

Navigating the Shifting ESG Landscape and Its Impacts on Value Chains

Companies should be prepared for increasing demand to factor ESG into their value chains as well as new mandates from government authorities.

Latham & Watkins is pleased to introduce a series of Clients Alerts on ESG and value chains.¹ This series will address how the shifting ESG landscape is impacting global value chains and provide practical takeaways for companies looking to manage the risks and opportunities. The first Alert in this series focuses on increasing regulatory pressure in the US, Europe, and Asia and the resulting compliance challenges.²

As the world of ESG rapidly evolves, businesses increasingly are being held to account for ESG issues not only within their direct control, but also throughout their value chains. Often complex and transnational in nature, value chains, particularly the more attenuated aspects, can pose unique — and even hidden — ESG risks. If companies do not identify and manage these risks, they may result in reputational, operational, and economic losses.

Meanwhile, the world continues to reel from global supply chain disruptions due to the conflict in Ukraine, the COVID-19 pandemic, and climate change, among many other factors. Regulators, investors, consumers, and other stakeholders are increasingly demanding that companies also take into account ESG factors throughout their value chains, such as upstream and downstream environmental impacts and workforce and workplace considerations, in addition to traditional areas of compliance, including bribery or corruption issues.³

Failure to take into account these factors can lead to operational challenges, including supply chain disruptions, as well as regulatory scrutiny, corporate liability, shareholder and securities litigation risks, and significant brand and reputational damage.⁴ At the same time, businesses may be able to increase their resilience and versatility by thinking creatively about the risks and opportunities within their value chains.

Increasing ESG Regulatory Requirements

The United States

Climate Change

- In January 2022, the California Senate passed the Climate Corporate Accountability Act (CCAA), which would require public and private corporations with more than US\$1 billion in annual revenue to disclose all scopes of their greenhouse gas (GHG) emissions to the California Secretary of State's office.⁵
- In March 2022, the Securities and Exchange Commission (SEC) proposed climate-related disclosure rules that would require public companies to make certain disclosures regarding climate change-related matters, including Scope 1, Scope 2, and, in some cases, Scope 3 emissions.
- In June 2022, a group of climate change scientists and activists filed a petition with the Environmental Protection Agency (EPA) under the Toxic Substances Control Act (TSCA) requesting the EPA to make a TSCA Section 6 determination that greenhouse gases “present an unreasonable risk of injury to health or the environment” and “to impose requirements upon appropriate parties (a) to restrict or phase-out the manufacture (including production and importation) and, as warranted, the processing, distribution, use, or disposal, of the subject chemicals and mixtures, and (b) to compel industry to remove and, as necessary, to securely sequester legacy GHG emissions.”⁶

Sustainability Claims

- The Federal Trade Commission (FTC) announced plans to initiate review in 2022 of its 2012 “Guides for the Use of Environmental Marketing Claims” or “Green Guides.”⁷ As a result of this review, the FTC is expected to revise the Green Guides to address “sustainability” and other ESG-relevant marketing claims, including climate change-related marketing claims that it declined to address back in 2012 and that are encompassed within the SEC’s proposed climate-related disclosure rules.
- In 2021, Congress passed a law that mandated the White House Office of Science and Technology Policy (OSTP) to develop a consensus definition for the term “sustainable chemistry” and to coordinate federal programs and activities in support of sustainable chemistry.⁸ Under this mandate, OSTP has recently solicited public comment on different potential approaches to defining “sustainable chemistry” as well as on the technological, financial, economic, environmental, and other policy implications of those approaches.⁹ OSTP received comments from a wide range of stakeholders, including chemical manufacturers, complex goods producers, and consumer products companies, emphasizing the need for a flexible “sustainable chemistry” definition so as not to stifle innovation and the importance of standardizing life-cycle analysis approaches.
- In 2022, the EPA has restarted — and given a more prominent role and funding to — its “Safer Choice” program for identifying environmentally preferable substitute chemicals, while also evaluating requests to streamline its pre-market new chemical approval program for chemicals deemed “sustainable.”

Human Rights

- On June 21, 2022, the key operative provision of the Uyghur Forced Labor Prevention Act (UFLPA) entered into force, introducing a “rebuttable presumption” that any goods mined, produced, or

manufactured wholly or in part in China's Xinjiang Uyghur Autonomous Region are in violation of Section 307 of the Tariff Act of 1930. (Read Latham's [blog post](#) for more details.)

