Paths of convergence: When ESG meets trade compliance

Ten years ago, it was safe to say that trade controls and the suite of compliance requirements described by the 'ESG' portmanteau were separate and distinct. For the most part that still holds true, but there are increasingly areas of overlap (such as the reporting obligations and stringent penalties for breach of US forced labour laws), and as Jonathan Esser and Amirreza Hesami describe, it is starting to make sense to visualise both as part of a broader sweep of concerns – especially as ESG regulations gather pace (and grow teeth).

Global corporations are increasingly confronted with the challenges of both environmental, social, and governance ('ESG') principles and trade compliance. This convergence goes beyond compliance as we know it, reflecting a broader responsibility in today's interconnected world.

ESG addresses a company's environmental impact, social responsibility, and governance practices. This approach emphasises the importance of companies broadening their focus beyond traditional profit-driven goals to include practices that address global challenges and promote responsible business practices.

The environmental component of ESG focuses on a company's environmental impact and supports practices that minimise negative environmental impacts. This includes efforts to reduce carbon emissions, improve energy efficiency, manage waste responsibly, and protect natural resources.

Trade compliance ensures conformity to international trade laws, tariffs, and export controls while promoting ethical and legal practices globally. It is not an isolated function but an integral part of a broader commitment to responsible behaviour.

Social responsibility within the ESG framework refers to how a company manages its relationships with employees, suppliers, customers, and the communities in which it operates. Key aspects include ensuring fair labour practices, upholding human rights, and promoting diversity and inclusion. Governance refers to the rules, practices, and processes by which a company is directed and controlled, e.g., business ethics. ESG is a holistic approach to business that encourages companies to operate in a manner that is environmentally sustainable, socially responsible, and governed by high standards of ethics and transparency.

Simultaneously, trade compliance ensures conformity to international trade laws, tariffs, and export controls while promoting ethical and legal practices globally. It is not an isolated function but an integral part of a broader commitment to responsible behaviour.

This convergence between ESG and trade compliance is driven by specific regulations such as the Carbon Border Adjustment Mechanism ('CBAM'),[1] national supply chain due diligence provisions such as the German Supply Chain Due Diligence Act ('LKSG'),[2] the Corporate Sustainability Reporting Directive,[3] and regulations on deforestation and forced labour.

Integrating ESG into trade compliance goes beyond mere legal adherence; it signifies a dedication to global sustainability, ethical business practices and responsible corporate governance, but also requires a rethinking of trade compliance departments and functions and their responsibilities and tasks.

WHY COMPLIANCE MATTERS MORE THAN EVER

In today's fast-paced and ever-changing global business environment, staying up to date with trade regulations is essential. Trade compliance is not just a 'nice to have' – it is a critical part of keeping a business running smoothly and avoiding legal issues, fines, and damage to reputation.

However, the legal world of global trade has become so complex that it increasingly feels like navigating a complex maze of laws. Here we offer only a brief overview of trade compliance provisions to be kept in mind by European operators:

- **National Foreign Trade Law:** E.g., companies operating in Germany must be well-versed in the nationally applicable *Außenwirtschaftsrecht* as set up by the Foreign Trade and Payments Act[4] and Ordinance governing the export and import of goods, technology, and services with a focus on national security and foreign policy objectives. However, for multinationals this means keeping track of national legal developments in all countries where they are located, including even the national specialties that still exist in various EU Member States.
- **EU export control regulations:** The European Union has established a harmonised approach to control the export of sensitive goods and technologies, requiring businesses to align with these regulations across all Member States with Council Regulation 2021/821 - the EU Dual-Use Regulation[5]. It also governs various embargo regulations on countries and individuals, entities and organisations.
- **Extraterritorial legal considerations:** Certain regulations, in particular US (re-)export control provisions, have extraterritorial reach, necessitating an understanding of global legal acts. This adds another layer of complexity, requiring organisations to navigate domestic and international laws.

And the challenge continues. Regulatory expectations are increasing:

- **Compliance-ready organisational structures:** Regulatory bodies expect companies to establish robust internal structures facilitating seamless compliance with export control and customs regulations.
- **Stringent internal organisation standards:** Stricter requirements are imposed on the internal structures and processes of companies engaged in international trade, emphasising the importance of transparent and accountable procedures.

The proposed deforestation regulation requires companies to trace their supply chains and ensure products are deforestation-free. It also establishes a due diligence system for companies to identify and mitigate risks. It has significant implications for businesses engaged in international trade.

