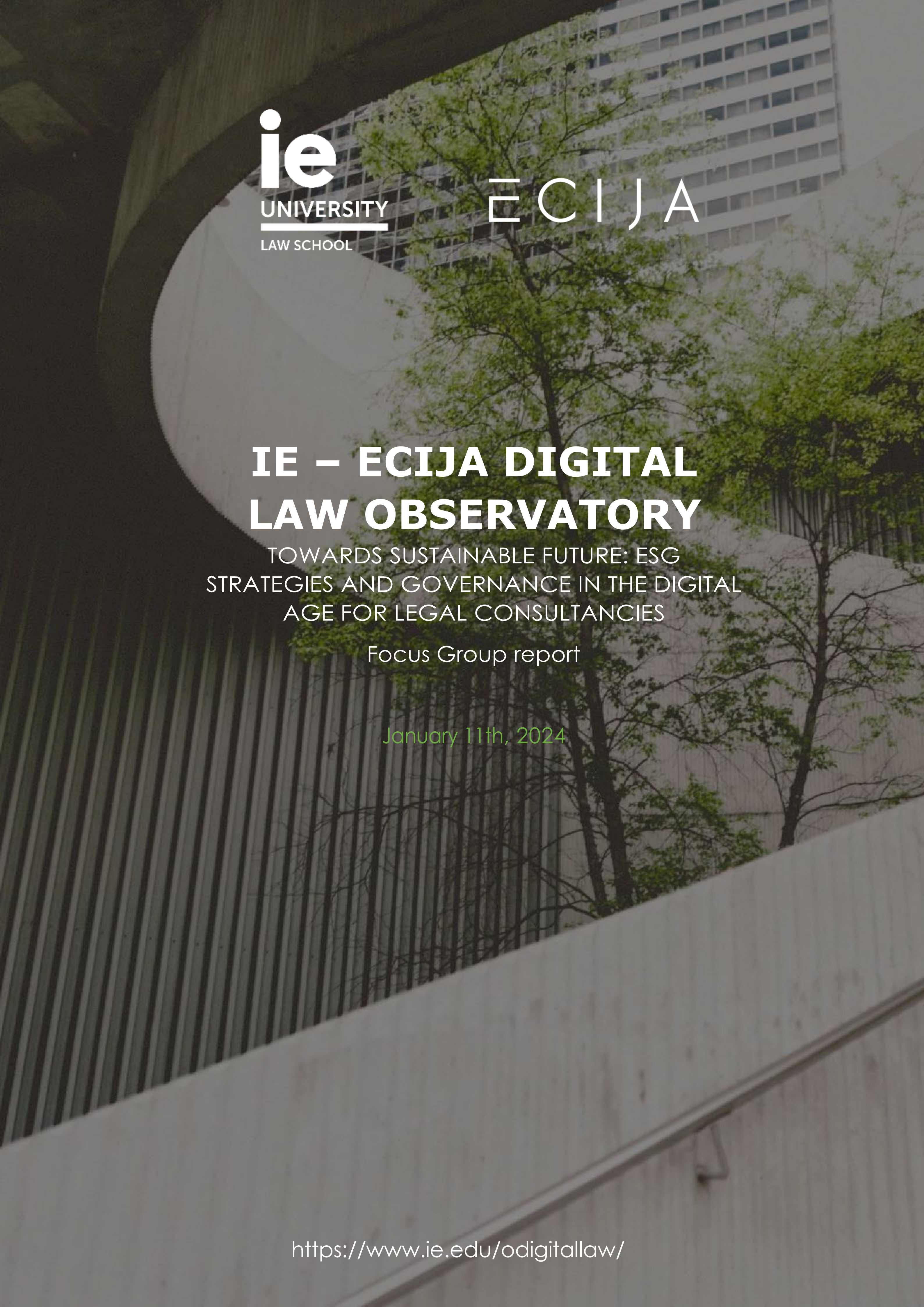


IE – ECIJA DIGITAL LAW OBSERVATORY

TOWARDS SUSTAINABLE FUTURE: ESG STRATEGIES AND GOVERNANCE IN THE DIGITAL AGE FOR LEGAL CONSULTANCIES

Focus Group report

January 11th, 2024

https://www.ie.edu/odigitallaw/

Introduction

We are in transition towards a new social, energy, and economic reality. We also witness a profound legal change. A new era of law in sustainability aspects for businesses, characterized by deeper and more stringent regulations, more cross-cutting and integrative, and above all, with an explicit transformative vocation.

