GEORGIA JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW

VOLUME 52 | 2024 | NUMBER 3

SYMPOSIA

ESG AND CORPORATE SUSTAINABILITY: A VIEW FROM THE UK

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[*] University of Warwick School of Law, UK. Paper presented at symposium 'ESG and Corporate Sustainability: Global Perspectives on Regulatory Reform' Monday, October 16, 2023, Larry Walker Room, Dean Rusk Hall, University of Georgia School of Law.

ABSTRACT

The idea that companies and corporate governance should contribute to sustainability is gaining ever greater acceptance, but there is far less consensus on how exactly this is supposed to happen. The mainstream approach, and the one currently taken by the United Kingdom ("UK"), has been that shareholders (and especially institutional investors) should be informed so that they can press companies to bring their activities in line with the imperatives of sustainability. This is reflected in the emergence of Environmental, Social, and Governance (ESG) investment, in which investor preferences for companies that disclose good ESG performance or receive good ESG ratings from third-party agencies are supposed to steer companies toward more sustainable business.

Since 2006, the UK's approach to mandatory corporate non-financial and sustainability reporting has been narrowly financial, intending to inform shareholders so that they can steer companies to take more or less account of what we now call ESG matters. Despite the UK leaving the European Union ("EU"), it appears that many large UK companies will still have to follow the new EU sustainability disclosure rules, which extend further, requiring disclosure of stakeholder impacts. Moreover, some UK companies will have to follow EU rules on mandatory environmental and human rights due diligence in the near future. The EU has also proposed regulation of ESG rating providers that goes further than the UK's recently published code of conduct. Beyond these developments, the UK's corporate governance and stewardship codes pay lip service to questions of corporate purpose, sustainability, and ESG matters but remain primarily oriented towards shareholder value.

I. INTRODUCTION

The idea that corporate governance should contribute to sustainability is gaining greater acceptance, but there is far less consensus on how exactly this is supposed to happen. The mainstream approach, and the one currently taken by the UK, is that informed shareholders (and institutional ones in particular) should press companies to bring their activities in line with sustainability imperatives. This is reflected in a shift in terminology from market-driven corporate social responsibility ("CSR"), in which board decision-making is central, to market-driven Environmental, Social, and Governance ("ESG") investment, in which investor preferences are central and should steer companies towards a more sustainable approach to business.[1]

ESG appears to have originated from a group of financial institutions in 2004 in response to an invitation from the United Nations to consider integrating environmental, social, and corporate governance issues into asset management.[2] It is more focused on sustainability than its predecessor, CSR, which all too often amounts to little more than corporate reputation management rather than a concerted effort on the part of companies to internalize their social and environmental externalities.[3] However, ESG does not map perfectly with sustainability either. The "environmental" and "social" aspects of ESG certainly seem to correspond to two of the three generally accepted principal dimensions of sustainability: environmental, social, and economic.[4] That leaves the "governance" aspect to correspond to "economic"

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[1] Ian MacNeil & Irene-marié Esser, *From a Financial to an Entity Model of ESG*, 23 EUR. BUS. ORG. L. REV. 9, 10 (2022).
[2] Igor Filatotchev et al., *Bringing the "S" Back to ESG: The Roles of Organizational Context and Institutions*, 56 J. FIN. TRANSFORMATION, 51, 51-60 (2022).
[3] Mark Eisenegger & Mario Schranz, *Reputation Management and Corporate Social Responsibility*, *in* THE HANDBOOK OF COMMUNICATION AND CORPORATE SOCIAL RESPONSIBILITY (Øyvind Ihlen, Jennifer L. Bartlett & Steve May eds., Wiley 2011); *see also* Andrew Johnston, *Facing Up to Social Cost: The Real Meaning of Corporate Social Responsibility*, 20 GRIFFITH L. REV. 221, 222 (2011).
[4] *See* Rep. of the World Comm'n on Env't and Dev.: Our Common Future, U.N. Doc. A/42/427 (Aug. 4, 1987) [hereinafter *Brundtland Report*]. In its 1997 resolution, the UN noted that "[e]conomic development, social development and environmental protection are interdependent and mutually reinforcing components of sustainable development." G.A. Dec. 51/240, U.N. Doc. A/RES/51/240, at 2 (Oct. 15, 1997). The *Brundtland Report* is famous for saying that "sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs." *Brundtland Report*, ch. 2, para. 1. However, it also said that "[t]he common theme throughout this strategy for sustainable development is the need to integrate economic and ecological considerations in decision making. They are, after all, integrated in the workings of the real world. This will require a change in attitudes and objectives and in institutional arrangements at every level." *Id*. at ch. 2, para 72. "Sustainability requires the enforcement of wider responsibilities for the impacts of decisions. This requires changes in the legal and institutional frameworks that will enforce the common

sustainability. This final category could embrace corporate risk management processes that aim to ensure the survival and success of the company over time. One aspect of these risk management processes may be conducting due diligence to identify, govern, mitigate, and internalize social and environmental costs. However, the "G" could also embrace much of the apparatus of shareholder primacy corporate governance, which is the root of much unsustainable economic activity and which, from a progressive view at least, the "corporate sustainability" movement is supposed to counteract. Moreover, most ESG analyses are done by rating agencies rather than institutional investors, with ratings handed out in accordance with schemes drawn up by raters. In the case of MSCI, the largest rating agency with around 60% of the market, its scheme focuses not on how companies impact the world but on the more "financially relevant" question of how ESG issues might impact the company and its shareholders.[5] By measuring whether the environment and societies in which companies operate are able to sustain or support those operations, ESG ratings consider economic sustainability but have moved a long way from the original tripartite notion of sustainability. In any event, ESG became mainstream as asset managers began pushing companies to make disclosures about ESG matters in order for them to rank their ESG performance as a means of managing risk in portfolios and selling funds that have a greater or lesser emphasis on ESG to institutional and retail investors. The rating agencies then simplified things for buyers and sellers of corporate securities by producing evaluations of companies' ESG performance. These evaluations are very widely used by asset managers and asset owners and, therefore, have a significant impact on the allocation of capital.

Given their growing influence, concerns have been expressed about the reliability of ESG ratings, as different rating agencies provide divergent assessments of companies.[6] Moreover, there are concerns about the use of a financial materiality methodology, which focuses on the impact of social and environmental factors on companies' financial performance rather than on the impact companies have on society and the natural environment. As a result,

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interest. Some necessary changes in the legal framework start from the proposition that an environment adequate for health and well-being is essential for all human beings including future generations. Such a view places the right to use public and private resources in its proper social context and provides a goal for more specific measures." *Id.* at ch. 2, para 76. "In its broadest sense, the strategy for sustainable development aims to promote harmony among human beings and between humanity and nature." *Id.* at ch. 2, para. 81.

[5] Cam Simpson et al., *The ESG Mirage*, BLOOMBERG (Dec. 10, 2021), https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/.

[6] Florian Berg et al., *Aggregate Confusion: The Divergence of ESG Ratings*, 26 REV. FIN. 1315, 1315 (2022).

poor performance on climate change is not necessarily reflected in a company's ESG ratings. For example, MSCI did not include carbon emissions when rating McDonald's on the basis that climate change did not pose a risk or opportunity for the company's business.[7] Finally, a lack of transparency about how ratings are determined affects not only investors but also companies themselves, as they find it hard to understand how they can improve their ESG ratings.[8] The upshot is that the contribution of large companies to sustainability has become rather peripheral to the ESG calculus. Their sustainability performance may be quite far removed from what retail and institutional investors expect when they put money into investment funds with an ESG focus.

In mainland Europe, at least, ESG reporting has recently moved beyond corporate voluntarism. With the introduction of the EU's Corporate Sustainability Reporting Directive (CSRD), mandatory sustainability reporting is now part of mainstream corporate governance, and the disclosure requirements are intended to correspond to the needs and expectations of users and undertakings for ESG reporting.[9] However, the EU's mandatory sustainability reporting goes beyond the practices of the dominant ESG rating agencies, requiring disclosures on a 'double materiality' basis, encompassing both disclosures relevant to investors and disclosures about corporate impact that will be relevant to stakeholders.

The UK once led Europe in sustainability reporting by requiring companies to comply with the narrower, financial materiality-focused *Recommendations of the Task Force on Climate-Related Financial Disclosures* (TCFD). However, it now lags behind, preferring to rely primarily on voluntary adoption of international standards by companies. Following the UK's departure from the European Union in 2020 ("Brexit"), the UK is not formally bound by the EU's CSRD. The UK has now announced its own plans for sustainability reporting but only on a financial materiality basis, which may become mandatory in time. However, as in so many matters, formal regulatory sovereignty may be little more than a mirage, not least because of the "Brussels Effect."[10] Joanne Scott refers to the notion of

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[7] Simpson et al., *supra* note 5; *see also* Cam Simpson and Akshat Rathi, *How to Get an ESG Rating Upgrade*, BLOOMBERG (Dec. 21, 2021), https://www.bloomberg.com/news/articles/2021-12-21/how-to-get-an-esg-rating-upgrade?.

[8] Elizabeth Meager, *EU's New ESG Ratings Framework Will be Major Overhaul*, CAP. MONITOR (Sept. 27, 2023), https://capitalmonitor.ai/regions/europe/eus-new-esg-ratings-framework-will-be-major-overhaul/.

[9] Council Directive (EU) 2022/2464, 2022 O.J. (L 322) 15, 23-24 (EU).

[10] ANU BRADFORD, THE BRUSSELS EFFECT: HOW THE EUROPEAN UNION RULES THE WORLD 20 (Oxford Univ. Press, 2019) ("This internally driven, passive externalization of EU rules has been particularly effective in that the EU institutions have only had to generate the consensus to pursue a goal that lies at the heart of the EU project: European

"territorial extension," a practice that allows the EU to "govern activities that are not centered upon the territory of the EU and to shape the focus and content of third country and international law."[11] In this case, foreign companies "trigger" the CSRD when they decide to establish themselves in the EU, either through a branch or subsidiary, and generate sufficient turnover. The result is the extension of "double materiality" sustainability reporting obligations to those foreign companies. Therefore, UK-incorporated companies that want to access the EU's single market and generate sufficient turnover within the EU will find themselves subject to the more far-reaching requirements of the EU's CSRD.[12] Perhaps ironically, but certainly predictably, the aim of regaining sovereignty has resulted in UK companies being subject to a regime that the UK government would almost certainly have opposed[13] had it remained in the EU.[14] It may have even been able to defeat such regulation by putting together

integration and the establishment of the single market. Often, EU standards have been externalized as a byproduct of that mission, not by EU institutions but by market participants who need to comply with EU rules and who often decide to apply the EU standard globally."). More recently, the Commission has become increasingly conscious of its potential global impact as a standard-setter, particularly in relation to data protection. *Id*. at 21-22. By acting as a standard setter in this way, the EU can protect the competitiveness of its industries. *Id*. at 23. More broadly, the EU also has regulatory capacity, historically regulating for and enforcing market integration, and has the political will to act. *Id.* at 25. In relation to corporate sustainability, the departure of the UK from the EU has probably made it to pass stringent regulation.