Ignoring these demands carries severe risks:

- **Liability risks for companies and individuals:** Non-compliance exposes companies and individuals involved in international trade to significant liability risks, including legal actions and penalties.
- **Severe penalties for violations:** Regulatory bodies can impose substantial penalties for violations, emphasising the need for rigorous compliance measures.
- **Reputational damage:** Beyond legal repercussions, non-compliance can tarnish a company's reputation, eroding customer trust and damaging stakeholder relationships which might be even more impactful than fines or penalties.

Given these considerations, it's imperative for companies to proactively embrace robust compliance measures, internalise evolving regulatory expectations, and diligently mitigate the considerable risks associated with non-compliance.

COMPLIANCE AND ESG

The world of international trade is changing rapidly, especially as ESG factors become more important. Today, companies trading across borders must think beyond legal compliance and act responsibly and ethically. ESG principles are crucial to reducing risk and building long-term value for companies.

This change brings additional ethical challenges and requires new compliance rules for companies operating internationally. Although many regulations support ESG goals, here we focus on a few essential regulations leading to this change and examine how they affect international companies.

Environmental concerns

Carbon Border Adjustment Mechanism

The Carbon Border Adjustment Mechanism ('CBAM') is a new EU regulation that aims to reduce the carbon footprint of imported goods. CBAM primarily targets goods with a high carbon footprint, such as steel, aluminium, cement, and fertilisers. Importers of these goods into the EU must purchase carbon certificates to offset the embedded emissions. CBAM is being implemented in phases, with the first phase beginning in October 2023 and ending in December 2025. During this phase, companies will be required to report on the carbon emissions of their imported goods within the scope of the regulation. The second phase, which will begin in January 2026, will require companies to purchase carbon certificates to offset the emissions of their imported goods.

CBAM has significant implications for businesses engaged in international trade. Importers of goods subject to CBAM must track and report emissions data accurately. They will also need to develop strategies to reduce their products' carbon footprints. This may involve investing in low-carbon technologies or sourcing products with a lower carbon footprint from suppliers.

REACH[6]

This EU directive focuses on managing the risks posed by specific chemicals, safeguarding human health and the environment. It is crucial in ensuring the responsible export of certain chemical substances.

REACH has a broad impact on global trade practices, especially concerning the responsible import of certain chemical substances. It requires companies to register chemicals; provides detailed information on their properties, uses, and safe handling guidelines; and, in some cases, lists reporting requirements for substances of very high concern.

Deforestation regulation[7]

The EU's ban on the import of products linked to deforestation, such as beef, palm oil, soy, wood, cocoa, and coffee entered into force in June 2023. The regulation requires companies to trace their supply chains and ensure products are deforestation-free. It also establishes a due diligence system for companies to identify and mitigate deforestation risks. Companies that fail to comply with the regulation may be subject to penalties.

The deforestation regulation has significant implications for businesses engaged in international trade. Companies that import products subject to the regulation must adapt their sourcing practices to avoid deforestation-linked products. They must also implement traceability and transparency measures in their supply chains. However, as a first step this always requires analysis of trade data and evaluation of supply chains based on this data.

Forced labour regulation

The EU has implemented regulations prohibiting the import of goods produced with forced labour.[8] These regulations require companies to implement due diligence measures to identify and prevent forced labour in their supply chains. They also establish a risk-based approach for companies to assess forced labour risks. Companies that import goods produced with forced labour may be subject to penalties.

The forced labour regulations have significant implications for businesses engaged in international trade. Companies that import goods subject to the regulations must implement due diligence measures in their supply chains. This may involve conducting supplier audits, developing training programmes for employees, and establishing a system for monitoring and reporting on compliance. The forced labour regulations are likely to increase compliance costs for businesses, but they also present an opportunity to improve ethical sourcing practices and reduce reputational risks.

Additional goods-specific restrictions

Various measures contribute to environmental protection through controlled international trade, from the Ozone Regulation and Chemical Weapons Convention to Waste Shipment and Prior Informed Consent regulations. Even the EU Dual-Use Regulation includes items which are within the scope of environmentally-driven regulations, particularly in the area of controlled chemicals, substances and toxins.