This new regulatory framework has its origins in the United Nations' 2030 Agenda for Sustainable Development, dated September 25, 2015. The Sustainable Development Goals (SDGs) are established: Clean water and sanitation, affordable and clean energy, sustainable cities and communities, responsible production and consumption, climate action, underwater life, and terrestrial ecosystem.

The Paris Agreement of December 12, 2015, is of particular relevance, as it requires Parties to make nationally determined contributions (NDCs) in the coming years. This includes the obligation to periodically report on their emissions and their implementation efforts. There will also be a global inventory every five years to assess collective progress towards the purpose of the agreement and to report on new individual measures by the Parties.

Also of particular relevance is the European Union's Action Plan for the Circular Economy, dated December 2015 (Origin of the European Circular Economy Directives of 2018 that modify the Waste Framework, Landfill, End-of-Life Vehicles, Packaging Directives); and also, EU Directive 2019/904 on reducing the impact of certain plastic products on the environment, known as the "SUP Directive."

Likewise, the European Green Deal, dated December 12, 2019, will set the roadmap for making the EU a sustainable economy. Achieving this goal will require us to transform climate and environmental challenges into opportunities in all policy areas and achieve a fair and inclusive transition for all.
Europe needs a new growth strategy that transforms the Union into a modern, resource-efficient, and competitive economy, where:
i) Net greenhouse gas emissions have stopped by 2050, with climate neutrality as the objective;
ii) Economic growth is decoupled from the use of natural resources (a new model of circular economy, responsible production and consumption);
iii) And no people nor places are left behind (integral ecology).

The era of SOFT LAW (recommendations) is gradually giving way to HARD LAW (compliance with objectives and measures). In this regard, new climate laws incorporate binding climate objectives and establish mandatory measures of various kinds.

There are numerous environmental and social factors that already affect business strategy: water management, rational use of resources, biodiversity, climate change, carbon footprint, sustainable mobility, energy efficiency, waste management, circular economy, recycling, reuse, due diligence, value chain, risk prevention and mitigation, etc.

The integration of ESG (Environmental, Social, and Governance) into corporate strategy

New factors of corporate sustainability that should be integrated into corporate strategy:

Environmental Factors:

- Management of natural resources: Biodiversity.
- Climate change, carbon footprint, and energy efficiency.
- Waste management, water, and emissions.
- Circular Economy: Recycling and Reuse.

Social Factors:

- Customer satisfaction.
- Human rights, diversity, and inclusion.
- Health and safety of workers.
- Company's relationship with the communities in which it operates.
- Personal development.

Governance Factors:

- Definition, structure, and operation of the company (Ethics and Transparency).
- Performance by governing bodies and senior management.
- Operational risks (Cybersecurity and Supply Chain).

This transformation must be led by companies, including SMEs, thus taking center stage in this process of changing the economic model.

Regulatory Framework

Since 2018, a new regulatory framework has been established, with its precedent found in the obligations of companies regarding the preparation and dissemination of non-financial information. In this context, we find Law 11/2018, of December 28, on non-financial information and diversity (which amends the Commercial Code, the Consolidated Text of the 2010 Companies Law, and the Audit of Accounts Law of 2015).