[11] Joanne Scott, *Extraterritoriality and Territorial Extension in EU Law*, 62 AM. J. COMPAR. L. 87, 89 (2014). Scott explains that "a measure will be regarded . . . as giving rise to territorial extension when its application depends upon the existence of a relevant territorial connection, but where the relevant regulatory determination will be shaped as a matter of law, by conduct or circumstances abroad." *Id*. at 90.

[12] *See* Richard Barker, *Get Ready for More Transparent Sustainability Reporting*, MIT SLOAN MGMT. REV. (Dec. 12, 2023), https://sloanreview.mit.edu/article/get-ready-for-more-transparent-sustainability-reporting/. Barker of the ISSB advises that "if your operations draw you into the extraterritorial reach of ESRS, your optimal response is simple: Do what you would do anyway to report in the U.S. and globally to your investors, and then separately include the additional disclosures required for ESRS compliance."

[13] Council Directive 2021/0508, 2022 O.J. (C 251) 104 (EU). The UK Government fairly consistently opposed any measure of stakeholder corporate governance proposed by the EEC, EC or EU from accession in 1973 to completion of Brexit in early 2020, including the Fifth Company Law Directive on Employee Participation and the General Directive on Employee Information and Consultation. As we will see below, it also took advantage of ambiguity to implement the Non-Financial Reporting Directive in a narrow way.

[14] BRADFORD, *supra* note 10, at 40; Council Directive, *supra* note 9, at 24. Bradford noted that the UK was supportive of the EU's fight against climate change, however, it was historically much less supportive of anything which extended company law or corporate governance beyond shareholder accountability. For example, the CSRD contains an explicit double materiality standard which the UK would almost certainly have opposed, as well as the requirement to make disclosures about impacts on stakeholders. Bradford

a coalition of like-minded Member States in the European Council.[15] Moreover, like companies from elsewhere in the world, even UK companies that have minimal business in the EU may decide to comply with the EU's requirements because they are the most far-reaching in the world,[16] encompassing both financial materiality and stakeholder impacts.[17]

A similar situation may well also emerge in relation to the regulation of ESG rating agencies. Where the UK, until recently, planned to rely on a code of conduct recently drawn up by the industry, the EU has consulted on the need for and form of regulation, and has published a proposal for far-reaching regulation that aims to enhance the quality of rating information through transparency and greater clarity about ESG raters' activities. As with sustainability disclosures, rating agencies will have to comply with the EU rules when they do business in the EU.

Beyond ESG disclosure and ratings, more progressive approaches recognize the limitations of relying on asset managers and institutional investors to challenge a system that seeks to prioritize the interests of shareholders above all.[18] Alternative approaches recognize the potential of

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also points out that the targets must be inelastic, and disclosure and due diligence obligations are inelastic: compliance is a condition of access to the market. These are not obligations that can be avoided by incorporating in a more lax jurisdiction, such as the UK might have hoped to be.

[15] Historically, the UK had a high level of network capital, enabling it to cooperate with multiple partners in taking a common position on issues in the European Council. *See* Daniel Naurin & Rutger Lindahl, *East-North-South: Coalition-Building in the Council Before and After Enlargement*, *in* UNVEILING THE COUNCIL OF THE EUROPEAN UNION 64, 71-74 (Daniel Naurin & Helen Wallace ed., Palgrave Macmillan 2008). *See also* Mikkel Mailand and Jens Arnholtz, *Formulating European Work and Employment Regulation During Pre-Crisis Years: Coalition Building and Institutional Inertia*, 25 J. EUR. SOC. POL'Y 194, 194 (2015) (discussing coalitions in relation to the European Works Council Directive and the European Private Company Initiative, as well as in matters of social policy, and the UK's role in leading an Anglo-Scandinavian coalition of Member States that were skeptical of regulation).

[16] *See* BRADFORD, *supra* note 10, at 54. Bradford refers here to non-divisibility—companies will prefer to conform to the "leading standard" which "typically is the most demanding standard imposed by a major jurisdiction that represents an important market for the corporation. This leading standard is particularly attractive in that it typically incorporates other standards as well, ensuring compliance across all markets in which the corporation operates."

[17] The EU's double materiality standard will incorporate the UK's and the TCFD's single materiality standard. The range of specified disclosures will include all those required by the UK, but also, as we will see below, a number of additional, more impact- and stakeholder-oriented areas as well that meet the preferences of a qualified majority of EU Member States.

[18] Andrew Johnston, *From Universal Owners to Hedge Funds and Indexers: Will Stewardship Drive Long-Termism and Sustainability?*, *in* INVESTMENT MANAGEMENT, STEWARDSHIP AND SUSTAINABILITY 37, 63 (Iris H-Y Chiu & Hans-Cristoph Hirt ed. Hart Publishing Ltd 2023).

harnessing the decision-making capacity of and superior information available to corporate boards and managerial hierarchies.[19] Experiments are underway in continental European jurisdictions with legally binding corporate purposes and procedural innovations such as due diligence, which rely on corporate decision-making to make companies more sustainable. Again, the UK is lagging somewhat, confining itself to encouraging aspirational statements of corporate purpose in its corporate governance code and steering well clear of mandatory due diligence. However, as with the CSRD, the EU is taking the lead and becoming a global norm-maker in some senses. Companies based in third countries that want to access the EU single market will likely have to comply with some aspects of the EU's proposed mandatory due diligence regime, which has been fiercely contested but on which political agreement was recently achieved.

This paper is structured as follows. The second part explores the evolution of the UK's existing approach to sustainability and ESG disclosure, as well as to regulating ESG ratings. The third part maps the EU's approach and its impact on UK companies. The fourth part explores the UK's approach to sustainable corporate governance beyond disclosure. A short conclusion follows.

II. THE UK'S APPROACH

A. THE UK'S APPROACH TO SUSTAINABILITY DISCLOSURE

Whilst financial reporting in its current form can be traced back to the Companies Act 1948, UK company law began experimenting with narrative and non-financial reporting in the Companies Act 2006 ("CA 2006"). This began with the proposal for an Operating and Financial Review (OFR), which was supposed to enlighten shareholders about the sources of wealth creation within companies and reduce the pressures for short-termism.[20] It was also linked to the reform of directors' duties and the introduction of § 172 of the CA 2006, which codified "enlightened shareholder value" as the duty of directors to act in good faith to promote the success of the company for the benefit of its members (shareholders) whilst taking account of a non-

[19] Andrew Johnston et al., *Corporate Governance for Sustainability* (Columbia L. Sch. Pub. L. Working Paper, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3502101; *see also* Beate Sjåfjell et al., *Securing the Future of European Business: SMART Reform Proposals*, (Univ. Oslo Fac. L. Legal Stud., Research Paper Series No. 2020-11, 2020), https://ssrn.com/abstract=3595048. *See generally* Andrew Johnston, *Integrating Sustainability into Corporate Governance*, *in* A RESEARCH AGENDA FOR CORPORATE LAW (Christopher Bruner & Marc Moore ed., Edward Elgar, 2022).

[20] Andrew Johnston, *After the OFR: Can UK Shareholder Value Still be Enlightened*, 7 EUR. BUS. ORG. L. REV. 817, 825 (2007).

exhaustive range of stakeholder interests. The presence of a strong but implicit business judgment rule makes directors' decisions effectively non-justiciable. The idea was that informed shareholders would be able to hold both directors and managers accountable whilst also giving directors space to take a long-term approach to value creation. Regrettably, the OFR was scrapped for short-term political reasons, becoming instead the Business Review section of the Directors' Report. While it was less prescriptive, it did still rely on forward-looking narrative reporting to complement historical, quantitative reporting. It is now to be found in the Strategic Report, [21] which is required for large companies to help shareholders understand how the directors have discharged their duty under § 172 of the CA 2006[22] and should include a fair review of the company's business and a description of the principal risks and uncertainties facing the company.[23] This was reinforced by 2018 reforms that required large companies to include a statement in their strategic report describing "how the directors have had regard to the matters" set out in § 172,[24] which include "the interests of the company's employees," "the company's business relationships with suppliers, customers and others" and "the impact of the company's operations on the community and the environment."[25] It is worth emphasizing that the matters set out in § 172 are not exhaustive and that directors only need to have regard to them in order to determine whether they are relevant to "promot[ing] the success of the company for the benefit of its [shareholders] as a whole." In 2008, listed companies were also required to include in their Director's Report quantitative information about energy usage and carbon dioxide emissions.[26]

In parallel with the UK's ongoing experiments with narrative reporting and §172, the EU introduced its Non-Financial Reporting Directive ("NFRD") in October 2014.[27] It requires large companies to disclose

[21] Companies Act 2006, c. 46, § 414B (UK).
[22] *Id*. at § 414C(1).
[23] *Id.* at § 414C(2). The requirement to disclose principal risks and uncertainties originated in the OFR proposal, but was to be complemented by optional disclosure of a number of other matters, including relations with employees and social and environmental issues. *See* Johnston, *supra* note 20 at 829-832. The OFR's original aim of covering intangibles and intellectual capital was lost from view during implementation, but as we will see below, has returned under the EU's CSRD.
[24] The Companies (Miscellaneous Reporting) Regulations 2018 (2018 No 860) inserting after § 414CZA. A strategic report "must include a statement . . . which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172." Note, this does not apply to qualified medium-sized companies.
[25] Companies Act 2006, c. 46, § 172(1)(b), (c) and (d).
[26] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008 No 410) amending Part 7 of Schedule 7 of the Companies Act 2006.
[27] Council Directive 2014/95/EU, 2014 O.J. (L 330).

environmental and social information in their annual reports "to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity." The non-financial statement should include, "as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters," explaining policies pursued and risks related to these matters and relevant key performance indicators. Where companies do not pursue policies in relation to one or more of these matters, they should explain this. This is presumably intended to allow stakeholders to put pressure on corporate management to develop policies in these areas. The NFRD was implemented in the UK by making changes to the required contents of the Strategic Report as applicable to listed companies. Such companies must also describe the main trends and factors likely to affect the company in the future, as well as information about "environmental matters (including the impact of the company's business on the environment), the company's employees, and social, community and human rights issues," including any policies in relation to these matters and their effectiveness.[28] The listed company should also include a description of its strategy and business model, as well as a breakdown of directors, managers, and employees by sex.[29] This text was taken directly from the EU Directive. This non-financial reporting in the Strategic Report will continue despite Brexit, and as we will see shortly, it has been expanded in order to accommodate the TCFD.