Social responsibility in trade

Trade agreements

The EU-Mercosur agreement is based on the premise that trade should not happen at the expense of the environment or labour conditions; on the contrary, it should promote sustainable development.[9] Additionally, within the EU-Vietnam Agreement, there is a chapter aimed at advancing the integration of sustainable development within the trade and investment relationship. This is achieved notably by setting forth principles and actions related to labour and the environmental dimensions of sustainable development that hold particular significance in the context of trade and investment.[10]

German Supply Chain Due Diligence Act ('LKSG')[11]

The LKSG is a German law that requires companies to implement risk-based due diligence measures to identify and mitigate human rights, environmental, and social risks within their supply chains. The LKSG applies to companies with more than 1,000 employees in Germany, requiring that they establish a process by which employees can report concerns about human rights or environmental and social risks. The LKSG also imposes a duty of care on companies to prevent and mitigate risks in their supply chains. Companies that fail to comply with the LKSG may face civil liability.

The LKSG has significant implications for businesses engaged in international trade. Companies subject to it must conduct risk assessments of their supply chains and implement appropriate measures to mitigate risks. This may involve conducting supplier audits, developing training programmes for employees, and establishing a system for monitoring and reporting on compliance.

Export control can be a potent tool for achieving governance objectives. By leveraging the four pillars of export control – items-based, country-based, end use-based, and person-based – businesses can effectively integrate ESG considerations into their global trade strategies.

Uyghur Forced Labor Prevention Act[12]

This US legislation, aimed at combatting forced labour and aligning trade practices with social responsibility, presumes that goods from China's Xinjiang region are banned unless imported ethically. Besides the existing US legislation, other legislative bodies such as the European Commission are also considering similar regulations.[13]

This legislation exemplifies the types of compliance measures necessary to align international trade practices with socially responsible principles and combat forced labour. Companies interested in trading with or within the Xinjiang region must exercise enhanced due diligence in reviewing their supply chains and documenting their compliance efforts.

Corporate Sustainability Reporting Directive[14]

The Corporate Sustainability Reporting Directive ('CSRD') is an EU regulation requiring sustainability reporting from companies. Effective from 1 January 2024, it applies to EU and non-EU companies with significant operations in the EU. It requires companies to report on a double materiality basis, meaning that they must disclose information on both the impact of their activities on sustainability issues and the impact of sustainability issues on their business. The CSRD also establishes a European Sustainability Reporting Standards Board to develop sustainability reporting standards. Companies will be required to have their sustainability reports independently evaluated.

The CSRD has significant implications for businesses engaged in international trade. Companies subject to the CSRD must develop robust systems for collecting and reporting sustainability data. They must also ensure that their sustainability reports are accurate and transparent. The CSRD is likely to increase compliance costs for businesses, but it also presents an opportunity for companies to improve their sustainability performance and attract investors.

From a compliance perspective this requires the implementation of processes, and maybe also IT-supported measures, to collect trade data and create transparency.

Dual-Use Regulation (Article 5)[15]

This EU regulation includes end use-based restrictions on digital surveillance goods that could potentially be used for human rights violations, demonstrating awareness of the social implications of technology exports.

Governance

The intricate intersection of trade compliance and ESG principles also demands a robust governance framework.

Export control, focusing on restricting the export of goods, technologies, and services to specific destinations, individuals, end users, and end uses can be a potent tool for achieving governance objectives. By leveraging the four pillars of export control – items-based, country-based, end use-based, and person-based[16] – businesses can effectively integrate ESG considerations into their global trade strategies.

What's going out? (Items-based control)

In implementing items-based control measures, i.e., restricting goods or technologies that could have a negative impact on the environment or society (such as weapons, chemicals or hazardous waste), companies can ensure that their exports are in line with ESG principles and can contribute to responsible global trade practices.

Where's it going? (Country-based control)

Country restrictions, in addition to existing sanctions and embargo regulations, can help reduce environmental and social risk by ensuring that goods and technologies are not exported to countries that violate human rights or cause environmental damage.

What's its purpose? (End use-based control)

In the context of ESG, this pillar could focus on ensuring that exported goods and technologies are not used for purposes that could have negative environmental or social impacts, such as pollution or human rights abuses – which, at least partially, is already included in the recent EU Dual-Use Regulation. However, the 2021 discussions on revising this regulation showed that, regarding the extension of end use-based provisions (so called 'catch-all rules') to further end uses, e.g., in the area of human rights violations, the EU was not able to find common cause.

Who's getting it? (Person-based control)

This pillar could help to prevent individuals involved in human rights violations or environmental destruction from accessing economic resources by restricting exports to them. By implementing person-based control measures, businesses can reinforce their commitment to ethical business practices and align with ESG principles.