The new legal framework is determined by Directive (EU) 2022/2464 of the European Parliament and of the Council of December 14, 2022, on sustainability reporting by companies (CSDR). This Directive requires companies to identify and assess their impact on sustainability issues, particularly the effect of their activities on the environment: to approve sustainability policies, report on the business model, describe environmental risks, set objectives for CO_2 emissions from 2030 to 2050, internal sustainability oversight bodies, sustainability-related incentive policies, and due diligence procedures.

This regulation will apply to large companies and those listed on regulated markets, except for microenterprises/small and medium-sized enterprises (SMEs) listed, non-European companies, small and non-complex financial institutions (Regulation 575/2013/EU), and captive insurance and reinsurance companies (Directive 2009/138/EC).

This regulation is expected to be implemented in three phases:

- Starting from January 1, 2024, for large companies (more than 500 employees) subject to the Directive on non-financial reporting.
- Starting from January 1, 2025, for large companies not subject to the Directive on non-financial reporting (more than 250 employees and/or a turnover of 40 million euros and/or 20 million in total assets).
- Starting from January 1, 2026, for listed SMEs and other companies.
- Starting from January 1, 2028, for non-European companies with subsidiaries or branches in the EU: the obligation to submit a sustainability report applies to all companies whose net turnover in the EU exceeds 150 million euros and which have at least one subsidiary or branch in the EU exceeding certain thresholds (more than 500 employees and 40 million euros in revenue).

Complementing the aforementioned CSDR Directive is the recent Regulation (EU) 2023/2772 of July 31 on Sustainability Reporting Standards (NEIS), effective from January 1, 2024, which distinguishes between Transversal, Thematic, and Sectoral standards.
Thematic Standards include:

- E1 Climate change, E2 Pollution, E3 Water and marine resources, E4 Biodiversity and ecosystems, E5 Rational use of resources and circular economy.
- S1 Own personnel, S2 Value chain workers, S3 Affected groups, S4 Consumers and end-users.
- G1 Corporate behavior.

The impacts, risks, and opportunities of the Value Chain must be assessed based on their Relative Importance (according to criteria of magnitude, scope, and probability) and Double Relative Importance (in terms of impact and financial terms).

There are also Directives in the approval process that will have a direct impact on companies, including:

Proposal for a Directive on new rules for substantiating green claims (Green Claims Directive). The aim is to establish common criteria against "greenwashing", in order to apply greater control and transparency to the environmental information that companies voluntarily use to promote their products. Companies will have to comply with minimum standards for substantiating and communicating such declarations (specific to all or part of the product, truthful, accurate, verifiable, and justified), and a series of minimum requirements will also be required for environmental labels, as they must be verified by a third-party assessment body (Regulation EC No 765/2008).

Proposed Directive on Due Diligence of companies regarding sustainability. It will affect limited liability companies in the EU with more than 500 employees and over 150 million euros in worldwide net turnover; with activities in defined sectors of significant impact and having more than 250 employees and a worldwide net turnover of 40 million euros; companies from third countries with activities in the EU with a turnover threshold generated in the EU that meets defined criteria.

This European regulation requires companies to integrate due diligence into their business strategies, determine actual or potential negative effects on human rights and the environment, prevent or mitigate possible negative effects, terminate or minimize actual negative effects, establish and maintain a complaints procedure, monitor the effectiveness of the strategy and due diligence measures, and publicly report on due diligence.

Alongside these regulations, there is a body of state laws defining the new energy and economic model, which affects companies, namely:

- Law 7/2021, of May 20, on climate change and energy transition. To address the "greatest challenge of humanity," a "[…] profound change in growth and development patterns" is necessary. The Law is a response to the international climate commitments of the Paris Agreement. It establishes the foundations for a new energy model that replaces fossil energy with renewable energy and imposes a new climate focus on public policies.

  The Law affects the economic model, promotes zero-emission vehicles and sustainable transport, mandates low-emission zones in municipalities with more than 50,000 inhabitants, installation of electric charging points at gas stations, consideration of climate change in all plans with climate impact, promotion of carbon sinks, just transition agreements, inclusion of climate considerations in public procurement, in the General State Budgets, and in the financial and energy system, and strengthening of citizen participation in decision-making on climate change.

