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CLIMATE
Connecting Climate Change and the Law

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Table of Contents:

Cadwalader Climate

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In this week's edition we discuss the implications of a decision against the National Crime Agency, which the UK's Court of Appeal held had misinterpreted the law when it refused to investigate whether imported cotton was produced using forced labor. We also discuss the rise of "greenhushing;" the FCA's update for firms on the use of investment labels as part of its Sustainability Disclosure Regime; and the Network for Greening the Financial System's new reports on nature-related risks.

Court's Forced Labor and Human Rights Abuses Decision to Have Implications for UK Companies

On June 27, 2024, the UK Court of Appeal (CoA) ruled that the National Crime Agency (NCA) had misinterpreted the law by refusing to investigate whether imported cotton goods from the Xinjiang Uyghur Autonomous Region (XUAR) were produced using forced labor. In *World Uyghur Congress v National Crime Agency* [2024] EWCA Civ 715, the CoA identified two key legal errors in the NCA's decision:

1. The necessity to identify specific criminal property and conduct before initiating a Proceeds of Crime Act (POCA) investigation was incorrect. The CoA emphasized that the purpose of an investigation under POCA is to determine if recoverable property exists, not to confirm its existence beforehand.
2. The belief that adequate consideration (i.e., payment of a fair market price) anywhere in the supply chain would cleanse the goods of their criminal status was also incorrect. The court clarified that this does not prevent the goods from being considered criminal property in other contexts.

The CoA's ruling highlighted that enforcement agencies should be proactive in investigating potential corruption and human-rights abuses in supply chains, even without concrete initial evidence of specific crimes. The decision can be considered an important bellwether as regulatory and criminal authorities take steps towards holding companies accountable for ensuring their supply chains are free from forced labor.

The decision in the case also has significant implications for companies from an ESG perspective. The ruling clarifies that companies can be investigated and prosecuted under the Proceeds of Crime Act (POCA) if they know or suspect that their supply chains involve forced labor or other human-rights abuses. This creates a direct legal obligation for companies to ensure that their products are free from such taint, underlining the importance of comprehensive and recorded due diligence of global supply chains.

From a social perspective, this decision underscores the importance of human rights within ESG frameworks and marks a precedent that could lead to stricter scrutiny and potential prosecution of companies complicit in such abuses. Ensuring supply chains are ethical aligns with broader societal expectations as well as incoming regulation such as the Corporate Sustainability Due Diligence Directive (CSDDD). **As we have observed frequently**, the CSDDD contains rules "for companies regarding actual and potential human rights adverse impacts and environmental adverse impacts, with respect to their own operations, the operations of their subsidiaries, and the value chain operations carried out by entities with whom the company has an established business relationship," and liability for violations of those obligations. Even the current **scaled back version of the CSDDD** will have wide-ranging implications for companies. The directive is likely to have significant global impact given that companies not headquartered in the EU, but operating there, will also be in-scope. The *World Uyghur Congress* case now means that UK companies that may not have fallen under the scope of the CSDDD will nonetheless need to undertake similar due diligence, albeit only in respect of forced labor and human rights abuses.

Companies associated with forced labor and human-rights abuses also face a high risk of reputational damage. The ruling highlights the need for transparency and ethical practices in supply chains, as failing to address these issues can lead to negative publicity, loss of consumer trust, and potential boycotts.

Investors are increasingly focusing on ESG criteria when making investment decisions, and the ruling may prompt them to scrutinize companies' supply chains more closely, seeking assurance that they are free from human-rights abuses. An example of how such issues can impact the cost of capital for companies is currently being played out in the London IPO market at the time of writing this article. Fast fashion company Shein's plans for a London public listing have come under scrutiny, with the Financial Conduct Authority (FCA) being **urged to block** the listing over forced-labor concerns. The company has been accused of using cotton produced in XUAR through forced-labor and exploitation. The controversy may affect the value of the listing, as well as timing if the FCA chooses to investigate the allegations. The claims have also raised questions around the recourse available to investors for recouping losses in

English courts if it later emerges that human-rights abuses were in fact present in a company's supply chain, despite statements made to the contrary.

The *World Uyghur Congress* decision also emphasizes the need for robust compliance programs and accurate ESG reporting. Companies must demonstrate that they have effective measures in place to prevent forced labor in their supply chains and transparently report on their efforts. This aligns with growing regulatory requirements and market expectations for ESG disclosures.