The UK's interpretation of the NFRD offers a fine example of how the UK's approach to corporate governance differs from that of the EU and many continental European countries. In the UK, the Financial Reporting Council confirmed that non-financial reporting under the Strategic Report (as it was under the proposed OFR) is based on a narrow single materiality test—"only information that is material for shareholders should be included in the strategic report. Immaterial information should be excluded as it can obscure the key messages and impair understandability."[30] A couple of years later, the European Commission issued non-binding guidelines stating that materiality is not—as is normally the case in relation to financial information—defined by reference to shareholders but by reference to "a company's fair view of the information needed by relevant stakeholders."[31] The Financial Reporting Council then issued revised guidance which repeated that only financially material information should be disclosed.[32] At the same time, it emphasized that information about impacts might still be relevant to shareholders, such as where environmental impacts might have "implications for the company's

[28] Companies Act 2006, c. 46, § 414C(7).
[29] *Id.* at § 414C(8).
[30] FRC*, Guidance on the Strategic Report,* June 2014 at 4
[31] Commission, 2017/C 215/01, 2017 O.J. C 215 at 5.
[32] FRC, *Guidance on the Strategic Report*, July 2018 at 4

long-term value generation arising from stakeholder, legal or regulatory responses."[33]

No doubt there was an element of ambiguity in the Directive, with the Commission taking the view that the reference to impacts implied a double materiality perspective.[34] In its review of the consultation around the reform of the NFRD, the European Parliament stated that there was wide support for the concept of double materiality but that it "should be further clarified and explicitly included in the directive."[35] As we will see below, the new CSRD is unequivocally based on double materiality, and large UK companies will, despite Brexit, be likely to have to comply with that standard, at least if they desire to access the EU's single market.

The most recent change to Companies Act requirements now requires UK-listed companies, financial companies, and high-turnover companies—companies with more than 500 employees and more than £500m in turnover—to make disclosures in line with the *Recommendations of the Task Force on Climate-Related Financial Disclosures* (TCFD) in the form of a Non-Financial and Sustainability Information Statement (NFASIS).[36] The UK Government trumpeted the achievement of "its ambition of the UK becoming the first G20 country to mandate TCFD-aligned climate disclosures across the economy," part of its "commitment to making the UK financial system the greenest in the world."[37] Section 414CB(1) of the CA 2006 sets out the contents of the NFASIS, which mirrors the NFRD disclosures discussed above, but adds a requirement to disclose "any due diligence processes implemented by the company in pursuance of those policies"[38] before then moving on to climate-related financial disclosures.[39] This includes

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[33] *Id.* para. 5.5.

[34] Commission, 2019/C 209/01, 2019 O.J. C 209 § 2.2. (emphasizing that the reference to "impact of activities" required that climate-related information should be reported "if it is necessary for an understanding of the external impacts of the company. This perspective is typically of most interest to citizens, consumers, employees, business partners, communities and civil society organisations. However, an increasing number of investors also need to know about the climate impacts of investee companies in order to better understand and measure the climate impacts of their investment portfolios.").

[35] *Non-Financial Reporting Directive*, EUR. PARLIAMENT at 7 (2021), https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/654213/EPRS_BRI(2021)654213_EN.pdf.

[36] The Companies (Strategic Report) (Climate-Related Financial Disclosure) 2022, No 31 (UK).

[37] *UK to Enshrine Mandatory Climate Disclosures for Largest Companies in Law*, GOV.UK (Oct. 29, 2021), https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law.

[38] Companies Act 2006, c.46, § 414CB(2)(b) (UK).

[39] *Id.* at § 414CB(2A). In addition, the UK Listing Rules 9.8.6R(8) require UK incorporated listed companies to disclose TCFD recommendations not followed and give

governance arrangements for assessing and managing climate-related risks and opportunities, evaluating their integration into the risk-management process, describing principal climate-related risks and opportunities with relevant time periods, identifying actual and potential impacts on business models and strategy, assessing resilience under different scenarios, targets used to manage these risks and opportunities, and key performance indicators. In line with the TCFD recommendations, all this disclosure is based on a single (i.e., investor) materiality standard.[40]

The UK has a long history of relying on information disclosure to harness market forces rather than on instrumental regulation, so it is not surprising that it took the lead on mandating TCFD reporting. Its approach to corporate sustainability remains that it must be driven by shareholders rather than companies, boards, and managers.[41] It also has a long history of opposition to any kind of stakeholder initiative in company law or corporate governance, so it is equally unsurprising that it adopted a strict single materiality standard on non-financial disclosures after 2014. One notable exception to this, on paper at least, and relating to the 'Social' in ESG, was the revision to the UK Corporate Governance Code to require companies to 'comply or explain' with a set of requirements relating to workforce engagement. This is discussed in more detail in the final section.

The most recent development—perhaps prompted by the EU's successful introduction of the CSRD, discussed in the next section—is the proposal to publish a set of UK Sustainability Disclosure Standards (UKSDS) by July 2024.[42] The UKSDS are expected to be based on the standards drawn up by the International Sustainability Standards Board (ISSB) (which is part of the International Financial Reporting Standards Foundation). The UKSDS will form the basis of any future requirements for companies to report on risks and opportunities arising from climate change. Perhaps anticipating the possibility of UK companies being required to comply with the EU CSRD, the government insists that "decisions [requiring] disclosure will be taken

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reasons (i.e. 'comply or explain'), and 9.8.6BG gives guidance on determining consistency of TCFD disclosures with the recommendations.

[40] *Final Report: Recommendations of the Task Force on Climate-Related Financial Disclosures*, Task Force on Climate-Related Financial Disclosures at 33 (2017), https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf. ("Based on its review, the Task Force determined that preparers of climate-related financial disclosures should provide such disclosures in their mainstream (i.e., public) annual financial filings . . . Importantly, in determining whether information is material, the Task Force believes organizations should determine materiality for climate-related issues consistent with how they determine the materiality of other information included in their financial filings.").

[41] Johnston, *supra* note 19.

[42] Department for Business and Trade, *UK Sustainability Disclosure Standards*, GOV.UK (Aug. 2, 2023), https://www.gov.uk/guidance/uk-sustainability-disclosure-standards.

independently by the UK government, for UK registered companies and limited liability partnerships, and by the Financial Conduct Authority (FCA) for UK listed companies."[43]

There are currently two IFRS sustainability standards on which the UKSDS will be based. The first is IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information. It requires entities to disclose information about "sustainability-related risks and opportunities" that will be useful for "primary users of general purpose financial reports"[44] and that "could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term."[45] Hence, the standard is single materiality. However, as Appendix B makes clear, the entity's own operations might impact the resources on which the company depends, and this might affect its financial performance and position, which somewhat blurs the distinction between single and double materiality. Much of the standard reflects already existing rules in the CA 2006, which is unsurprising given the influence of TCFD on the UK's rules on disclosure of sustainability-related risks and opportunities. The IFRS S1 goes further in certain respects, requiring more detail around short-, medium, and long-term time frames, including how they are defined, as well as more information about risk management and prioritization of the risks identified under a scenario analysis.[46]

The second is IFRS S2: Climate-related Disclosures, which requires disclosure of the risks to which the entity is exposed and the opportunities available to it. Again, much of this is already required by the NFASIS, but it adds more detail about physical and transition risks, a detailed climate-related transition plan,[47] greenhouse gas emission targets and scope 1-3 emissions, details about how climate-related considerations are factored into executive remuneration, and the quantitative and qualitative climate-related targets that have been set to monitor progress towards strategic goals, including how the latest international agreement has informed those targets.[48]

As we will see in the third section, the EU CSRD will expand the obligations of UK companies above a certain size that access the single market. This will cover a number of issues, some relating to the broader scope of the CSRD and some resulting from the EU's definitive adoption of a double materiality standard.

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[43] *Id*. The FRC is consulting and asking whether the relevant IFRS standards will result in disclosures which are "understandable, relevant, reliable and comparable for investors."
[44] *Id.* para. 1.
[45] *Id.* para. 3.
[46] *Id.* para. 44. IFRS S1 Appendix A states that sustainability-related financial disclosures should provide disclosures about "governance, strategy and risk management in relation to those risks and opportunities, and related metrics and targets." *Id*. at 24.
[47] *Id*. para. 14.
[48] *Id.* para. 33.

B. THE UK'S APPROACH TO ESG RATINGS

The UK Government announced in late 2021 that it was considering bringing providers of ESG ratings within the scope of the Financial Conduct Authority (FCA) authority and regulation.[49] The FCA announced informally in May 2022 that it planned to regulate ESG rating providers,[50] but by July 2023, it expressed support for an "industry-led solution" in the form of a Code of Conduct.[51] The first draft of the Code was based on IOSCO's November 2021 recommendations.[52] It emphasized that rating providers should make "adequate levels of public disclosure and transparency a priority for their ESG ratings and data products." "This includes their methodologies and processes to enable users to understand the product and any associated potential conflicts of interest, while maintaining a balance with respect to proprietary or confidential information, data and methodologies."[53]

The Working Group that drafted the Code included all the major rating agencies, as well as stock exchanges, asset managers, and others, with the FRC, FCA, and Bank of England as observers. They were aware of the publication of the EU's proposed regulation,[54] but no EU representatives were involved in their deliberations. The Code was finalized, following consultation, and published on 14th December 2023[55] by the International Regulatory Strategy Group.[56] The goal is to shape "a globally coherent regulatory framework that will facilitate open and competitive cross-border

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[49] HM GOVERNMENT, GREENING FINANCE: A ROADMAP TO SUSTAINABLE INVESTING 7 (Oct. 18, 2021), https://www.gov.uk/government/publications/greening-finance-a-roadmap-to-sustainable-investing [herinafter Greening Finance].