- Law 7/2022, of April 8, on waste and contaminated soils for a circular economy. Transposes the Directives of the European circular economy package of 2015 and the SUP Directive. Regarding resource and waste management, it consecrates the hierarchy principle that aims to define the new model of production and consumption, prioritizing rational resource use, waste prevention, reuse, over material and energy recovery from waste and its disposal. To promote material recovery, reuse, and recycling, the Law establishes new targets for separate collection, recovery, recycling, and reuse.

The Law regulates a new model of extended producer responsibility (EPR) in which the entrepreneur will assume obligations regarding the product introduced into the market, from cradle to grave, being responsible (totally or partially) for organizing waste management (with distributors sharing responsibility). This new EPR affects the cost coverage system in the waste management process after the end of the life cycle of products introduced into the market. The financial contribution of companies will cover the costs of separate collection, transportation, waste treatment, cleaning of public roads, green areas, recreational areas, and beaches.

The new substantive regulations on sustainability will increase product warranty periods, guarantee the right to repair, and prevent premature obsolescence. In summary:

- Climate change legislation defines a new energy model and conditions the new model of development and economic growth.
- The need to aspire to a model that ensures the rational use of resources and the circular economy is enshrined in the law.
- The concept of the Circular Economy is introduced: it is a new responsible model of production and consumption. The Circular Economy model promotes more efficient resource utilization, extends the lifespan of products, prevents and reduces waste generation, enhances waste valorization, and reintroduces them as new resources in the production cycle, thereby contributing to sustainable economic growth, job creation, and the preservation of the environment and protected natural areas.
- The law requires companies to focus on both environmental and social aspects, even within the companies' Value Chain.
- The Value Chain is understood as all the activities required to carry out a product or service from its conception, through intermediate stages of production and delivery to final consumers and their final disposal after use.
- In the near future, throughout 2024, European companies will be subject to criteria for "Due Diligence" in environmental and social aspects affecting the entire Value Chain, posing compliance challenges for companies.
- Impact on corporate governance: Companies will have to report on their policies, protocols, and other internal standards in this regard, requiring the definition of a specific governance model on these matters.

In this new context, it is necessary for large companies to adopt appropriate internal organization measures to ensure compliance with the new obligations regarding due diligence and sustainability arising from existing or pending regulations, which will affect various internal units, including the Compliance function.

Therefore, a regime of competencies attribution and functions assignment should be articulated concerning the design, development, application, and supervision of sustainability plans, as well as strategic lines and general guidelines to mitigate the risk of causing adverse effects particularly in human rights and the environment resulting from the development of their own activities, those of their subsidiaries, or those carried out throughout the value chain, thus reducing the liability risk for companies and their managers.

New Opportunity Implications

As indicated, companies affected by Sustainability Due Diligence regulations must Identify, Assess, Prevent, and Mitigate the adverse effects of their economic activity throughout the Value Chain.

- They must specify the adverse effects present in their activities and commercial relationships, as well as the level of severity, probability, and urgency, and the data, information, and methodology that led to these conclusions.
- They will describe their value chain and, with due consideration for commercial confidentiality, publicly disclose relevant information about the company's value chain, which may include names, locations, types of products and services supplied, as well as other relevant data regarding subsidiaries, suppliers, and business partners in their value chain.
- They will take proportionate measures to halt, prevent, or mitigate adverse effects.
- Establish complaint mechanisms, such as early warning systems and mediation systems.

Companies must also develop and implement the Due Diligence Plan (with stakeholder participation) and communicate with representatives of their workers, unions, business relationships, competent national authorities, and potentially affected stakeholders.

