected to have at least three years from the CS3D coming into force to comply. The financial sector will initially be out of scope in respect of their financial services (but in scope in relation to their own operations and upstream activities), subject to a review clause for possible inclusion in future based on an impact

assessment. Companies that are not directly in scope are likely to be impacted by virtue of being in the value chain of an obligated company undertaking its due diligence.

With regard to civil liability, the deal establishes a five-year period for interested parties (including trade unions and civil society organisations) to bring damages claims and caps the cost of proceedings for claimants. Member state supervisory authorities will be empowered to launch investigations, impose fines of up to 5% of the company's net worldwide turnover, implement injunctive measures and to "name and shame" companies that fail to comply.

The CS3D is intended to complement other supply chain diligence instruments, such as the EU Deforestation Regulation and Conflict Minerals Regulation and to cover both human rights and environmental issues, recognising their connected impact. This integrated approach poses a challenge to businesses that are more used to treating environmental and social impacts separately. Methodologies will need to be established: currently, data for climate emissions and diversity are quantitative; human rights, for example, is typically assessed using qualitative data.

Many hope the CS3D will harmonise domestic HREDD laws that have already emerged across some member states. If the finalised directive falls short of stakeholder expectations, companies settling for the lower, regulatory bar may nonetheless face challenge, as may insufficient or inconsistent implementation across EU member states.

Innovative claims based on existing laws

In 2024, we will continue to see claims in England (i) seeking to incrementally expand duties to hold companies to account (e.g. through test cases on the scope and application of tortious and statutory duties to ESG issues); (ii) seeking to test the accuracy, or more likely the inaccurate or misleading nature of disclosures made by corporates; or (iii) brought under foreign law seeking to impose or expand liability for the conduct of corporates, their subsidiaries and suppliers across the globe. Increased public regulatory enforcement action against corporates is likely to fuel this trend.

However, continued attempts to stretch legal boundaries for harm suffered abroad may be tempered by the challenges presented by the post-Brexit jurisdiction rules. Previously, English courts were sometimes required by EU law to hear litigation involving English companies, even where the claims involved foreign subsidiaries, claimants or law, or where the conduct occurred wholly overseas. For newly filed cases, the English courts have reverted to looking to identify the "natural forum" to hear the claim and whether the parties can achieve substantial justice in the jurisdiction with the closest connection to the dispute. We expect to see cases testing the attitude of the English courts given the availability of litigation funding to support such claims. In all such cases, businesses' legal risks may extend beyond English legal duties, to duties imposed by the laws of the countries relevant to their subsidiaries and suppliers.

TAKING ACTION: ADDRESSING THE HUMAN RIGHTS IMPACTS OF YOUR BUSINESS

Early corporate accountability laws, such as the UK's Modern Slavery Act, focussed on driving change through disclosure alone. Increasingly, developing laws (like the CS3D) require corporate action including and based on due diligence.

Seeking advice on how the various laws will apply to an organisation, and then implementing robust internal policies and processes to conduct, report and act on due diligence will be important first steps. Governance processes to monitor progress and escalate issues are essential, as is cross-business coordination to ensure that risk, compliance, legal, procurement, communications, and other teams are consistent in their activities and messaging to minimise risk and scope for claims. Good governance and processes that enable corporates to identify and respond to challenges effectively are likely to provide the best defence.

How a business impacts human rights will vary based on its sector, geography and activities. However, in an increasingly multinational world operating with global value chains and increasing regulation and scrutiny of human rights impacts, now more than ever is the time for businesses to take note and take action.

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SUSTAINABLE FINANCE: LOOKING TO 2024

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The sustainable finance market experienced its first year-on-year contraction in 2022, as inflation, higher borrowing costs, geopolitical tensions and general economic uncertainty depressed activity in most sectors of the debt markets. Although these challenges remained, during 2023 sustainable finance volumes showed signs of recovery. Global sustainable finance issuance totalled $717bn in the first half of 2023 alone, an improvement on the second half of 2022.

Green bonds have been the driving force of this recovery, with global green bond issuance in the first half of 2023 reaching $310bn, the highest half-year total since the inception of the green bond market. Sustainability-linked products have performed less well. Overall volumes of sustainability-linked loans (**SLLs**) and bonds (**SLBs**) have struggled to reach even 2022 levels.