- In 2022, additional legislation has been introduced in Congress that would augment the UFLPA by requiring annual audits and reporting to the Secretary of Labor.¹⁰

The UK and the EU

- In June 2021, the European Commission, as part of its broader “Fit for 55” initiative, proposed a regulation to establish a European Union Carbon Border Adjustment Mechanism (CBAM) to avoid carbon leakage.¹¹ CBAM intends to regulate greenhouse gas emissions embedded in “covered products” (including, initially, cement, and certain iron, steel, and aluminum products) imported into the EU, which may otherwise offset the EU's greenhouse gas emissions reduction efforts that are to be led by revisions to the EU Emissions Trading System (EU ETS). In March 2022, the European Council reached an agreement on the terms of the CBAM, but inter-institutional negotiations have been held back due to the European Parliament's rejection of the proposed revisions to the EU ETS (which are closely related to the CBAM) in May 2022.
- In February 2022, the European Commission released a proposed directive on human rights and environmental due diligence that would require qualified EU and non-EU companies operating in the EU market to conduct human rights due diligence across their entire value chains and mitigate such risks.¹²
- In April 2021, the European Commission released a proposed directive called the Corporate Sustainability Reporting Directive (CSRD), which would require large companies and all companies listed on regulated markets to audit and disclose certain social and environmental information and to “tag” their reported sustainability information according to a digital categorization system.¹³ The specific disclosure requirements that companies would be subject to will be enumerated in a set of European Sustainability Reporting Standards (ESRS), drafts of which are currently under consultation and cover a variety of ESG topics, including value chains. If adopted, the CSRD would amend the provisions of the Non-Financial Reporting Directive (NFRD), adopted in 2014, which requires large public-interest companies with more than 500 employees to disclose certain social and environmental information.¹⁴ Approximately 11,700 companies are subject to the NFRD's reporting requirements, but the CSRD would increase the number of companies subject to its scope.¹⁵

Asia

- In January 2022, the Securities and Exchange Board of India (SEBI) released a consultation paper stating that it planned to regulate what it described as “ESG risk ratings” and “ESG impact ratings” alongside similar products, such as carbon risk ratings, ESG disclosure ratings, corporate transaction risk scores, and others. (Read Latham's [blog post](#) for more details.) Just this month, SEBI announced the formation of an ESG advisory board with the mandate to look at ESG ratings and ESG investing, among other issues.¹⁶
- In August 2021, the Singapore Exchange Regulation proposed amendments to require Singapore-listed companies to include climate-related disclosures that are consistent with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD Recommendations), and to improve board diversity.¹⁷ Singapore is also developing a taxonomy to classify green and transition activities in a bid to encourage the flow of capital to support low carbon transition. (Read Latham's [blog post](#) for more details.)

- Since 2018, China's Securities Regulatory Commission (CSRC) has introduced a series of consultation papers on and amendments to ESG disclosure requirements. In its most recent amendments in 2021, CSRC required disclosure of administrative penalties relating to environmental issues and encouraged companies to disclose measures they have taken to reduce carbon emissions.¹⁸ In January 2022, China's Ministry of Ecology and Environment issued new rules requiring domestic entities to disclose a range of environmental information, including carbon emissions and environmental management, on an annual basis.¹⁹

Challenges to Navigating ESG Developments

Companies face a number of challenges when it comes to navigating this rapidly evolving ESG landscape. Being aware of these challenges is a crucial step in determining how a company can assess the related risks and opportunities with respect to its value chains, particularly in the absence of standardized rules and regulations across jurisdictions. Below are a few examples of these challenges.

Accurately Identifying and Measuring Risks

Measuring ESG risks can be difficult, as much of the recent regulations and guidance do not clearly address just how far down a value chain a company must go to ensure ESG compliance. Companies may not be able to acquire quality data from second- and third-tier suppliers in complex value chains, or the data may simply not exist. Identifying operational exposure can further prove challenging for companies that have offshored and for companies that rely on third-party software providers with access to sensitive consumer and competitive data.²⁰ Furthermore, identifying risks that are material to one's specific industry, sector, or company, and assessing how those risks intersect with certain regulations, may prove difficult.²¹

ESG Disclosures

While the majority of US public companies disclose ESG information in one form or another (e.g., on their websites or through securities filings), increasing legal requirements and investor demand to provide ESG disclosures bring certain unique challenges. In particular, companies with complex and transnational value chains must analyze risks across those chains, and yet, may face challenges in fully understanding their options for mitigation as well as navigating different ESG disclosure requirements across various jurisdictions.

These challenges include difficulty in knowing what exactly to disclose in light of impacts from the pandemic, labor shortages, evolving sanctions, and climate change. This difficulty is even more pronounced for certain sectors such as the automotive and construction industries, which have been hit particularly hard due to shortages of raw materials (such as timber and cement) and semiconductor chips.²² As such, it may be necessary for any disclosures to contextualize the extent to which a company can account for its value chains and to identify any specific limitations a company faces in doing so.