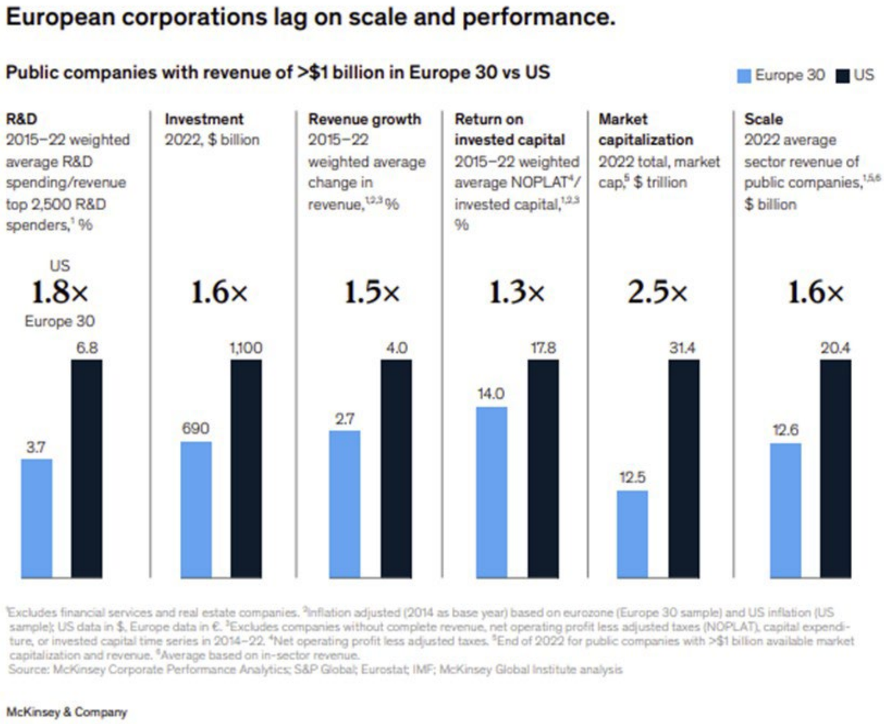
Risk Perspective

From the above, it follows that companies must implement a sustainability governance model from a risk perspective. This will involve the establishment of systems for:

- Evaluation and measurement.
- Control and monitoring.
- Forecasting and response planning.
- Protection of stakeholders.
- Identification and protection of new intangible assets.

The outsourcing of the Sustainability function has made it cross-cutting throughout the company, with extensive training at various levels of responsibility; for example, financial directors are assuming internal reporting functions in this regard. Corporate roles for Governance will be very different from now on: they will be defined by the new management system. With new management KPIs associated with the new model and new regulations (there will be criminal and civil liability for companies and their management bodies).

International investors, primarily institutional ones, have begun, as part of their engagement policies, to demand companies' sustainability roadmaps. A sustainability model, therefore, undoubtedly involves costs but also represents opportunities for European companies, potentially serving as a positive competitiveness factor in the future.



In other relevant markets, such as the USA, there has been significant litigation regarding greenwashing. Particularly noteworthy is the lawsuit filed by the New York State Attorney General against PepsiCo for polluting the Buffalo River and for greenwashing by "misleading" the public about its efforts to address it. In the fieldwork conducted by New York authorities on plastic pollution in the Buffalo River, it was concluded that most of the waste originated from the littering of single-use packaging (bottles, wrappers, and caps), which has adverse health and environmental effects due to microplastic pollution, a highly concerning environmental issue. Therefore, the focus is on extended producer responsibility, both in the design phase, during production, waste management resulting from use, risk prevention, and the environmental information provided by companies regarding the products they introduce to the market.