[50] Elizabeth Meager, *UK Plan to Regulate ESG Ratings Divides Market*, CAP. MONITOR (May 30, 2022), https://capitalmonitor.ai/asset-class/equity/uk-esg-ratings-regulation-plan-divides-market/.

[51] *We Welcome the Consultation of a New Code of Conduct for Environmental, Social and Governance Data and Ratings Providers*, FIN. CONDUCT AUTH. (May 7, 2023), https://www.fca.org.uk/news/news-stories/we-welcome-consultation-new-code-conduct-environmental-social-and-governance-data-and-ratings.

[52] INT'L ORG. OF SEC. COMM'NS, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATINGS AND DATA PRODUCTS PROVIDERS, FINAL REPORT (2021), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf.

[53] *Id.*

[54] *ESG Data and Ratings Working Group – Minutes for Meeting 7 on 15 June 2023*, INT'L. REGUL. STRATEGY GRP. 1 (June 15, 2023), https://www.irsg.co.uk/assets/Mintues/DRWG-7-Public-Minutes-070923.pdf.

[55] Code of Conduct for ESG Ratings and Data Products Providers, City of London, https://www.cityoflondon.gov.uk/supporting-businesses/economic-research/research-publications/code-of-conduct-for-esg-ratings-and-data-products-providers (last update Jan. 31, 2024).

[56] The IRSG is a joint venture between TheCityUK and the City of London Corporation. *About Us*, INT'L REGUL. STRATEGY GRP. (last visited Apr. 2, 2024), https://www.irsg.co.uk/about-us/.

financial services."[57] The Code is based on the IOSCO recommendations and covers issues like conflicts of interest and quality of ratings. On transparency, providers are expected to "make public disclosure and transparency a priority for their ESG ratings and data products offerings, subject to commercial sensitivity considerations" and "publish sufficient information about the methodologies underlying their ESG ratings and data products and how they ensure their consistent implementation to enable the users of these products to understand how their outputs were determined."[58] It then sets out an illustrative list of a number of categories of information that rating providers "may" disclose.

The approach that led to the development of this Code is strongly reminiscent of the processes the Bank of England used to steer financial institutions in the City of London through "self-regulation," first in relation to takeovers and then corporate governance, with the goal of heading off more formal regulation.[59] As we will see below, this seems unlikely to work on this occasion as the UK has given up its influence on the EU, which has determined that corporate self-regulation will not work and requires the introduction of formal regulation. It now appears that the UK will also introduce a binding regulation for ESG ratings agencies, but details were not available at the time of writing.

III. THE EU'S APPROACH AND ITS IMPACT ON THE UK

In this section, we will explore the EU's initiatives in the ESG and sustainability space, particularly focusing on their impacts on companies and investors located in the UK. We will see that the "Brussels effect" is particularly strong in this area, with extraterritoriality being the norm. The EU is well aware that it is in a position to take the lead in combatting climate change,[60] and its most recent instruments have, as we will see, cast it in the role of global norm setter.

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[57] *Id.*
[58] *Id*. at 4.
[59] Andrew Johnston, *From Managerialism to Shareholder Primacy: the Role of the Cohen Committee and the Bank of England, in* VICTORIA BARNES AND JONATHAN HARDMAN, THE ORIGINS OF COMPANY LAW: METHODS AND APPROACHES (Hart, 2024) (forthcoming).
[60] Interim Rep. of the High-Level Expert Group on Sustainable Finance, at 5 (July 13, 2017), https://finance.ec.europa.eu/document/download/7f8b937b-10ee-4d71-9f2b-6263e0c26676_en?filename=170713-sustainable-finance-report_en.pdf. The High-Level Expert Group on Sustainable Finance notes that the "EU has been leading on the global sustainability agenda." Similarly, in its Sustainable Finance Action Plan, the Commission stated:

> In the State of the Union Address 2017, President Jean-Claude Juncker declared the ambition for Europe to be the leader when

A. THE EU CRSD

On 5 January 2023, the EU's Corporate Sustainability Reporting Directive (CSRD) entered into force.[61] This new directive drops the term "non-financial information" in favor of "sustainability information."[62] The CSRD aims for "relevant, comparable and reliable sustainability information" in order to "achieve sustainable and inclusive growth, manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues, and foster transparency and long-termism in financial and economic activity."[63] It is explicitly based on double materiality, referring to two groups of users, investors, and civil society actors, and aims to meet their expectations by covering matters falling under the heading of ESG.[64] A broader set of large companies, that is, all listed companies with more than 500 employees,[65] as well as banks and insurance companies, and other companies designated by Member States as 'public-interest entities' will now be required to report on sustainability.[66]

The EU CSRD goes further than what is likely to be required by the UK, at least if the UK's standards are based on IFRS S1 and S2. In particular, the CSRD requires a description of the company's due diligence process and its impacts; reporting to be done on a double materiality basis; and reports to be audited.

Disclosure will encompass sustainability matters, including "the resilience of the undertaking's business model and strategy to sustainability-related risks and opportunities." It also includes a number of matters that

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> it comes to the fight against climate change. Following the decision of the United States to withdraw from the 2015 Paris Agreement, there is a growing need for global leadership in the move towards sustainable development. Europe is well-placed to step into the role of global leader and, in doing so, can become the chosen destination for sustainable investments, such as low-carbon technologies.

European Commission, *Action Plan: Financing Sustainable Growth*, at 12, COM (2018) 97 final(Mar. 8, 2018).

[61] Directive 2022/2464, of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting, 2022 O.J. (L 322) 15-80.

[62] *Id.* para. 8.

[63] *Id*. para. 2.

[64] *Id.* para. 28.

[65] *Id*. art. 5, § 2.

[66] *Id.* (referring to of Directive 2013/34/EU, art. 3, § 4 (setting size thresholds) and art. 2, § 1 (defining public interest entities as listed companies, credit institutions, insurance companies and companies "designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees." Listed SMEs get a derogation and are allowed to publish more limited sustainability reports: Art 19a(6)).

appear to go beyond what is required or proposed to be required in the UK. It includes:

> The plans of the undertaking ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5 °C in line with the Paris Agreement; how the undertaking's business model and strategy take account of the interests of the undertaking's stakeholders and of the impacts of the undertaking on sustainability matters; . . . time-bound targets related to sustainability matters set by the undertaking, including, where appropriate, absolute greenhouse gas emission reduction targets at least for 2030 and 2050, a description of the progress the undertaking has made towards achieving those targets, and a statement of whether the undertaking's targets related to environmental factors are based on conclusive scientific evidence; . . . a description of the role of the administrative, management and supervisory bodies with regard to sustainability matters, and of their expertise and skills in relation to fulfilling that role or the access such bodies have to such expertise and skills.[67]

Due diligence reporting is also expanded, requiring not only a description of the due diligence process but also "the principal actual or potential adverse impacts connected with the undertaking's own operations and with its value chain" and "any actions taken by the undertaking to prevent, mitigate, remediate or bring an end to actual or potential adverse impacts, and the result of such actions."[68] Hence, even before the EU's proposed CSDDD is formally adopted, due diligence disclosure is already mandated, creating pressure on companies to put in place due diligence processes that they can disclose.

Finally, companies should disclose principal risks from sustainability matters, including the "undertaking's principal dependencies on those matters, and how the undertaking manages those risks."[69] "Sustainability matters" are defined as "environmental, social and human rights, and governance factors."[70] In addition to disclosures that largely relate to the 'E' of ESG, sustainability reporting is expected to encompass reporting about intangibles, covering matters such as "information about employees' skills, competences, experience, loyalty to the undertaking and motivation for improving processes, goods and services' because 'certain information on intangible resources is intrinsic to sustainability matters, and should therefore

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[67] *Id*. at art. 1, para. 4.
[68] *Id.* at art. 1, para. 4 (amending art. 19a, § 2(f)).
[69] *Id*. (amending art. 19a, § 2(g)).
[70] *Id*. para. 28 (adding art. 2(b)(17) to Directive 2013/34/EU).

be part of sustainability reporting."[71] "Key intangible resources" are defined as "resources without physical substance on which the business model of the undertaking fundamentally depends and which are a source of value creation for the undertaking."[72] Companies falling within the scope of the Directive are required to "report information on the key intangible resources and explain how the business model of the undertaking fundamentally depends on such resources and how such resources are a source of value creation for the undertaking."[73]

UK companies, as "third country undertakings," will be required to comply with aspects of the EU's Sustainability Reporting regime where they are present in the EU and meet threshold criteria.[74] Member States will require subsidiaries or branches of third-country parent undertakings established in their territory to publish certain information at the group level.[75] The obligation is triggered when the company or group has generated a net turnover in the EU of more than EUR 150 million for each of the last two consecutive financial years. A third-country parent company with a branch or subsidiary in the EU will have to comply with corporate sustainability reporting for the whole group. Specific standards will be drawn up for third-country undertakings covering the information that is required to be disclosed and the possibility of obtaining certifying equivalence of third-country sustainability standards.[76] Finally, the third country company's disclosure

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[71] *Id*. para. 32. Like the expansion of requirements in relation to due diligence and climate transition plans, this emphasis on intangibles reporting goes far beyond the requirements of the NFRD. Ironically, it is much more in line with the original spirit of the OFR proposed for inclusion in the Companies Act 2006, but cancelled for political reasons.
[72] *Id*. art. 1, para. 2 (amending art. (2)(b)(19) to Directive 2013/34/EU).
[73] *Id.* art. 1, para. 3 (amending art. 19(1) of Directive 2013/34/EU).
[74] *See* Joanne Scott, *The New EU 'Extraterritoriality*,' 51 COMMON MKT. L. REV. 1343, 1353-1355 (2014) (noting that "presence" has been a long-standing trigger for extraterritorial regulation, albeit that there is a range of available definitions).
[75] Directive 2022/2464, *supra* note 63 art. 1, para. 14 (inserting Article 40a into Directive 2013/34/EU). The existence of subsidiaries will be obvious, since they will be incorporated under the law of a Member State. Branches, which do not have separate legal personality but are places of business in an EU Member State that conduct business directly for a company incorporated elsewhere, are regulated under the Eleventh Company Law Directive (Directive 89/666/EEC of 21 December 1989 concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State *OJ L 395, 30.12.1989, p. 36–39*), Art 7(1) of which requires companies incorporated in non-EU countries to make certain disclosures about their branches. Finally, it should be noted that there is a potential loophole for third country companies that do business in the EU through an agency. Art 2(5) of the draft CSDDD deals with the situation where there is no branch: the Member State where most of the turnover is generated will regulate.
[76] *Id*. art. 1, para. 14 (inserting Article 40b).

