

TRICKER

BUSINESS JOURNAL
OF THE GERMAN CHAMBER OF COMMERCE
IN CHINA

SPRING
2024



CORPORATE SUSTAINABILITY AND ESG IN CHINA





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ESG REGULATIONS IN CHINA

*Why and How Should Companies Ensure
ESG Compliance in China*

Since the beginning of the millennium, the People's Republic of China ("China") has been undergoing a significant transition from a focus on GDP growth at any cost to a more sustainable and ESG-oriented approach. Due to significant costs for cleaning up air, water, and soil pollution and social discontent based on pollution-related diseases, the Chinese government has recognized the importance of sustainable development, and has taken significant steps to address environmental, social, and governance (ESG) issues.

Government work reports have been addressing ESG issues since 2013. In 2015, the 5th Plenary Session of the 18th CPC Central Committee set sustainable development as a national goal. In 2020, China pledged to peak its CO₂ carbon emissions by 2030 and to reach CO₂ neutrality by 2060, which is embodied in China's 14th Five-Year Plan. Currently, the sectors promoted by the Chinese government include, for example, green energy (such as NEVs, energy storage devices and solar cells), hydrogen and recycling industries. By 2035, China plans to continue its ESG efforts and to "form green production," further reducing carbon emissions and improving environmental protection.

Considering these ESG goals, it is fair to expect more regulatory requirements in the near future. Companies, including foreign-invested enterprises, are therefore well advised to pay attention to the regulatory developments and ESG trends to prepare for their ESG compliance.

ESG Legal Framework in China

From a legal perspective, ESG compliance means strict conformity with mandatory legal norms in the environmental, social and governance areas. Such norms are stipulated in laws, regulations, and national standards, and violating them may be sanctioned by law.

General stipulations on ESG on a national law level can be found, for example, in the *Environmental Protection Law*, which requires companies to prioritize environmental protection and prevent pollution; the *Labour Law*, which obligates companies to develop and improve their labor systems to ensure legality and equality in their organizations, or the *Consumer Protection Law* and the *Advertising Law*, which penalizes greenwashing.

More recently, ESG has been included in the *Company Law*, effective July 1, 2024. According to the law, companies shall consider the interests of their employees, consumers, and other stakeholders, as well as environmental protection, and assume social responsibility. The new *Company Law* further stipulates that companies should be encouraged to publish social responsibility reports.

The nucleus of ESG compliance is the so-called EHS (Environment, Health and Safety) regime, which is composed of regulations governing environmental protection, workplace safety, and public health. The basic EHS regulations include the *Environmental Protection Law*, the *Water Pollution Control Law*, the *Work Safety Law* and the *Occupational Disease Prevention and Control Law*. Specific ESG and EHS requirements

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are further provided in implementing regulations and national standards.

ESG-related policies issued by governmental departments, industry associations, and self-regulatory bodies are mainly composed of guidelines, incentives and literally hundreds of ESG-related national standards, whereby the vast majority cover environmental protection, energy consumption, enterprise greenhouse gas reporting, etc. In the social responsibility context, the Guide to Social Responsibility (GB/T 36000) provides guidelines for organizations to promote and implement social responsibility practices. In the governance context, the Guidelines on Compliance Management Systems (GB/T 35770) cover compliance management, risk management, and other governance issues in organizations.

Another aspect of ESG compliance is ESG disclosure. At the date of this article, China has no proper legal framework for ESG disclosure and an ESG reporting obligation only applies to certain industries, including financial and insurance institutions, and listed companies.

For non-listed companies, ESG disclosure is basically voluntary and encouraged through green

investment and other market-based forces. However, there are mandatory information disclosure requirements on environmental performance for certain companies. *The Measures for Enterprises to Disclose Environmental Information* are applicable to:

- 1 Major dischargers of pollutants (companies included in respective lists, e.g., *2023 Shanghai List of Key Units for Environmental Supervision*)
 - 2 Companies that are required to undergo mandatory clean production audits under the *Clean Production Audit Measures*, and
 - 3 Publicly listed companies, including their subsidiaries, and companies that issue bonds, provided they have been penalized for ecological or environmental violations in the previous year.
- These companies are required to establish a comprehensive environmental information disclosure management system and disclose environmental information in a timely, truthful, accurate, and complete manner in the form as prescribed in the *Guidelines on the Format for the Legal Disclosure of Environmental Information by Enterprises*.