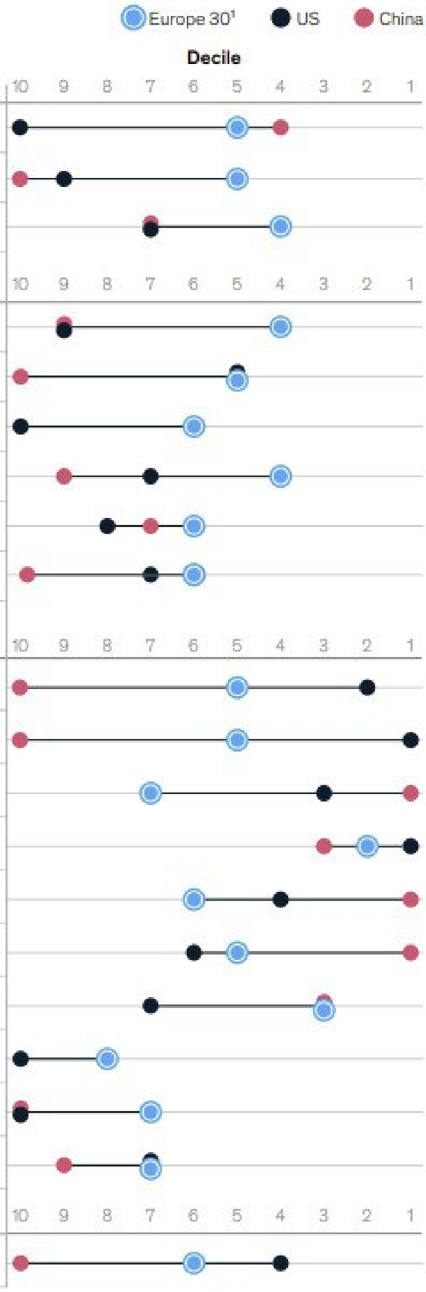
In the current situation, it is particularly significant to prevent rainbow washing and greenwashing through the aforementioned Green Claims Directive, which aims to apply greater control over the environmental information companies use to promote their products. Environmental product claims must be truthful, accurate, verifiable, and justified. Failure to comply with control and transparency obligations in environmental product claims may result in penalties: a fine amounting to at least 4% of the trader's annual turnover; confiscation of income obtained by the trader from a transaction involving the products in question; or temporary exclusion for a maximum of 12 months from public procurement processes and access to public funding, including tender procedures, grants, and concessions.

The rules are becoming increasingly disruptive, with greater mandatory content. This has led to the negotiation of ESG clauses gaining special importance.

Europe leads on sustainability and inclusion, but lags behind on growth and prosperity.

Decile ranking compared with OECD countries, by category/metric (1 = best, 10 = worst)

Category/metric	Europe 30 average[1]
Sustainability	
CO_2 emissions (consumption), megatons per capita, 2020	7.3
CO_2 emissions (production), kg per 2017 PPP $ of GDP, 2020	0.1
Fossil fuel consumption, % of primary energy, 2022	71%
Inclusion	
Income inequality, Gini index, 2022	30
Population below the empowerment line, 2020	27%
Poverty rate at national poverty lines, % of population, 2022	11%
Social mobility index, 2020	76
Life expectancy, years, 2021	81
Social progress index, 2022	86
Growth and prosperity	
GDP per capita,[2] $ 2017 PPP,[3] 2022	46,526
GDP per hour worked, $ 2017 PPP,[3] 2021	56
Number of hours worked per year,[4] 2022	1,571
GDP, $B 2015,[3] 2022	19,587
GDP growth 2000–22, $ 2017 PPP[3] CAGR	1.4%
GDP per capita growth, CAGR, 2000–22	1.3%
Current account balance, % of GDP, 2022	1.2%
Public debt, % of GDP, 2021	106%
Private debt, % of GDP, 2020	102%
Fertility rate, children per woman, 2022	1.5
Happiness	
Life satisfaction index, 2022	6.7