should be accompanied by an assurance opinion by a person authorized to do so under the national law of the third country company or a Member State.[77]

That information should cover "points (a)(iii) to (a)(v), points (b) to (f) and, where appropriate, point (h) of Article 29a(2),"[78] which is the 1.5-degree plan. The information should take into account stakeholders and impacts, the implementation of strategy on sustainability matters, time-bound targets for 2030 and 2050, board-level skills and policies in relation to sustainability (that is, ESG) matters, and information about board-level incentive schemes linked to sustainability matters and expanded due diligence requirements. These requirements include a number of matters which are not covered or which go further in scope than either the CA 2006 or the IFRS S1 and S2, with which larger UK companies are likely to comply in the future, voluntarily or pursuant to additional changes to the CA 2006. These requirements are the company's plans to bring the business model in line to limit warming to 1.5 degrees Celsius;[79] how the group's business model and strategy take account of stakeholders and the impacts of the group on sustainability matters; time-bound targets and absolute greenhouse gas reduction targets for 2030 and 2050; the existence of ESG skills at board level; and extended information about the group's due diligence process, including adverse impacts connected with operations and value chain, and actions taken to mitigate those impacts.[80]

Other aspects of the CSRD will not be explicitly imposed on UK-based companies, although they may comply voluntarily. These include mandatory reporting on intangibles, although this is already covered to some extent by IFRS S1.[81] Similarly, the CSRD expects that sustainability reporting standards

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[77] *Id*.

[78] *Id*.

[79] Greening Finance, *supra* note 50 at 16. In its Greening Finance paper, the UK government proposed requiring certain disclosures on transition plans, including alignment with government's net zero commitment, or to offer explanations. The aim is to gradually strengthen disclosure requirements. As seen in the analysis here, the EU's requirements will be both more far-reaching and more specific. Whether the UK's rules formally reflect the EU's or whether the EU's simply become a de facto norm for UK companies remains to be seen.

[80] In a requirement left over from the EU's NFRD, Companies Act 2006 § 414CB requires disclosure of "a description of the policies pursued by the company in relation to the matters mentioned in subsection (1)(a) to (e) and any due diligence processes implemented by the company in pursuance of those policies." Companies Act 2006 § 414CB(2)(b). The requirements of the CSRD in relation to the due diligence disclosure are considerably more far-reaching. Thibault Meynier et al., *EU Finalizes ESG Reporting Rules with International Impacts*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 20, 2023), https://corpgov.law.harvard.edu/2023/01/30/eu-finalizes-esg-reporting-rules-with-international-impacts/.

[81] B3 of IFRS S1, which highlights that

> if an entity operates in a highly competitive market and requires a highly specialised workforce to achieve its strategic purposes, the

will require reporting on 'social factors' including 'working conditions, social partner involvement, collective bargaining, equality, non-discrimination, diversity and inclusion, and human rights.'[82] However, this part of the CSRD will not apply to third-country companies.

In one final important development, the absence of existing suitable standards meant the European Financial Reporting Advisory Group (EFRAG) was given the task of producing recommendations for sustainability reporting standards.[83] The preamble made clear that those standards were expected to take account of a number of existing standards, including TCFD and any developed by IFRS, but they would inevitably be broader than those standards, given that the CSRD is based on double materiality.[84] The Commission formally adopted the European Sustainability Reporting Standards (ESRS) at the end of July 2023.[85] Shortly afterward, EFRAG and GRI, the leading standard for impact reporting, issued a "joint statement of interoperability" between their respective standards. The result is that existing GRI reporters will be well placed to report under the ESRS, whilst ESRS reporters are also considered to be reporting with reference to GRI Standards.[86] ESRS 1 sets out general requirements, highlighting that the basis for reporting is double materiality, and that engagement with stakeholders is "central to the undertaking's on-going due diligence process and sustainability materiality assessment."[87] A sustainability matter will be considered material

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> entity's future success will likely depend on the entity's ability to attract and retain that resource. At the same time, that ability will depend, in part, on the entity's employment practices—such as whether the entity invests in employee training and wellbeing—and the levels of employee satisfaction, engagement and retention.

B4 adds:

> Resources and relationships that an entity depends on and affects by its activities and outputs can take various forms, such as natural, manufactured, intellectual, human, social or financial. They can be internal—such as the entity's workforce, its know-how or its organisational processes—or they can be external—such as materials and services the entity needs to access or the relationships it has with suppliers, distributors and customers. Furthermore, resources and relationships include, but are not limited to, the resources and relationships recognised as assets in the entity's financial statements.

[82] Directive 2022/2464, *supra* note 62, para. 49.
[83] *Id*. para. 39.
[84] *Id*. para. 43.
[85] *The Commission Adopts the European Sustainability Reporting Standards*, EUR. COMM'N (July 31, 2023), https://finance.ec.europa.eu/news/commission-adopts-european-sustainability-reporting-standards-2023-07-31_en.
[86] *Id*.
[87] EUR. FIN. REP. ADVISORY GRP., DRAFT EUROPEAN SUSTAINABILITY REPORTING STANDARDS ESRS 1 GENERAL REQUIREMENTS, paras. 25, 28 (2022),

from an impact perspective "when it pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- and long-term time horizons."[88] Decisions about impact materiality will be made by due diligence and based on the severity of actual impacts or the severity and likelihood of potential negative impacts.[89] Material positive impacts should also be disclosed.[90] A sustainability matter will be material "from a financial perspective if it triggers or may trigger material financial effects on the undertaking."[91] Third-country undertakings that meet the thresholds detailed above will have to comply with the relevant ESRS drafted by EFRAG and will be required to report on a "double materiality" basis, regardless of the policy of their country of incorporation. The Commission's deadline to adopt ESRS is June 2026.[92] Moreover, in contrast to UKSDS proposals, third-country companies will have to audit their sustainability disclosures.[93] EU companies are expected to report for financial years beginning after 1 January 2024 based on the standards already adopted.[94] Third-country companies are expected to report on financial years beginning after 1 January 2028.[95]

B. THE EU CSDDD

The EU's proposal for a Corporate Sustainability Due Diligence Directive (CSDDD) has given rise to a great deal more controversy, and it has not yet been formally adopted. At the time of writing, 14 December 2023, an agreement had just been reached on the main provisions of the text in trilogue negotiations between the European Parliament, Council, and Commission. A full text still needs to be drafted and approved by both the Council and the

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https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2F06%2520Draft%2520ESRS%25201%2520General%2520requirements%2520November%25202022.pdf.

[88] *Id*. para. 46.

[89] *Id*. para. 48.

[90] *Id.* para. 49.

[91] *Id*. para. 52.

[92] *Commission Proposal for a Decision of the European Parliament and of the Council amending Directive 2013/34/EU as regards the time limits for the adoption of sustainability reporting standards for certain sectors and for certain third-country undertakings*, at 4, COM (2023) 596 final (Oct. 17, 2023). Article 40b of the CSRD anticipated that the Commission would adopt a standard for disclosures by third country undertakings, but that has been postponed for two years from June 2024, in line with the postponement of adoption of sector-specific ESRS from 2024 to 2026.

[93] Directive 2022/2464, *supra* note 62, art. 3, para. 18 (inserting art. 28a into Directive 2006/43/EC, requiring audits of sustainability reporting, and amending art. 45 of Directive 2006/43/EC, requiring registration of third country auditors who audit third country companies' sustainability reporting).

[94] *Id*. art. 5, para. 2.

[95] *Id.*

Parliament. In broad terms, the Directive will apply to EU-based companies with more than 500 employees and a worldwide net turnover of more than EUR 150 million in the last financial year. It will also apply to companies in high-risk sectors with over 250 employees and EUR 40 million turnover, of which EUR 20 million must be in those sectors, namely textiles, agriculture, food manufacturing, extraction and trade of mineral resources, and construction. Controversially, under pressure from France, plans to include the financial sector were dropped from the Directive. The Council, however, stated this is temporary, and the sector may be included in the future when a scheduled review takes place. [96]

The Directive's first contribution will require companies that fall within its scope to integrate due diligence into policies and risk management, identify actual or potential impacts, prevent or mitigate those impacts, maintain a complaints procedure, monitor the effectiveness of policy and measures, and make public communications on due diligence and its outcomes.[97] In line with the guiding principle of double materiality, this extends to identifying impacts from companies' own activities, those of their subsidiaries, and those of their business partners in their value chain (although this may be recast as their 'chain of activities'), prioritizing them according to severity and likelihood of adverse impact.[98] It seems likely—although the agreed text is not publicly available—that companies will be required to consult with affected stakeholders as part of the process, this being a red line for the European Parliament.

Individuals and representative organizations will be able to sue companies for damages if they can show violations of human rights and environmental standards as a result of due diligence failure. There is also apparently the possibility of action by national authorities if due diligence is not being conducted adequately. The biggest limitation here is that liability can only arise for harms that fall within the scope of the human rights and environmental conventions listed in the Annex. So, there is no risk of liability for failing to prevent and mitigate broader climate impacts linked to the company's activities. This limitation is imposed in the name of legal certainty

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[96] European Council Press Release, Corporate Sustainability Due Diligence: Council and Parliament Strike Deal to Protect Environment and Human Rights (Dec. 14, 2023) https://www.consilium.europa.eu/en/press/press-releases/2023/12/14/corporate-sustainability-due-diligence-council-and-parliament-strike-deal-to-protect-environment-and-human-rights/.

[97] *Commission Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937*, art. 4, § 1, COM (2022) 71 final (Feb. 23, 2022) [hereinafter Corporate Sustainability Due Diligence Commission Proposal].

[98] *Id*. art. 6, 6a.

and is in line with the approach taken by German due diligence law,[99] but it is a serious limitation in terms of moving companies toward greater sustainability.