Data Privacy and Security

At the outset, companies may face significant issues with data availability and verification across complex value chains, particularly in relation to the data needed for assessment and reporting of ESG risks. Partly to address this challenge, companies have increased data-sharing to help better anticipate and manage value chain disruptions and monitor risk, improve tracking and tracing, share information across supplier tiers, verify authenticity and compliance benchmarking, etc.²³ In this context, the use of emerging technologies, such as AI and digital twin technology, continue to grow. This growth poses new risks, such as potential algorithmic bias, which can include systematic bias in AI systems that often replicates human biases, including bias along racial lines.²⁴ Companies should

also be aware that when sharing information, they need to keep their data privacy, security, and intellectual property obligations front of mind.

Specific Ways to Manage ESG Risks and Opportunities

Future Alerts in this series will address specific ways that companies can manage ESG risks and opportunities. In the meantime, below are some broad steps companies may consider in order to effectively identify and manage ESG issues in their value chains.

Know what reporting requirements apply: Mandatory reporting requirements for value chain practices are increasing around the world, as discussed above. While companies operating in telecommunications, biotechnology, infrastructure, and energy have been subject to regulatory scrutiny for some time, such scrutiny is increasing across all sectors.²⁵ Companies should ensure that they are receiving the most up-to-date legal advice on reporting requirements and how such requirements impact their business practices and disclosures. Companies should also understand how reporting requirements across jurisdictions may overlap, create gaps, or potentially even create conflict.

Consider international guidance: Beyond mandatory reporting, companies can look to voluntary disclosure standards as guiding frameworks. These standards include those being set by the newly-formed International Sustainability Standards Board (ISSB), as well as those already in place, such as the United Nations Guiding Principles on Business and Human Rights (UNGPs) and OECD Due Diligence Guidance for Responsible Business Conduct (OECD Guidance). While not binding, such guidance has often been incorporated into national and regional regulations. Within these frameworks, companies should take into account the industry, geography, products, services, and stakeholders for purposes of evaluating and managing risks. In many instances, it may make sense to prioritize the highest areas of risk; get buy-in from stakeholders including leadership, suppliers, employees, and customers; and develop targeted methods of mitigating those risks.

Establish vendor engagement: Businesses should engage closely with suppliers through multiple supply chain tiers, include ESG considerations at the start of the procurement process and incorporate appropriate language into vendor contracts, consider including a supplier code of conduct, and have regularly updated performance indicators and obligations to flag problems.²⁶

Include ESG factors in due diligence and internal investigations: Appropriately factoring ESG considerations into business and investment decisions requires ensuring that value chain risks are a priority in the context of M&A due diligence. Close coordination with counsel is imperative for this process, as maintaining legal confidentiality can prove challenging when investigations include fact-finding in relation to third-party suppliers. Business and investment decisions may also then factor in specific actions to close ESG performance gaps uncovered in any due diligence process.

Ensure compliance and maintain oversight: Businesses should develop effective and measurable corporate policies and practices around ESG governance. This starts with company management and boards showing commitment to ESG as an important part of that business' operations. Developing dedicated systems to operationalize ESG policies, reporting on material ESG issues to senior management and the board, and maintaining appropriate controls for recordkeeping and document retention are also critical. Lastly, companies should consider various methods of oversight, audit protocols, and monitoring of value chains. Maintaining such intra-organization governance, compliance, and monitoring systems is likely to be particularly challenging for companies with large and complex corporate structures, but may be critical for assuring long-term compliance.

Conclusion

In light of increasing ESG-related scrutiny across multiple jurisdictions, companies are facing a number of challenges in navigating this shifting regulatory landscape. The cost of failing to take into account ESG in value chains is significant, and may include regulatory scrutiny, litigation risks, and reputational damage. Future Alerts in this series will delve into further detail about key ESG regulations that companies and counsel should be aware of. The Alerts will also identify steps for companies to formulate effective and appropriate actions in light of these emerging regulations and developments.

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Endnotes

¹ In this article series, the term "value chains" is used in a general, colloquial sense to encompass not only value chain concepts pertaining to consumers, but also to encompass supply chains in the fullest sense (i.e., not only direct suppliers, but also upstream and downstream suppliers and other supply chain actors, ranging from retailers to end users to post-end user entities, such as recyclers).

² Future Alerts will address developments in other regions.