To standardize and ensure consistency and comparability in voluntary ESG reporting, companies in China may refer to some of the latest guidelines, such as Guidelines on Corporate Social Responsibility Reporting for Chinese Enterprises (CASS-ESG 5.0 - 2022), CERDS Guidance for Enterprise ESG Disclosure (2022), CERDS Guidance on Enterprise ESG Reporting (2023) or adhere to internationally recognized reporting frameworks and standards, such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), Carbon Disclosure Project (CDP), etc.

Why Should Companies Pay Attention to ESG?

Based on the recent developments in ESG, it is expected that China will continue emphasizing sustainability and ESG compliance in the future. The ESG regulatory requirements will become more standardized and mandatory. Consequently, companies operating in China and their management will face more obligations and increased ESG compliance risks. Non-compliance may result in penalties, reputational damage, and even the withdrawal of their business license.

ESG compliance efforts, as a part of a company's compliance system, may help companies to better understand their ESG performance and support the timely detection of potential risks. Companies that proactively integrate non-mandatory ESG principles into their operations are more likely to stay ahead of regulatory changes and minimize risks. The demonstrable addressing of grievances within the company also generally improves the company's social credit rating.

Furthermore, under the EU Draft Directive on Corporate Sustainability Due Diligence ("CSDD Directive"), companies falling within the scope of the CSDD Directive have due diligence obligations and shall seek the necessary contractual assurances from their business partners and other entities in their global value chain to assure ESG compliance. The CSDD Directive will not only affect the companies falling within the CSDD Directives' scope, but also, indirectly, companies in their global value chains, including companies in China. Whether due to the obligation under the CSDD Directive or on a voluntary basis, ESG contractual obligations will often be passed through the value chain from European OEMs via contractual cascading downstream to the raw material supplier, as the final chain link.

COVER STORY

The violation of ESG contract clauses may lead to contract disputes and substantial damage claims.

Besides legal and contractual compliance, investors and consumers are also significant drivers of companies' ESG efforts. As consumers in China become more conscious of the environmental and social impact of their purchasing decisions, companies that demonstrate a commitment to ESG values can build trust, enhance brand loyalty, and gain a competitive edge in the market.

Furthermore, companies with positive ESG performance may enjoy an accelerated process for authority approvals and enhance their access to capital, as banks consider ESG performance as a criterion when granting bank loans.

How Can Companies Improve their ESG Compliance?

To ensure ESG compliance, enhanced ESG performance and improved ESG ratings, companies are advised to develop a comprehensive ESG strategy and consider the following actions for implementation:

- 1 Establish an ESG compliance system as a basis for improving ESG performance.
- 2 Embed ESG compliance in the corporate culture by formulating clear and concise internal guidelines, highlighting the importance of ESG considerations and outlining specific actions that align with the company's ESG objectives.
- 3 Promote ESG compliance and ensure that management communicates

("tone-from-the-top") and employees understand and adhere to ESG compliance.

- 4 Conduct regular ESG trainings at all levels of the organization to raise awareness and provide guidance on integrating ESG principles into daily workflows.
 - 5 Designate a person or team responsible for ESG implementation that will have the power to supervise and enforce ESG compliance and the expertise to conduct ESG evaluation and reporting.
 - 6 Assess and manage ESG risks throughout the supply chains by evaluating suppliers' environmental and social practices and promoting responsible sourcing.
 - 7 Conduct regular compliance and risk reviews, including assessing internal processes, practices and policies to identify potential compliance issues and areas for improvement.
 - 8 Stay up-to-date with the latest rules and requirements by utilizing compliance software and other tracking tools that can help companies monitor changes in ESG regulations and ensure timely compliance updates.
 - 9 Implement a whistleblower hotline, including the company's employees, suppliers and customers, to become aware of ESG-related risks before the authorities are notified.
- Summarizing the above, ESG compliance is — and will become — more important for successful

business operations in China. By proactively embracing ESG best practices, companies can comply with regulatory requirements and gain a competitive advantage, enhance brand value, and improve access to capital. This also includes ensuring contractual ESG compliance through the supply chains by assessing contracts with business partners, including general terms, conditions and code of conduct to identify potential ESG risks. For that purpose, it is recommended to establish a contract management system. As the implementation of ESG compliance is a long-term process, we advise companies to start with their ESG implementation as soon as possible.

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Saturday, May 25, 2024

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