As we enter 2024, there are questions around the future of the sustainable finance market, and perhaps more importantly how the different product categories will fare. Will green bonds continue to dominate? Does the more recent uptick in SLB issuance (in the context of a very quiet year for SLBs) signal good times ahead? Will the upcoming wave of refinancings prompt a surge in SLL volumes? Is an increase in activity the inevitable result of the sustainable finance targets which most of the larger financial institutions have now set for themselves?

Wherever the figures end up in 2024, sustainable finance products and their evolution will remain a key focus area for finance and treasury teams across sectors and jurisdictions, with the flow of legal, regulatory and market developments showing no signs of slowing down. Below we consider some of the developments in sustainable finance to anticipate in 2024.

DEVELOPMENTS IN THE GOVERNANCE AND REGULATION OF SUSTAINABLE FINANCE PRODUCTS

Sustainable finance products have, until recently, been governed exclusively by voluntary recommended guidelines published by the LMA and ICMA.

2023 saw the first step towards more formal regulation of the market with the finalisation of the EU Green Bond Standard (**EU GBS**), a voluntary "gold" standard available to all green bond issuers in and outside Europe which will begin to apply from the end of 2024 at the earliest. There are no immediate plans to adopt a similar standard in the UK or US, but regulators around the world will no doubt be keeping a watchful eye on how far the EU GBS goes to improving the effectiveness, transparency and credibility of the green bond market, not least in the face of questions around its usability and adoption (discussed further in our client briefing **here**).

In the meantime, the debt trade associations are expected to continue to take the lead in the governance of sustainable finance products. The LMA and ICMA will be keeping their voluntary principles under review in the coming year, and each has several supplementary projects in the pipeline to support the growth and integrity of the market.

Increased regulatory scrutiny can, however, be expected. Earlier this year, the UK's FCA **outlined various concerns with the operation and integrity of the SLL market**, stating that it will continue to monitor the market with a view to considering the need for further measures as necessary. In the bond market, it is expected that sustainability disclosure requirements will be introduced for bond prospectuses as part of upcoming UK and EU prospectus regulation reforms, with ESMA having already outlined initial guidance for EU prospectuses.

INCREASED FOCUS ON MITIGATING GREENWASHING RISK

2023 saw a marked increase in greenwashing allegations. While the bulk of these claims have not arisen in a sustainable finance context, the unwavering focus on, and discussion of, greenwashing in a wider sustainability context has brought the risks within the sustainable finance market to the fore.

There is no agreed definition of greenwashing but in a sustainable finance context it typically manifests as the inappropriate use of the green, social or sustainability-linked product label, and can have significant reputational consequences.

Greenwashing concerns amongst sustainable finance market participants tend to manifest in increasing focus from lenders and investors on the materiality of KPIs and ambitiousness of SPTs in a sustainability-linked context, and of the green/social credentials of projects in a "use of proceeds" context, to ensure that ESG labels are being applied appropriately. Contractual protections sought by lenders in SLLs with a view to protecting against greenwashing, for example ESG amendment and declassification provisions, have become more widespread and detailed over the last year. Contractual protections along these lines are expected to evolve further as the market develops.

Mitigating greenwashing risk is, of course, of equal concern to borrowers and issuers. Risk mitigation is predominantly focussed on compliance with the relevant LMA/ICMA voluntary guidelines, which specify robust reporting and external verification processes. Compliance with these reporting and verification requirements requires treasury functions to collaborate with their wider sustainability teams. The upskilling of financing and treasury personnel in relation to the company's ESG strategy, risks and reporting requirements has become a priority for many businesses, both to mitigate greenwashing risks and to ensure that ESG messaging that comes into the public domain is robust and consistent.

INCREASED LENDER AND INVESTOR SCRUTINY AND DUE DILIGENCE

Increased ESG-related due diligence and scrutiny from lenders and investors of the ESG profile of borrowers and issuers has, in recent years, become a feature of all finance transactions (not just those with an ESG label). This is an area that continues to develop, driven in part by evolving reporting requirements (in the UK, the EU and internationally), as well as reputational pressure on the financial sector to lend responsibly and avoid greenwashing (as discussed above). This focus is set to continue into 2024.

Lender/investor due diligence, up until quite recently, has been heavily focussed on climate considerations. More recently (in light of the publication of the final TNFD recommendations) there has been greater focus on nature and biodiversity risks and strategies, and increasing discussion of the need to bring the 'S' and 'G' in ESG to the fore.