The second major effect of the Directive requires companies and financial institutions to "adopt and put into effect" a transition plan to bring their business model and strategy in line with limiting global warming to 1.5 degrees, a provision that mirrors the CSRD.[100] National authorities will check that these plans are adopted and feasible and that companies are making progress in achieving the targets they have set for themselves. This obligation relates to what is within the company's power, not the results achieved by the company.[101] If the supervisory authorities believe the company is not complying, they may impose penalties. There was a long-running dispute about whether directors' duties should be used to ensure compliance, but this provision was eventually dropped. In contrast, there will be rules requiring companies to link executive remuneration to the targets included in the transition plan.

It also seems clear that the CSDDD is going to apply to third-country companies with a turnover of more than EUR 150 million in the EU during two consecutive financial years, or more than EUR 40 million if at least EUR 20 million is generated in those high-risk sectors mentioned above.[102] The Parliament was trying to make the threshold stricter, referring to "generat[ing] a net worldwide turnover of more than EUR 150 million, provided that at least EUR 40 million was generated in the Union in the financial year preceding the last financial year."[103] The Member State in which the third country company has a branch will be competent to regulate, or if there are no branches or multiple branches, then the Member State where the company

[99] Lieferkettensorgfaltspflichtengesetz [LkSG] [Act on Corporate Due Diligence Obligations for the Prevention of Human Rights Violations in Supply Chains], June 11, 2021, BGBL I at 2959 (Ger.).
[100] Corporate Sustainability Due Diligence Commission Proposal, *supra* note 100, art. 15.
[101] *Id*. art. 19-20.
[102] *Id*. art. 2(2); *see also* Scott, *supra* note 11, at 99 (highlighting existing precedent for territorial extension of due diligence obligations to third country companies selling timber into the EU in the form of the EU's Forest Law, Governance and Trade Regulation 2173/2005).
[103] Amendments Adopted by the European Parliament on 1 June 2023 on the Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and Amending Directive (EU) 2019/1937, A9-0814/2023 (June 1, 2023). The new rules will apply to EU-based companies, regardless of their sector, including financial services, with more than 250 employees and a worldwide turnover over EUR 40 million as well as to parent companies with over 500 employees and a worldwide turnover of more than EUR 150 million. Non-EU companies with a turnover higher than EUR 150 million, if at least EUR 40 million was generated in the EU, will also be included.

generated most of its net turnover in the EU will regulate.[104] The CSDDD will also impact UK companies that do not do business in the EU but are in the value chains (or 'chain of activities') of large EU businesses and so will come under pressure to identify and mitigate their human rights and environmental impacts.

C. The EU's Proposal for a Regulation on ESG Ratings Agencies

Another area where the UK's new-found freedom to regulate, or indeed to not regulate, is likely to be more formal than substantive relates to ESG rating agencies. We saw above that the UK originally proposed to let the industry regulate itself in the form of a code of conduct. The EU has other ideas. The EU's High Level Expert Group on Sustainable Finance recommended that the European Securities and Markets Authority (ESMA), which is responsible for regulating credit rating agencies,[105] should "ensure that regulations covering public disclosure of methodologies are adhered to with particular reference to ESG aspects."[106]

The EU launched a public consultation on ESG ratings in the first half of 2022,[107] following which, in June 2023, the European Commission published a proposal for a regulation on the transparency and integrity of ESG ratings.[108] Although it was aware of the UK's original intention to rely on self-regulation,[109] the Commission rejected the use of an industry code of conduct on the basis that

[104] Corporate Sustainability Due Diligence Commission Proposal, *supra* note 100, art. 2(5).
[105] Council Regulation 513/2011, 2011 O.J. (L 145) 1.
[106] EUR. UNION HIGH-LEVEL WORKING GRP. ON SUSTAINABLE FIN., FINANCING A SUSTAINABLE EUROPEAN ECONOMY 78 (2018), https://finance.ec.europa.eu/system/files/2018-01/180131-sustainable-finance-final-report_en.pdf.
[107] *About this Initiative*, EUR. COMM'N, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13330-Sustainable-finance-environmental-social-and-governance-ratings-and-sustainability-risks-in-credit-ratings_en (last visited Apr. 2, 2023).
[108] *Proposal for a Regulation of the European Parliament and of the Council on the Transparency and Integrity of Environmental, Social and Governance (ESG) Rating Activities*, 1, COM (2023) 314 final (June 13, 2023) [hereinafter Proposal for ESG Rating Activities].
[109] *Commission Staff Working Document Impact Assessment Report Accompanying the Document Proposal for a Regulation of the European Parliament and of the Council on the Transparency and Integrity of Environmental, Social and Governance (ESG) Rating Activities*, 7 n.19 (June 13, 2023), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52023SC0204. In its Impact Assessment, the Commission notes that the UK is working on a code of conduct "as a first step" with the aim of introducing "a regulatory framework . . . in the longer term."

> there would be no incentive to produce a sufficiently rigorous code of conduct. Existing market pressures would determine the rigour and comprehensiveness of the Code, and those pressures have proven insufficient to address the problems. Moreover, a code of conduct would be voluntary. Some providers might choose not to adopt it, or multiple industry codes might arise. Both cases would undermine any prospect of greater clarity across the market for users or rated entities.[110]

The Commission's proposal envisages that ESMA will authorize and supervise rating agencies that provide ESG ratings in the EU and that the rating agencies will be required to make disclosures about their methodologies, including clarifying whether their ESG ratings are determined on the basis of single or double materiality. This is expected to assist companies that are rated, allowing them to understand how they can improve their ratings; investors, who can have a better idea of what is being rated; and stakeholders, who will be able to hold rated companies more accountable for their sustainability and other ESG performances. Whilst there are carve-outs for smaller rating agencies operating outside the EU, in the form of ESMA-authorized endorsements of ratings issued outside the EU[111] or recognition for low turnover agencies,[112] it is likely that there will be another Brussels effect here. A rating agency based outside the EU that wants to provide ratings in the EU will have to register and rely on the Commission deciding that the agency's home state imposes "binding requirements" that are equivalent to those in the Regulation.[113] Alternatively, EU-based agencies may endorse ratings issued by third-country rating providers in the same group as them, provided the ESMA authorizes this, and the EU-based agency can demonstrate that the rating is subject to requirements at least as stringent as the Regulation.[114] ESG rating providers are required to ensure independence from political and economic influences and use rating methodologies that are "vigorous, systematic, objective and capable of validation and shall apply those rating methodologies continuously."[115] There are rules to prevent conflicts of interest,[116] and, perhaps most importantly, there are binding and far-reaching transparency requirements. "ESG rating providers shall disclose on their website the methodologies, models and key rating assumptions they

[110] *Id.* at 5. *See also id*. at 35-37 (exploring the shortcomings of the Code of Conduct in more detail and noting low levels of support from rating users and rated companies (7% and 11% respectively).
[111] *Id*. art. 10.
[112] *Id*. art. 11.
[113] *Id*. art. 9.
[114] *Id*. art. 10.
[115] *Id*. art. 14.
[116] *Id*. art. 15.

use in their ESG rating activities, including the information referred to in point 1 of Annex III."[117]

It remains to be seen whether the EU will be able to reach an agreement on this proposed Regulation. The UK's FCA was hoping that ESG data and ratings providers would sign up for the Code published by the City of London in December 2023. No doubt they would, having been involved in drafting the Code and knowing that the EU's proposal is much more far-reaching and onerous. However, company and investor preferences seem to be strongly in favor of more far-reaching regulation,[118] and the EU's proposal will no doubt also gain approval from wider stakeholders with its emphasis on transparency around, particularly, double materiality. As with due diligence, it seems likely that the EU's rules will become global norms, and post-Brexit UK will be a rule-taker in this area.

IV. BEYOND REPORTING AND ESG RATINGS: SUSTAINABLE CORPORATE GOVERNANCE IN THE UK

The UK's last major company law reform process finished in 2006, and none of the reports produced during the years leading up to legislation mentioned sustainability. The closest we can find to a reference to sustainability is the mention of the environment in § 172 of the CA 2006. Given that the list of considerations in that section is non-exhaustive, directors clearly have the discretion to take sustainability into account. The business judgment rule is implicit in the reference to "good faith" in that section, meaning shareholders will find it very difficult to sue directors for business decisions, whether they are claiming to have had regard for sustainability or not. However, directors of listed public companies are unlikely to use the full breadth of their discretion, given the wider corporate governance environment, especially executive pay and the ever-present threat of hostile takeover.

Moving to consider the codes, the UK Corporate Governance Code (UKCGC) and the UK Stewardship Code (UKSC) have both been amended multiple times since 2006 and now pay lip service to sustainability. For example, Principle A of the 2018 UKCGC states that "[a] successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society." In order for the board to be held accountable by the shareholders, the board "should describe in the annual report how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company's business

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[117] *Id*. art. 21.

[118] Proposal for ESG Rating Activities, *supra* note 108, at 6-7.

model and how its governance contributes to the delivery of its strategy."[119] The Financial Reporting Council, which is responsible for the UKCGC, found that 63 of the 100 companies they examined stated they provided disclosures fully compliant with TCFD. 45 of those companies in the sample now had board-level committees responsible for environmental issues, with names such as "sustainability committee," "ESG committee," and "CSR committee."[120] 62 companies in the sample had set net zero or carbon neutrality targets with timings from 2030 to 2070, 50 of them setting targets in line with the Science-Based Targets Initiative.[121] Moreover, the UKCGC encourages companies to make a statement of their purpose and to have processes in place to ensure workforce engagement. While listed companies are not bound by the UKCGC to make disclosures and only have to "comply or explain" their non-compliance, these measures are unimpressive, as will be discussed shortly.

The UK's post-global financial crisis Stewardship Code[122] has also introduced references to sustainability, evolving from its original 2010 expectation that large shareholders would steer companies towards "long-term returns to shareholders"[123] via its 2012 aim to "promote the long-term success of companies in such a way that the ultimate providers of capital also prosper."[124] Most recently, in 2020, the code claimed that stewardship will "create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."[125] Like the UKCGC, the Stewardship Code 2020 expects institutional investors to have a non-binding purpose statement.

Continental European jurisdictions such as Italy and France have been experimenting with allowing companies to adopt legally binding purposes.