In addition, the internal compliance programme ('ICP') plays a diverse role, serving not only as documentation of a company's internal controls to ensure compliance with relevant export control regulations, but also as a channel for embedding ESG principles into the company's core governance structure. In this regard, it should be noted that even if ESG purposes can be served via existing export control structures and processes and their documentation in an ICP, whether the trade compliance function is able to take care of these additional topics, deriving risks and tasks, must still be evaluated internally. What should definitely be considered is that this will require additional resources as well as interfaces with various departments within the organisation.

The European Union's Recommendation (EU) 2019/1318[17] of 30 July 2019 on ICPs for dual-use trade controls under Council Regulation (EC) No 428/2009 provides a valuable framework into which ESG principles could be integrated:

- **Top management commitment:** This element could be extended beyond compliance with export control laws to include a commitment to sustainable and socially responsible business practices. A company's top management could clearly state its commitment to ethical behaviour, environmental protection and social responsibility, which are increasingly becoming state-of-the-art since ESG criteria are within the top management´s responsibility and a decisive factor in company valuation.
- **Organisational structure, responsibilities, and resources**: In addition to establishing responsibilities for export control compliance, this element could explicitly allocate resources to ESG initiatives, underscoring the company's commitment to social and environmental responsibility. This could include establishing dedicated and interdisciplinary teams, allocating budgets, and providing training and support for ESG-related activities.

LINKS AND NOTES

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- **Training and awareness**: Beyond training on export control regulations, this component may include comprehensive awareness programmes on integrating ESG principles throughout the organisation. This could involve workshops, seminars, and regular communication to ensure that all employees understand the importance of ethical business conduct, sustainability, and social responsibility in their daily work.
- **Performance review, audits, reporting, and corrective actions**: This element could be used to assess not only export control performance, but also a company's adherence to ESG principles. Regular audits and corrective actions should cover compliance issues and deviations from established ESG standards to ensure continuous improvement and accountability.
- **Screening process and procedures for business transactions:** Integrating ESG screening criteria within existing processes ensures that business transactions align with the company's commitment to ESG considerations. This could involve conducting due diligence on suppliers and partners, assessing products' and services' environmental and social impacts, and avoiding transactions that may violate human rights or contribute to environmental degradation.
- **Record-keeping and documentation:** In maintaining records and documentation, the company may explicitly capture its adherence to ESG principles, providing transparency and accountability in sustainable business practices. This could involve keeping records of ESG-related policies and procedures as well as training, and reports on ESG performance.
- **Physical security and information security:** Beyond ensuring goods' physical and informational security, this component may extend to safeguarding against ESG-related risks such as environmental harm or human rights violations. This could involve implementing measures to prevent data breaches, protect sensitive information, and ensure the security of physical assets.

By incorporating these elements into an ICP, companies can create a framework that facilitates the integration of ESG principles into their trade practices.

BENEFITS OF ESG-DRIVEN TRADE COMPLIANCE

Even if the implementation of ESG-driven trade compliance takes a lot of effort and necessitates expanding existing trade compliance structures and procedures, it brings a host of benefits to companies, from enhancing brand reputation to driving long-term sustainability and profitability. Two of the most important benefits are:

- **Improved reputation and competitive advantage:** Companies that proactively integrate ESG principles into their trade compliance strategies often enjoy a stronger reputation.[18] This enhanced reputation can lead to increased customer loyalty, as consumers are increasingly drawn to brands that demonstrate a commitment to ethical and sustainable practices. It can also provide a competitive advantage in markets where consumers and investors are more aware of ESG issues.
- **Risk mitigation**: ESG-driven trade compliance helps companies identify and mitigate a wide range of risks, including legal, reputational, and operational. By adhering to strict ESG and trade compliance standards, companies can avoid costly fines, sanctions, and the reputational damage associated with non-compliance.

A STRATEGIC IMPERATIVE

Integrating ESG principles into trade compliance is not just a regulatory requirement; it is a strategic imperative for companies operating in the global marketplace. The convergence of ESG and trade compliance is driven by regulatory pressures, market forces, and the ethical considerations involved in doing business in an interconnected world. The benefits of ESG-driven trade compliance are many, including opportunities to enhance companies' reputations, mitigate risks, attract investment and drive innovation. Nevertheless, it brings new challenges for trade compliance departments and their role within organisations.

Companies that embrace ESG-driven trade compliance not only meet the demands of regulators and consumers, but contribute to a more sustainable and equitable global economy. As the business landscape evolves, integrating ESG principles into trade compliance will likely become an increasingly critical factor in determining a company's long-term viability and success. The path to sustainable trade practices is complex and challenging, but the rewards for companies that embark on this journey are substantial and far-reaching.

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