MAYER • BROWN

Legal Update
September 2013

Environment, Social and Governance ("ESG") New UK Mandatory Reporting Rules

The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (the **"SR Regulations"**) come into force on 1 October 2013.

The SR Regulations both extend the scope of mandatory non-financial reporting obligations in the UK and introduce a new format for reporting.

The SR Regulations are another step in the emergence of ESG as a top-of-mind boardroom issue. This has been prompted by the conviction that companies that address ESG concerns can achieve higher growth rates and increased profitability, better stakeholder reputation and improved brand strength and an acknowledgement that ESG risks can seriously undermine investor confidence and the long-term prospects for businesses.

For some time, major companies have embraced voluntary reporting on sustainability issues, but mandatory ESG reporting presents particular liability risks.

What you need to know is how to avoid criminal, civil sanctions or reputational damage for deflective reporting.

In this update, we consider the challenges mandatory ESG reporting presents and how the risks can be mitigated, summarise the changes to be introduced by the SR Regulations and look forward to what's in the pipeline in terms of ESG regulation. We begin with a summary of the legal requirements.

ESG Mandatory Reporting: the Requirements

The SR Regulations abolish the requirement on companies[1] to publish a Business Review and replace it with a requirement to produce a Strategic Report. They also introduce changes to the content of the Directors' Report. The requirements take effect for companies whose financial year ends on or after 30 September 2013.

It is important to appreciate the differentiated requirements for quoted, large and medium companies in this area and these are summarised in the table below.

First, we set out the changes introduced by the SR Regulations for quoted companies.

The scope of the Strategic Report differs from that of the Business Review in the following ways. Quoted companies have to provide "*to the extent necessary for an understanding of the development, performance or position of the company's business*":

- information about human rights issues alongside social and community issues;
- a gender breakdown at the end of the financial year of the directors of the company, the senior managers and employees of the company.

If the report does not contain this information, it has to say so clearly.

The new focus on human rights follows the adoption of the UN Guiding Principles on Business and Human Rights and follows the publication this month of the UK Government's action plan on how businesses should integrate human rights considerations into their activities.

The SR Regulations also introduce a new requirement on quoted companies to state the annual quantity of emissions expressed in terms of tonnes of carbon dioxide equivalent arising from the activities for which that company (and its consolidated undertakings) is responsible (for example, from direct emissions to the atmosphere) and arising from the purchase of energy for heating or cooling.

1 Excluding "small companies".

Taking these changes together with existing reporting requirements, the UK's mandatory ESG provisions can be summarised as follows.

Type of disclosure	Quoted companies	Large companies	Medium-sized companies
Principal business risks and uncertainties	✓	✓	✓
Analysis of Key Performance Indicators (**"KPIs"**) for non-financial matters	✓	✓	X
Business strategy and model	✓	X	X
Environment Employees, Social, Community and Human Rights Diversity	✓	X	X

These requirements are supported by draft "Guidance on the Strategic Report" published in August 2013 by the Financial Reporting Council. In addition, DEFRA has published guidance on "Environmental Reporting Guidelines" (June 2013) to assist companies in preparing their reports.

Legal & Reputational Risk

ESG reporting presents a number of challenges for businesses and getting it wrong can have serious consequences. If companies fail to comply with mandatory reporting obligations, the directors can face fines. In addition, defective or inadequate sustainability reporting can lead to requirements by regulators to amend reports. Indeed, the Financial Reporting Council has taken such action in the past in connection with a complaint about sustainability reporting from a mining company.

In addition, in the US, investors are currently pursuing litigation against a large energy company based on supposedly recklessly made claims about the sustainability performance of the company.

Problems can arise for businesses because of the multiplicity of standards for reporting of sustainability issues – this is especially the case as companies move from voluntary to mandatory reporting, but it is not restricted to this. Carbon emissions, for instance, are frequently reported under a number of different schemes, often with differing requirements, conversion factors and boundaries. This can cause confusion, which can lead to accusations (often unfair) of a lack of consistency and candour.

Sustainability information is also often disseminated by a range of people within a business: again giving rise to a risk of inconsistency. Therefore, the key elements of any risk mitigation strategy must be:

- **balance**: not only is this requirement set out in SR Regulations, but unremittingly positive ESG reports are, in practice, a prime target for activist NGOs;
- **transparency**: the source of information and supporting materials should be clearly signposted in the Strategic Report;
- **consistency**: internal control and reporting lines should be put in place to mitigate the risk of contradictory messages being disseminated to stakeholders.

Understanding how to manage disclosures relating to actual or potential litigation, preserving legal privilege in respect of draft ESG reports and assuring compliance with legal requirements on reporting, are some of the ways in which lawyers assist in mitigating ESG risk.

Looking forward

ESG is one of the megatrends shaping the business landscape, both because of the risks and the opportunities it presents.

Increased regulation is inevitable: the EU, for instance, has published a proposal for a Directive on mandatory ESG reporting for quoted and large companies and we can expect to see developments in the concept of integrated reporting with the publication of sustainability accounting standards.

As the ESG agenda gains momentum, we also expect to see more companies linking ESG performance to remuneration, as some have already done.

If you have any questions or require specific advice on any matter discussed in this update, please contact:

Michael Hutchinson
Head of Environment Group
Tel: +44 (0) 20 3130 3164
E: mhutchinson@mayerbrown.com

Kate Ball-Dodd
Partner, Corporate & Securities Group
Tel: +44 20 3130 3611
E: kball-dodd@mayerbrown.com

Mayer Brown is a global legal services organisation advising many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. Our legal services include banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

OFFICE LOCATIONS AMERICAS: Charlotte, Chicago, Houston, Los Angeles, New York, Palo Alto, Washington DC
ASIA: Bangkok, Beijing, Guangzhou, Hanoi, Ho Chi Minh City, Hong Kong, Shanghai, Singapore
EUROPE: Brussels, Düsseldorf, Frankfurt, London, Paris
TAUIL & CHEQUER ADVOGADOS in association with Mayer Brown LLP: São Paulo, Rio de Janeiro

Please visit our website for comprehensive contact information for all Mayer Brown offices. www.mayerbrown.com

0134env
September 2013