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[119] *Id*.
[120] *Id.*
[121] *Id*. at 34
[122] *See* DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES, FINAL RECOMMENDATIONS para. 5.11 (2009), https://www.ecgi.global/sites/default/files/codes/documents/walker_review_261109.pdf. Walker recommended that that the Institutional Shareholders' Committee's 2009 *Responsibilities of Institutional Shareholders* be converted into a Stewardship Code, encouraging pension funds, insurance companies and the asset managers they hire to comply and disclose an engagement policy or explain their non-compliance. He emphasised "the need for those who are naturally longer-term holders to be ready to engage proactively where they have areas of concern," both to address board shortcomings and to offset the short timeframe of shareholders such as "hedge funds with significant stakes." *Id*.
[123] Financial Reporting Council, The UK Stewardship Code 1 (2010), https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf [hereinafter 2010 UK Stewardship Code].
[124] *Id*.
[125] *Id.* at 4.

For example, following the introduction of the *loi Pacte*, France allows companies to publicly commit to a purpose or "raison d'être" beyond shareholder value, including setting out the company's strategy to achieve this purpose. If it is included in the articles, the directors have a duty to observe it.[126] Companies can also go further by becoming a *Société à Mission*, committing in its statutes to a specific *mission* to address a social or environmental challenge, and setting up a special committee including at least one employee to monitor the execution of the mission and report to the board. This effectively sidesteps the vexed question of legal enforceability of even formal, legally binding purposes clauses by making compliance with the question of how the mission should be pursued and achieved an internal corporate governance matter to be resolved between the board and the special committee.

Since 2006, UK law, under § 172(2) CA 2006, has permitted companies to specify a legally binding purpose other than "the benefit of members," thereby displacing the default of "enlightened shareholder value" under § 172(1). This is the basis on which B Corps can include a provision in their articles that their purpose is to "promote the success of the company for the benefit of its members as a whole and, through its business and operations, to have a material positive impact on society and the environment, taken as a whole."[127] However, beyond the B Corp movement, companies rarely alter their purposes under § 172(2).[128] Even if they do, it seems very unlikely that the balance between different, possibly conflicting, interests in any bespoke purpose clause would be justiciable given the wide latitude traditionally accorded by courts in England and Wales to good faith management decisions.

In light of this, it is interesting that the UK Corporate Governance Code 2018 requires company boards to "establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned" and explain actions taken to align policy, practices, and behavior with purpose and strategy in the annual report.[129] This is part of the 2018 Code's attempt to encourage directors to "assess the basis on which the company generates and

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[126] *See generally* Blanche Segrestin et al., *When the Law Distinguishes Between the Enterprise and the Corporation: The Case of the New French Law on Corporate Purpose*, 171 J. BUS. ETHICS 1 (2020).

[127] David Hunter, *The Arrival of B Corps in Britain: Another Milestone Towards a More Nuanced Economy?*, *in* SHAPING THE CORP. LANDSCAPE 260 (Nina Boeger & Charlotte Villiers eds., Bloomsbury Publishing, 2020).

[128] *Id.* at 262. Compaies in the FTSE 350 have not displaced § 172(1), although one plans to become a B Corp in the near future. *See generally* Longjie Lu, *ESG-based Renumeration in the Wave of Sustainability*, 23 J. CORP. L. STUD. 297, 297 (2023).

[129] Financial Reporting Council, *The UK Corporate Governance Code* at 4, https://www.ecgi.global/sites/default/files/codes/documents/2018-uk-corporate-governance-code-final.pdf.

preserves value over the long-term." However, the purpose required to comply with the UKCGC does not need to be included in the articles. As such, it will remain aspirational, more akin to a CSR measure, enforceable only indirectly through market forces. This, in turn, creates the need to report whether the purpose was achieved. In its 2023 Review of Corporate Governance Reporting, the FRC noted "a slight dip [compared to 2022] in the number of companies clearly stating their corporate purpose" but that "the rate of disclosure remains very high". However, the "rate of good supporting information is much lower, only around half of organisations, but it has significantly increased from last year… better disclosures were clear on each element of the purpose, explaining for example, why the company exists, what it does, the market in which it operates, what it is seeking to achieve, and how it will achieve it."[130]

The following example highlights the limitations of using both aspirational and legally binding purposes as envisaged by the UKCGC and § 172(2) CA 2006. Anglian Water's aspirational purpose is "to bring environmental and social prosperity to the region we serve through our commitment to Love Every Drop." It is hard to see how this sets any standard against which its sustainability performance can be assessed. In contrast, its legal purpose, which it included in its articles of association in July 2019, is "to conduct its business and operations for the benefit of shareholders while delivering long-term value for the company's customers, the region and the communities it serves, and seeking positive outcomes for the environment and society." Anglian Water's purpose statement is cited as an example in the British Academy's *Future of the Corporation* report, which placed great faith in the ability of corporate purpose to steer companies towards greater economic, social, and environmental sustainability.[131] The report adds that inclusion in the articles "puts a legal requirement on its board of directors to take account of the impact of the company's decisions on society and the environment, as well as their financial implications."

However, it appears to be shareholder-value business as usual in the East of England. In June 2022, the *Financial Times* reported that:

> Anglian Water, one of the UK's largest suppliers of water and sewerage services, is paying a £92mn dividend to its owners despite rising customer bills and sewage and

[130] FRC, *Review of Corporate Governance Reporting* at 11 (Nov., 2023), https://www.frc.org.uk/documents/6614/Review_of_Corporate_Governance.pdf.

[131] THE BRITISH ACADEMY, PRINCIPLES FOR PURPOSEFUL BUSINESS 16, 21 (2019), https://www.thebritishacademy.ac.uk/documents/224/future-of-the-corporation-principles-purposeful-business.pdf [hereinafter Future of the Corporation Report]; The British Academy, Policy & Practice for Purposeful Business 24 (2021), https://www.thebritishacademy.ac.uk/documents/3462/Policy-and-Practice-for-Purposeful-Business-The-British-Academy.pdf [hereinafter Policy & Practice for Purposeful Business]. For a critique, *see* Johnston, *supra* note 19.

> pollution failures . . . . Peter Simpson, Anglian Water's chief executive, and Steve Buck, its chief financial officer, were together paid more than £2.2mn in bonuses, as well as their combined base pay of more than £900,000 in 2021, according to company records."[132]

The Water Services Regulation Authority ("Ofwat"), the water companies' regulator, asserted that Anglian "has a track record of high dividends and has paid extraordinarily high dividends over the last 10 years" and "has a track record of high gearing which is detrimental to customer interests."[133] According to the company's articles, this excellent performance in terms of shareholder value should be balanced against positive outcomes for the environment. It seems hard to argue that this provision of the articles has been complied with. In January 2023, Anglian Water was fined a total of £560,170 after raw sewage discharge killed 5,000 fish in a Northamptonshire river; in April 2023, it was fined a sum of £2.65 million by the Environment Agency (EA) for allowing 7.5 million liters of untreated sewage to overflow into the North Sea.[134] An independent journalist reported that:

> [r]aw sewage was dumped into rivers more than 16,000 times last year by Anglian Water according to shocking figures published by the Environment Agency. The sewage was pouring into local waterways for more than 89,000 hours, the data shows. That was a significant reduction compared with the previous year—and Anglian Water has declared itself "pleased with this progress."[135]

The issue here is that the balance between shareholders and the environment and society is not justiciable, just as the balance between the different interests in § 172(1) CA 2006 is not justiciable.

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[132] Gill Plimmer, *Anglian Water Pays £92mn Dividend to Owners as Customer Bills Rise*, FIN. TIMES (June 21, 2022), https://www.ft.com/content/a5669358-bc40-4065-a864-88fa671e71d4.
[133] ANGLIAN WATER, EXECUTIVE SUMMARY: REPLY TO OFWAT'S RESPONSE TO ANGLIAN'S STATEMENT OF CASE 4 (2022), https://www.anglianwater.co.uk/siteassets/household/about-us/rep01-rep10-combined-anglian-reply-to-ofwat.pdf.
[134] Environment Agency, *Anglian Water Fined £2.65* After Sewage Discharge into North Sea*, GOV. UK (Apr. 28, 2023) https://www.gov.uk/government/news/anglian-water-fined-265m-after-sewage-discharged-into-north-sea#:~:text=Anglian%20Water%20was%20ordered%20to,environmental%20offences%20in%20the%20region. ("It is the largest ever fine imposed for environmental offences in the region.").
[135] Alex Spencer, *Raw Sewage Dumped into Rivers 16,000 Times Last Year by Anglian Water*, CAMBRIDGE INDEP. (Apr. 7, 2023), https://www.cambridgeindependent.co.uk/news/raw-sewage-dumped-into-rivers-16-000-times-last-year-by-angl-9307468/.

As a comparative analysis concluded nearly a decade ago, the problem is not that directors lack discretion to consider sustainability. Rather, the problem is that the corporate governance system creates powerful incentives for directors to serve the short-term interests of shareholders.[136] In Anglian Water's case, it has a highly complex corporate group structure, is heavily leveraged, and has five very large institutional investors from the UK, Australia, Canada, and Luxembourg as shareholders who are able to impose their will on the board. This example shows that legally binding purpose can, in practice, be largely indistinguishable from aspirational purpose and CSR and only creates positive publicity with little substance for stakeholders or sustainability.[137] Moreover, it raises questions about how far large institutional investors are really committed to reducing social and environmental impacts where they are tolerated by a pliant regulator.