Although the case is *prima facie* of greater relevance to the NCA's decision-making process in relation to launching investigations appropriately, the ruling reinforces the necessity for companies to integrate strong ESG practices, particularly concerning social and governance aspects, to mitigate legal risks, uphold human rights, maintain their reputation, meet investor expectations, and comply with evolving regulations.

Report Highlights Increase in Greenhushing

Regular readers of this publication will be acutely aware of the increasing prevalence of greenwashing and the ensuing proliferation of legislation and regulation designed to reduce and prevent it. But few will be as familiar with so-called "greenhushing"; where companies deliberately downplay or withhold information about their sustainability efforts. This trend is emerging as businesses face increased scrutiny and fear of backlash from stakeholders over their environmental claims, according to **The Transparency Index 2024 report** published in July.

The report provides analysis of the ESG transparency of the top 200 companies in the UK and U.S. (that is, the UK's FTSE 100 and the top 100 largest public and private U.S. companies using publicly available revenue data) and evaluates how well these companies disclose and communicate their ESG efforts, identifying gaps between their actions and their public communications. The report estimates that six in ten (58%) of the U.S.'s 100 largest public and private companies are trying to avoid greenwashing concerns by greenhushing. While many companies balance ESG commentary with factual disclosures, some have significant transparency gaps, either under-communicating or over-promoting their ESG efforts.

The report was produced by reviewing over 600,000 corporate communications over the course of 12 months, looking at discrepancies between company actions/disclosures and their communications on ESG topics.

Recommendations made in the report include that companies should strive to balance their ESG disclosures and communications to build trust and credibility. In addition, the authors say that transparent and honest reporting, even on challenges and areas needing improvement, is more beneficial than glossy promotions.

A major driver of greenhushing is what some companies perceive as a complex and sometimes hostile environment around ESG reporting. Companies find themselves in a dilemma: disclosing their sustainability initiatives can lead to criticism for not doing enough or, conversely, for compromising profitability; **a dilemma also facing asset managers**. This conundrum has led some companies to "go green, then go dark," opting to quietly pursue sustainability without publicizing their efforts.

The negative implications of greenhushing are significant. It can stymie industry-wide progress by reducing transparency and collaboration, which are crucial for collective climate action. When companies do not share their sustainability practices, it becomes challenging for stakeholders, including consumers and investors, to make informed decisions. Additionally, it can erode trust in corporate sustainability efforts, fostering skepticism about the authenticity of environmental claims.

Recent regulatory developments are also influencing greenhushing. In the U.S., the Federal Trade Commission is updating its Green Guides, which govern environmental marketing claims, to provide clearer guidelines and stronger enforcement against greenwashing. Similarly, the EU's Green Claims Directive aims to curb false advertising about sustainability. These regulatory efforts, while necessary to prevent greenwashing, may inadvertently contribute to greenhushing as companies fear potential legal repercussions from missteps in their ESG disclosures.

Despite these challenges, experts, including the report's authors, argue that transparency is vital. External verification of sustainability claims and regular engagement with stakeholders are recommended strategies to enhance credibility and avoid the pitfalls of greenhushing. Looking beyond overcoming regulatory and compliance concerns, **85% of investors reportedly believe** ESG assets – which surpassed $30 trillion in 2022 – lead to better returns. Companies engaging in greenhushing are therefore potentially missing opportunities for investment.

The ongoing debate around greenhushing highlights the need for balanced and transparent communication about corporate sustainability efforts. As the regulatory landscape evolves, it is essential for companies to navigate these changes thoughtfully, ensuring that their environmental contributions are both genuine and visible.

FCA Updates Notification on Use of Investment Labels Under Sustainability Disclosure Requirements Regime

On July 1, 2024, the Financial Conduct Authority (FCA) **updated its guidance** on the notification of the use of investment labels under the Sustainability Disclosure Requirements (SDR) regime. Firms can start using the sustainability labels from July 31, 2024, and must comply with naming and marketing rules by December 2, 2024. Firms need to notify the FCA of their intention to use these labels through the FCA's online notification system before they begin using them. The FCA does not approve the labels but requires notification when labels are used, revised, or discontinued.

As we have discussed previously, the FCA introduced four sustainability investment labels under the SDR:

- *Sustainability Focus*, for funds which invest in assets that are environmentally and/or socially sustainable determined by a robust evidence-based standard of sustainability.
- *Sustainability Improvers*, for funds which invest in assets that have the potential to improve their environmental and/or social sustainability over time, determined by their potential to meet a robust, evidence-based standard of sustainability over time (this is required to be an absolute measure).
- *Sustainability Impact*, for funds which achieve a predefined, positive, measurable impact in relation to an environmental and/or social impact.
- *Sustainability Mixed Goals*, for funds which invest in two or more of the above sustainability objectives.