On climate-related matters, scope 3 emissions have become a particular focus for lenders and investors, who are increasingly asking borrowers and issuers for disclosures as well as the inclusion of scope 3 emissions targets in a sustainability-linked context. A lack of reliable data has, up to now, hampered many borrowers and issuers, but as reporting requirements expand and data flows improve, an uptick in scope 3-related disclosure and targets is foreseeable in the coming year. In the absence of available data, borrowers and issuers can expect to be put under pressure to indicate the timeframe within which such data will be available.

Increased focus on the role of transition plans in sustainable finance products is also expected in 2024, especially in the UK, following the launch of the Transition Plan Taskforce's Disclosure Framework in October 2023 and ongoing discussion around future legislative/regulatory requirements in relation to transition plans.

Access to financing for those in carbon-intensive sectors has become a key area of contention. Some lenders and investors, faced with overwhelming pressure from stakeholders, have over the course of 2023 adopted increasingly restrictive lending and investment policies with regards to these sectors. Where funding continues to be available, it is frequently conditional on having a robust and credible transition plan in place, a requirement which it seems likely will be extended to further sectors in the coming year.

The impact of ongoing work to regulate ESG rating providers, both at UK and EU level, on lender/investor due diligence also remains an area to watch in 2024, although it seems most likely that, if anything, ESG ratings will simply serve to supplement rather than replace existing due diligence processes.

DEVELOPMENTS IN THE STRUCTURE AND TERMS OF SUSTAINABILITY-LINKED PRODUCTS

The SLL and SLB products are conceptually accessible to a wider range of borrowers and issuers when compared to "use of proceeds" products, but this has not translated into volumes of sustainability-linked products (SLBs in particular). The 2023 recovery of SLL/SLB activity has been significantly weaker than, for example, the green bond market.

Faced with the same macro-economic and political headwinds, it is clear that the sustainability-linked market is facing deeper-rooted challenges which need to be addressed to facilitate further uptake and growth.

Nervousness from lenders, investors and regulators around the credibility of the asset class, particularly SLBs, has contributed to the reduction in volumes. The debt trade associations have sought to address this challenge through updates to their principles and accompanying guidance in 2023.

Reticence to issue sustainability-linked products currently appears more apparent on the borrower and issuer side. Sustainability-linked products, considered by early movers as an effective way for businesses to demonstrate their commitment to sustainability, may now not be viewed as critical, with wider corporate sustainability strategies and disclosures adequately fulfilling this role.

This is against the backdrop of very thin economic incentives to adopt sustainability-linked structures. As identified by the UK's FCA as part of its review of the SLL market mentioned above, the economic incentive structure for sustainability-linked products is weak, with margin discounts minimal (and increasingly so as a proportion of now higher borrowing costs).

This, coupled with the increasingly stringent reporting and verification requirements involved in sustainability-linked structures laid down in the latest LMA/ICMA principles (which no one disputes are important in protecting the integrity of the market but no doubt impose a greater burden on borrowers and issuers) and the extra scrutiny and greenwashing risk that comes with issuing a sustainability-linked product, and the calculation for borrowers and issuers is perhaps no longer what it was. Whether a reassessment of the incentive structure (in particular in the leveraged and other sectors of the loan market where relationship pricing is less apparent) might tip the balance for borrowers and issuers is a question that many have started to ask.

In addition to the incentive structure, the terms of sustainability-linked products, which are still relatively new and untested, have also been under the spotlight in 2023 to ensure they provide necessary levels of protection to lenders and investors (see the discussion on greenwashing above) as well as supporting the integrity of the wider market. ICMA recently added to its SLB guidance in this regard and, in May 2023, the LMA published template drafting for SLLs which addresses a number of these concerns. SLL and SLB terms will continue to evolve in 2024, with the direction of travel towards greater detail and complexity.

With sustainable finance now an established feature of the debt markets, the question of whether and how best to engage with the products available has become a question that is routinely considered by all market participants. 2023 was a testing year overall for the sustainable finance market. While there are some signs of recovery, aggregate volumes of sustainable financing mask an interesting dynamic at play, one in which green bonds have dominated and sustainability-linked products have lagged behind. Under pressure to increase volumes, we expect that lenders and investors will take steps to respond to product-specific challenges, supported and driven by efforts from governments, regulators and industry bodies, in recognition of the key role sustainable finance has been designated in advancing the wider sustainability agenda.

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