The vogue for purpose also extends to the UK Stewardship Code 2020, which requires institutional investors, asset managers, and asset owners who are signatories to explain "the purpose of the organisation and an outline of its culture, values, business model and strategy; and their investment beliefs, i.e. what factors they consider important for desired investment outcomes and why."[138] The aim here seems to be to encourage shareholder engagement on ESG matters. The clients and end beneficiaries of asset managers can, theoretically, hold companies accountable for their approach to engagement, and a market for stewardship might emerge[139] if those clients and end beneficiaries move their business to asset managers who take sustainability seriously, at least in their purpose statements. In its 2022 *Review of Stewardship Reporting*, the FRC observed "effective stewardship reporting that is transparent about the purpose and approach of the organisation."[140]

There remains an important question about whether requiring asset managers and owners to disclose an aspirational purpose will result in

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[136] Beate Sjåfjell et al., *Shareholder Primacy: the Main Barrier to Sustainable Companies*, *in* COMPANY LAW AND SUSTAINABILITY: LEGAL BARRIERS AND OPPORTUNITIES (Beate Sjåfjell & Benjamin J. Richardson eds., Cambridge Univ. Press, 2015)
[137] *See, e.g.,* Li-Wen Lin, *Say on Purpose: Lessons from Chinese Corporate Charters*, 19 J. CORP. L. STUD. 251, 271 (2019).
[138] FINANCIAL REPORTING COUNCIL, THE UK STEWARDSHIP CODE 8 (2020), https://www.frc.org.uk/documents/5127/The_UK_Stewardship_Code_2020.pdf.
[139] FINANCIAL REPORTING COUNCIL/FINANCIAL CONDUCT AUTHORITY, Building a Regulatory Framework for Effective Stewardship, para. 3.11 (2019), https://www.fca.org.uk/publication/discussion/dp19-01.pdf. ("Transparency of firms' stewardship activities should help to develop a competitive market for stewardship in the interests of consumers. When working well, financial services firms would compete with each other to deliver high-quality investment decision-making.").
[140] FINANCIAL REPORTING COUNCIL, REVIEW OF STEWARDSHIP REPORTING 2022, 10 (2022), https://www.frc.org.uk/documents/4634/Review_of_Stewardship_Reporting_2022.pdf.

institutional investors and end beneficiaries moving their assets in ways that incentivize more sustainable approaches to investment. During the 2008 to 2022 zero interest rate period, institutional investors had to prioritize yield in order to meet their liabilities.[141] Whilst the recent rise in interest rates might reduce the pressure for short-term yield on the part of asset owners, it is still quite a stretch to expect asset owners and individual investors to demand that asset managers press individual companies to improve their ESG performance. The proxy policies of asset managers on matters of corporate governance are largely straight out of the shareholder value playbook,[142] and it is hard to imagine that the large asset owners who hire the asset managers are dissatisfied with these policies. Moreover, with the rise of indexing and pressure to cut research costs, asset managers are less likely to focus on individual company ESG performance. Greater reliance on agency-produced ESG ratings is a much more likely outcome, and, as we saw above, ESG ratings are a long way from being a reliable proxy for sustainability in its environmental, social, and economic guises.

V. WORKPLACE ENGAGEMENT AND THE ORIENTATION OF THE UKCGC

From its origins in the Cadbury Report, the UKCGC always focused on managerial accountability to shareholders until, in a shock post-Brexit announcement, one of the UK's recent short-lived prime ministers, Theresa May, announced in 2016 that by the end of the year, she was going to publish rules requiring employee representation on boards,[143] something the UK had always strongly opposed during the 1970s when it first joined the EEC.

The 'S' aspect of ESG is probably the vaguest of the three component parts and is sometimes considered to refer to "a firm's relationships with its stakeholders, both internal and external to the organization," so covering workforce, supply chain partners and impacted communities, as well as ensuring human rights protected throughout the firm's business operations.[144] In the end, of course, May bowed to opposition from business groups[145] and ultimately reverted to voluntarism, canvassing four reform options: stakeholder advisory panels, designated NEDs responsible for ensuring that the voices of key interested groups are heard at the board level, the

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[141] David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L. J. 1013, 1041 (2013).
[142] Johnston, *supra* note 18 at 60-61.
[143] Theresa May, Launching Her National Campaign to Become Leader of the Conservative Party and Prime Minister of the United Kingdom (July 11, 2016); *see also* Theresa May, Prime Minister, U.K., Keynote Speech at Conservative Party Conference (Oct. 5, 2016).
[144] Filatotchev et al., *supra* note 2, at 52.
[145] Sarah O'Connor and Jim Brunsden, *Businesses Wary of Theresa May's Board Reforms*, FINANCIAL TIMES (July 11, 2016), https://www.ft.com/content/09fc5360-4780-11e6-b387-64ab0a67014c.

appointment of individual stakeholder representatives to company boards, and strengthened stakeholder reporting requirements.[146] Provision 5 of the UKCGC 2018 states that:

> For engagement with the workforce, one or a combination of the following methods should be used:
>
> • a director appointed from the workforce;
> • a formal workforce advisory panel;
> • a designated non-executive director.
>
> If the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective.

Companies listed on the London Stock Exchange with a premium listing are required to "comply or explain" their non-compliance with the UKCGC.[147] The idea is that company boards decide how far the company should comply with the code, and then the shareholders can determine whether they are satisfied. Comply or explain has resulted in large amounts of compliance and relatively little explanation, probably because companies do not want to provoke their shareholders by not complying with best practices. This provision is different in substance from the rest of the Code: it accepts an explanation of alternative arrangements and their effectiveness as a form of compliance. As such, failure to adopt one of the three suggested mechanisms will not show up as non-compliance. Research conducted for the FRC found that while 68% of FTSE 350 companies had adopted one or more of the three methods, only one in the sample had appointed a worker director, along with four others that already had them. The remaining 32% of FTSE 350 firms have not adopted any of the three, either adopting 'alternative arrangements' or claiming existing mechanisms, such as staff surveys or site visits, to be adequate.[148] This is a far cry from improving company ESG performance through board-level employee representation, which is a legal requirement in many EU Member States.

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[146] Department for Business, Energy & Industrial Strategy, Corporate Governance Reform Green Paper paras. 2.15-2.35 (2016), https://assets.publishing.service.gov.uk/media/5a80ae13e5274a2e87dbb360/corporate-governance-reform-green-paper.pdf.

[147] FINANCIAL CONDUCT AUTHORITY, FCA HANDBOOK Listing Rule 9.8.6 (2024), https://www.handbook.fca.org.uk/handbook/LR/9/8.pdf.

[148] Chris Rees and Patrick Briône, *Workforce Engagement and the UK Corporate Governance Code: A Review of Company Reporting And Practice* 5, The Financial Reporting Council (2021) https://www.frc.org.uk/getattachment/56bdd5ed-3b2d-4a6f-a62b-979910a90a10/FRC-Workforce-Engagement-Report_May-2021.pdf. *See also* Andrew Johnston and Navajyoti Samanta, *ESG and Workforce Engagement: Experiences in the UK*, *in* RSCH. HANDBOOK ON ENV'T, SOCIAL, AND CORP. GOVERNANCE (Thilo Kuntz ed., Edward Elgar 2024) (discussing how companies have responded to the UKCGC requirements).

The UKCGC does not require due diligence, and the 'S' part of ESG finds little expression beyond a weak obligation for companies to engage with their workforce. Beyond purpose and workforce engagement, the UKCGC basically reflects the policy of appointing more non-executive directors and strengthening the monitoring role of the board, a policy that has remained unaltered since the Bank of England's activities during the early 1970s.[149] Shareholder engagement has been a mainstay of UK corporate governance since the early 1970s, too, moving from the UKCGC to the UKSC when the latter was introduced in the aftermath of the 2008 financial crisis. In both cases, the expectation that compliance with the code or shareholder activism will drive companies toward greater sustainability has simply been bolted onto a set of pre-existing policy recommendations. It amounts to little more than saying that market forces will bring corporate activity into line with the sustainability imperative.

Under the UK system, much will depend on investors who are committed to putting pressure on companies to make more far-reaching disclosures, draw up ambitious transition plans and sustainability strategies, and take due diligence seriously. Yet, Blackrock's 2020 engagements with investee companies were dominated by "Governance,"[150] whilst its European proxy guidelines commit to many of the conventional shareholder value mechanisms that are viewed by progressives as driving short-termism and social and environmental externalities, such as takeovers, remuneration linked to the share price and share buybacks.[151] Vanguard's European proxy voting policies do not differ materially. On one level, this should not be a surprise. These large asset managers are competing for assets to manage, and the best way of doing this is to trumpet their shareholder value credentials. Moreover, given fierce competition and the rise of indexing, these asset managers do not have the resources or even expertise to push for firm-specific improvements in ESG. It is much simpler and cheaper for the asset owners to outsource the question of whether individual companies rate highly for ESG to ratings agencies, allowing the asset managers to offer ESG funds and vehicles that are highly competitive in terms of cost whilst both having highly visible ESG rankings and pursuing shareholder value as normal, allowing them to attract

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[149] Andrew Johnston, *From Managerialism to Shareholder Primacy: the Role of the Cohen Committee and the Bank of England*, *in* THE ORIGINS OF CO. LAW (Victoria Barnes & Jonathan Hardman eds., Hart Publishing, forthcoming 2024).

[150] BLACKROCK, OUR APPROACH TO SUSTAINABILITY: INVESTMENT STEWARDSHIP 8 (2020), https://www.blackrock.com/corporate/literature/publication/our-commitment-to-sustainability-exec-summary-amrs-offshore.pdf. (reporting 1230 environmental engagements, 870 social engagements and 2835 governance engagements in 2020).

[151] BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP: PROXY VOTING GUIDELINES FOR EUROPEAN, MIDDLE EASTERN, AND AFRICAN SECURITIES 3-15 (2021), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-emea.pdf.

more assets to manage by highlighting both ESG performance and shareholder value performance (perhaps this is the famous win-win).

VI. CONCLUSION

This article has shown that the UK is committed to enabling institutional investors to take sustainability issues into account in their corporate governance activities. In line with its shareholder-centric approach to corporate governance, it adopts a narrow, single-materiality approach to this, requiring companies to disclose financially material sustainability information. This can be seen both in its earlier approach to non-financial reporting and in more recent measures, including requiring compliance with TCFD and the proposed development of UK Sustainability Disclosure Standards. It also maintains a long-standing preference for self-regulation, as can be seen in its approach to allowing ESG rating providers to draft and follow a non-prescriptive code of conduct. In contrast, the EU is adopting a more expansive approach, requiring sustainability disclosures to be made on a double materiality basis so that they are also useful to impacted stakeholders, moving firmly in the direction of mandatory due diligence and proposing to regulate ESG rating providers. As was widely predicted, Brexit may have given the UK greater formal sovereignty, but the "Brussels effect" will ensure that the UK is normally a rule-taker, having given up its right to contribute to EU rule-making.

Beyond disclosures, the UK has taken some steps in the direction of corporate purpose, and its corporate governance and stewardship codes now pay lip service to sustainability and stakeholders. However, these changes are largely cosmetic and should not distract from the fact that institutional investors—with their short-term demands for shareholder value and reliance on ESG ratings—will determine whether UK companies prioritize sustainability.