- ³ <https://www.reuters.com/legal/legalindustry/staying-alert-esg-risks-opportunities-global-supply-chain-2021-08-09/>
- ⁴ <https://www.reuters.com/legal/legalindustry/staying-alert-esg-risks-opportunities-global-supply-chain-2021-08-09/>
- ⁵ <https://sd11.senate.ca.gov/news/20220126-senator-wiener%E2%80%99s-climate-corporate-accountability-act-passes-senate>
- ⁶ “Petition to Phase Out Greenhouse Gas (GHG) Pollution to Restore a Stable and Healthy Climate” (June 16, 2022): http://www.columbia.edu/~jeh1/Documents/TSCA_Petition_Part_I_2022.06.16.pdf. Another recent regulatory requirement includes California’s Transparency in Supply Chains Act. <https://oag.ca.gov/SB657>.
- ⁷ “Notification of intent to request public comments”, 86 Fed. Reg. 35239 (July 2, 2021), available at <https://www.federalregister.gov/documents/2021/07/02/2021-13724/regulatory-review-schedule>.
- ⁸ Subtitle E of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021 (Pub. L. 116-283), <https://www.congress.gov/116/plaws/publ283/PLAW-116publ283.pdf>.
- ⁹ Request for Information: Sustainable Chemistry, 87 Fed. Reg. 19539 (Apr. 4, 2022).
- ¹⁰ Slave-Free Business Certification Act of 2022, S. 3578 (Feb. 3, 2022).
- ¹¹ <https://www.consilium.europa.eu/en/press/press-releases/2022/03/15/carbon-border-adjustment-mechanism-cbam-council-agrees-its-negotiating-mandate/#:~:text=CBAM%20is%20designed%20to%20function,allocation%20of%20EU%20ETS%20allowances>.
- ¹² The European Union’s new Sustainable Finance Disclosure Regulation, which went into effect in March 2021, adds pressure in a different way. It requires funds to report details on how they integrate ESG characteristics into their investment decisions. That has led some money managers to drop the phrase “ESG integrated” from some of their assets, Bloomberg reported. Similarly, the EU released in January 2022 the “EU Taxonomy,” a common classification system for sustainable economic activities. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en#development.
- ¹³ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189>.
- ¹⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095>.
- ¹⁵ Other recent regulatory requirements include the UK government’s procurement policy note (PPN 06/21), which requires bidding entities for government contracts to have Net Zero Carbon Reduction Plans (June 2021); Germany’s Supply Chain Due Diligence Act (June 2021); and the UK’s Modern Slavery Act (2015).
- ¹⁶ https://www.sebi.gov.in/media/press-releases/may-2022/sebi-constitutes-advisory-committee-on-environmental-social-and-governance-esg-matters_58794.html.
- ¹⁷ Additionally, the Stock Exchange of Hong Kong (HKEX) released a consultation paper last spring proposing mandatory disclosure of gender diversity targets for boards. (See Latham’s [blog post](#) for more details.) In November 2021, HKEX published guidance for listed companies on climate-related disclosures that also follow the TCFD Recommendations. https://www.hkex.com.hk/News/Regulatory-Announcements/2021/211105news?sc_lang=en.
- ¹⁸ <https://www.eyonesg.com/2021/05/china-proposes-new-environmental-and-social-disclosures-for-listed-companies/>.
- ¹⁹ <https://www.eyonesg.com/2022/01/new-environmental-disclosure-rules-to-take-effect-in-china/>.
- ²⁰ <https://corpgov.law.harvard.edu/2020/08/14/the-other-s-in-esg-building-a-sustainable-and-resilient-supply-chain/>.
- ²¹ Additionally, most ESG rating agencies do not take into account global supply chains when measuring companies’ ESG performance, although such agencies are actively working on how to measure and assess such risks. In terms of carbon emissions, such agencies have not yet been able to adequately include “Scope 3 emissions” from a company’s supply chain partners and customers, due to the lack of data. <https://www.fastcompany.com/90698724/esg-investing-has-a-sustainability-blind-spot-supply-chains>.
- ²² <https://www.restructuring-globalview.com/2021/11/supply-chain-risk-and-increasing-costs-how-are-uk-businesses-building-resilience/>.
- ²³ <https://corpgov.law.harvard.edu/2020/08/14/the-other-s-in-esg-building-a-sustainable-and-resilient-supply-chain/>.
- ²⁴ <https://www.brookings.edu/research/algorithmic-bias-detection-and-mitigation-best-practices-and-policies-to-reduce-consumer-harms/>.
- ²⁵ <https://corpgov.law.harvard.edu/2020/08/14/the-other-s-in-esg-building-a-sustainable-and-resilient-supply-chain/>.
- ²⁶ Some companies are starting to distribute questionnaires to suppliers about ESG practices and require suppliers to comply with a responsible sourcing policy with respect to, for example, labor rights and sustainable sourcing of wood and paper. <https://www.ft.com/content/a35776c3-d263-4b4e-ae10-3985c386b058>.