All labeled products must meet certain overarching criteria, such as having a clear sustainability objective, investing at least 70% of assets in line with this objective, and maintaining robust governance and stewardship strategies.

Firms must provide both consumer-facing disclosures and detailed product-level disclosures. These disclosures must be regularly reviewed and updated, ensuring transparency and accuracy regarding the sustainability characteristics of the products.

Products that do not use a sustainability label but employ sustainability-related terms in their naming and marketing must still meet specific criteria, including ensuring that 70% of assets possess sustainability characteristics and providing clear, accessible disclosures about these characteristics.

The FCA's SDR and investment labels regime includes the anti-greenwashing rule, which we discuss in detail in a related publication **here**.

The FCA will oversee compliance through its standard supervisory and enforcement approaches.

Network for Greening the Financial System Publishes Complementary Reports on Nature-Related Risks

In July 2024, the Network for Greening the Financial System (NGFS) **published two complementary reports** focused on integrating nature-related financial risks into financial frameworks and understanding nature-related litigation risks.

Conceptual Framework for Nature-Related Financial Risks

The objective of the first of the two reports is to establish a foundational approach for identifying, assessing, and managing financial risks associated with nature, complementing existing climate-related financial risk frameworks. Key elements are as follows:

- *Risk Categories:* Defines nature-related risks as physical, transition, and systemic. Physical risks include direct impacts on businesses from biodiversity loss, while transition risks arise from shifts towards a nature-positive economy.
- *Risk Transmission Channels:* Highlights how nature-related risks can affect financial stability through various channels, such as credit risk, market risk, and operational risk.
- *Assessment Methodologies:* Proposes methodologies for assessing these risks, including scenario analysis and stress testing, emphasizing the need for data and analytical tools to evaluate nature-related impacts accurately.

- *Integration into Financial Supervision:* Recommends integrating nature-related risks into existing financial supervision and regulatory frameworks, encouraging collaboration between regulators, financial institutions, and other stakeholders.

Nature-Related Litigation

The aim for the NGFS's second report is to explore the emerging risks and trends associated with nature-related litigation and their implications for financial institutions. Key elements include:

- *Litigation Drivers:* Identifies drivers of nature-related litigation, such as regulatory changes, evolving public awareness, and the increasing role of non-governmental organizations (NGOs) in holding companies accountable for biodiversity impacts.
- *Types of Litigation:* Discusses various types of nature-related litigation, including cases related to deforestation, pollution, and breaches of environmental laws, and how these cases are increasingly targeting financial institutions for their role in financing harmful activities.
- *Risk Management:* Highlights the importance of understanding and mitigating litigation risks through due diligence, better disclosure practices, and proactive engagement with stakeholders.
- *Case Studies:* Provides case studies to illustrate how nature-related litigation has evolved and its potential financial impacts, underscoring the need for financial institutions to adapt to this emerging risk landscape.

By publishing these reports, the NGFS aims to underscore the urgency of incorporating nature-related considerations into financial decision-making processes, emphasizing the dual approach of managing direct financial risks and addressing potential litigation threats.

Launched in 2017, the NGFS is a group of 125 central banks and supervisors based on five continents that share best practices and contribute to the development of environment and climate risk-management in the financial sector, and seek to mobilize mainstream finance to support the transition toward a sustainable economy. NGFS members themselves are responsible for the supervision of all global systemically important banks and 80% of internationally active insurance groups. The NGFS often publishes reports and guidance including in April 2024 when it **published three reports** analyzing the role of transition plans in the financial system.

The NGFS's focus on nature-related risks is part of a broader trend. **As we discussed in our July 2 edition**, the European Council voted to adopt the delayed EU Nature Restoration Law obligating Member States to reverse environmental and ecosystem damage to land and seas in their jurisdictions. The regulation is the EU's response to the Kunming-Montreal Global Biodiversity Framework (GBF) adopted during the fifteenth meeting of the Conference of the Parties (COP15). The GBF supports the achievement of the United Nations' Sustainable Development Goals and sets an ambitious pathway to restore and implement measures to maintain nature and biodiversity. In September 2023, the Taskforce on Nature Related Disclosures **published its final recommendations** and in the same month, the UK and France set out plans to **launch a new biodiversity credits scheme**. Various sectors have also been urged to do more to achieve biodiversity targets such as **banking** and **insurance**.