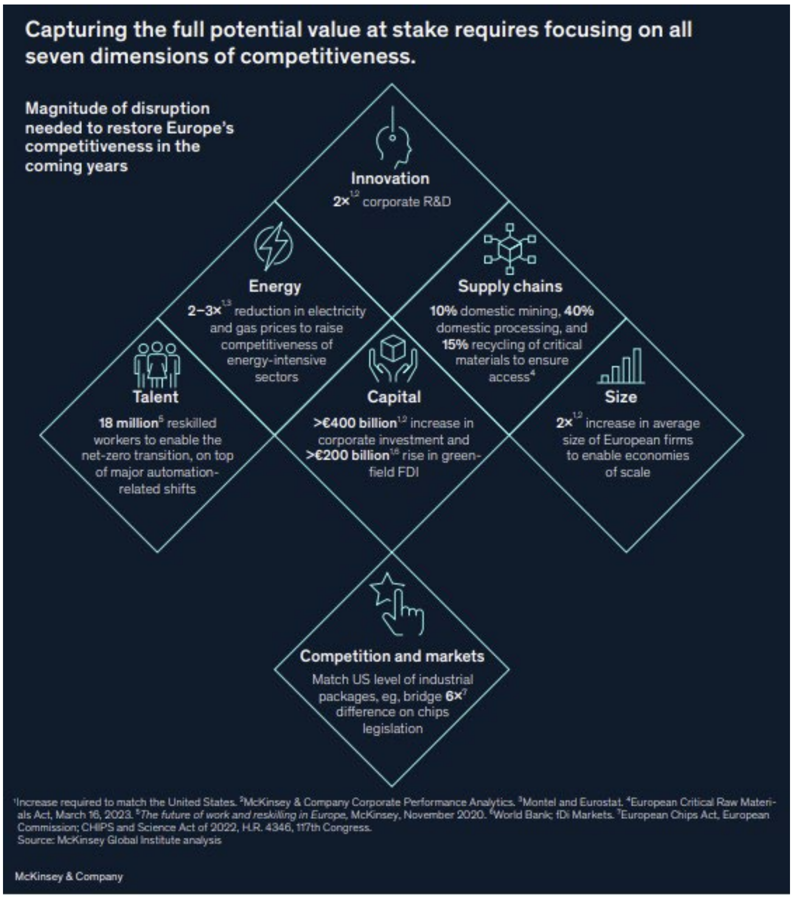
[1]Europe 30 includes the European Union plus Norway, Switzerland, and the United Kingdom. [2]Excluding Ireland and Luxembourg. [3]World Bank and OECD. [4]EU-27.

Source: Our World in Data; World Bank; Eurostat; World Economic Forum; Socialprogress.org; OECD; McKinsey Global Institute analysis

McKinsey & Company

How to make sustainability sustainable?

Not all companies can afford to have an ESG department. This fact seems evident due to the impact on internal costs:



Technology will indeed help us make all these sustainability requirements implementable. Certainly, Artificial Intelligence (AI), as an automated decision-making process, will be a great ally, highly useful for addressing all challenges related to the prevention and mitigation of damage to protected legal goods (environment and human rights).

Preventing potential adverse effects will depend on the geographical context and protected natural values, the sector of activity involved, the community where the activity takes place, the severity and likelihood of adverse effects, and the influence capacity that the company or its activity may exert on the direct cause of the impact.

In this context, machine learning and/or knowledge-based approaches can help develop Due Diligence Plans.

AI could be crucial for assessing and reviewing the effectiveness and suitability of due diligence measures and their implementation. AI could be used to serve the company's ESG strategy to improve:

- Environmental Factors (energy efficiency, carbon footprint, circular economy, recycling, and reuse);
- Social Factors (human rights, worker safety, relationships with consumers, communities);
- Governance Factors (transparency, operational risks, cybersecurity, supply chain).

In conclusion

Sustainability should be understood as a significant opportunity for businesses, and as such, it is being highly valued by various stakeholders, particularly by newer generations. This is affecting the Talent & Recruiting function, whereby advancements in this area are increasingly becoming an important aspect for retaining new talent.

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In this report, participants shared their experiences, knowledge and opinions. These opinions are the author's responsibility and do not necessarily represent those of the company.