International Insight: Climbing the ESG Everest: The Long and Difficult Path from Non-financial to Sustainability Reporting

Introduction

In a previous Client Alert, Curtis reported on the increasing attention of the European Union to sustainability, in particular through the development of a "green" and transparent financial system.

With its communication of April 21, 2021 (Commission, 2021), the European Commission has taken a further step towards the achievement of this goal.

The Commission[1] has presented a proposal for a Corporate Sustainability Reporting Directive (CSRD)[2] (Commission, 2021), which revises and strengthens the existing rules introduced by Directive 2014/95/EU (Non-Financial Reporting Directive – NFRD) with the aim of bringing, over time, sustainability reporting on a par with financial reporting (Parliament, 2021).

The text of the proposed Directive clearly shows the change of course that the European Union is trying to imprint on the business of European companies, in particular on the management of their supply chain, in order to enhance compliance with ESG factors[3] and the creation of long-term value for the benefit of shareholders and stakeholders in addition to the pursuit of profit (Cavallo, 2021).

Addressing Business Impacts

It is generally acknowledged and accepted that business impacts significantly on the environment, working conditions and human rights at a global level.

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[1] The Commission has also presented the EU Taxonomy Climate Delegated Act, which should have been adopted at the end of May. For more information about the EU Taxonomy, *see* Curtis' previous Client Alert on sustainable finance, as well as https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en#taxonomy.

[2] Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (COM/2021/189 final), *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0189.

[3] ESG is the acronym for Environmental, Social, and (Corporate) Governance. The purpose of the ESG factors is to measure the impact of companies in those three broad areas and to provide standard sector information to inform investment decisions. Each ESG factor is comprised of a number of criteria that may be considered, either by socially responsible investors or by companies aiming to adopt a more ESG-friendly operational stance.

With globalization, multinationals have developed global supply chains, using diverse criteria for workers' legitimate deployment,[4] multidisciplinary methods to manage risks of environmental disasters[5] and land grabbing episodes.[6]

In many cases multinational corporations, by acting through subsidiaries and by exploiting weak local legislation, have avoided being held accountable for their actions (Parliament, 2020).

As a consequence, there is a wide expectation that businesses improve their corporate social responsibility (CSR, or responsible business conduct, RBC) and take actions to assess, prevent, manage and mitigate any negative impacts their global supply chain may cause (*Ibidem*).

To date, the approach has been mainly on a voluntary basis, with some businesses – operating especially in certain sensitive industries – voluntarily conducting due diligence on their suppliers to avoid reputational damage and to ensure the respect of the human rights of their workers (*Ibidem*).

The EU adopted binding legislation to address human rights and environmental violations only in very limited and sensitive sectors, such as the extractive[7] and timber[8] industries.

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[4] *See, e.g.,* the Rana Plaza disaster: https://www.ilo.org/global/topics/geip/WCMS_614394/lang--en/index.html.

[5] Two years ago in Brumadinho, Minas Gerais (Brazil) 270 people died because of tailings liquefaction that led to a dam collapse at Vale's Córrego do Feijão mining complex. For more information, *see*: https://www.mining.com/vale-drills-caused-brumadinho-dam-collapse-police-say/.

[6] For more information, *see*: http://www.europarl.europa.eu/RegData/etudes/STUD/2016/578007/EXPO_STU(2016)578007_EN.pdf.

[7] On January 1, 2021, the EU Conflict Minerals Regulation (Regulation (EU) 2017/821) went into effect. The Regulation lays down supply chain due diligence obligations for EU importers of tin, tantalum and tungsten, their ores, and gold originating from conflict-affected and high-risk areas. EU importers of these minerals must check that the minerals or metals they buy do not contribute to conflict, forced labor or other illicit activities. The regulation requires importers to follow the five-step framework established by the OECD: (i) establish strong company management systems; (ii) identify and assess risk in the supply chain; (iii) design and implement a strategy to respond to identified risks; (iv) carry out an independent third-party audit of supply chain due diligence; and (v) report yearly on supply chain due diligence. For more information, *see*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R0821.

[8] Regulation (EU) No 995/2010 of the European Parliament and of the Council of October 20, 2010 laying down the obligations of operators who place timber and timber products on the EU market entered into force in March 2013. The regulation takes measures to stop the trade in illegally harvested timber and timber products and it applies to both imported and domestically produced timber and timber products. It requires EU traders who place timber products on the EU market for the first time to exercise "due diligence," that is a system of measures and procedures to minimize the risk of placing illegally harvested timber and timber products derived from such timber on the internal market. The due diligence system includes three elements inherent to risk management: (i) access to information about the origin of wood, (ii) risk assessment, and (iii) mitigation of the risk

Unfortunately, public statements about sustainability and climate change integration in companies' business strategies are often nothing more than greenwashing, since some companies claim better sustainability performance than they actually have by outsourcing their noncompliant activities to overseas suppliers (Rui Dai, 2021).

Under the European Green Deal, as part of the EU's effort to implement the United Nations' sustainable development goals (SDGs), and the Sustainable Finance Action Plan,[9] the Commission has outlined its commitment towards the creation of global sustainable supply chains by addressing the need to avoid relocating harmful environmental and social activities outside the EU's borders and by promoting new standards for sustainable growth (Commission, 2021).

The Green Deal aims to build the conditions to unlock the investment needed to achieve the EU's 2050 climate neutrality objective, directing financial and capital flows to sustainable investments (*Ibidem*).

Key in achieving the EU goals is the improvement of the quality and standardization of ESG data and its transparency and availability through the disclosure of non-financial information. As a result, it will become easier to measure, monitor and manage companies' performance as well as their impact on society (Parliament, 2020).

From the Non-financial Reporting Directive...

The adoption of Directive 2014/95/EU (Non-Financial Reporting Directive – NFRD) represented a major step towards greater business transparency and accountability on social and environmental issues. The NFRD requires large public-interest entities[10] to disclose information regarding their business models, policies (including due diligence processes implemented), the outcomes of the policies, risks and risk management, and non-financial key performance indicators relevant to their particular business[11]. (Parliament, 2021).

Investors and non-governmental organizations, as well as shareholders and other stakeholders, asked for more and better detailed information and called for a new regulatory approach to non-financial reporting (*Ibidem*).

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identified. For more information, *see*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32010R0995.

[9] Communication from the Commission – Action Plan: Financing Sustainable Growth, COM (2018)097 final.

[10] The NFRD is applicable to public-interest entities with an average number of employees in excess of 500 and public-interest entities that are parent companies of a large group with an average number of employees in excess of 500 on a consolidated basis. Public-interest entities are defined in the Accounting Directive (Directive 2013/34/EU) as companies with securities listed in EU-regulated markets, banks (whether listed or not), insurance companies (whether listed or not) and any other companies designated by Member States.

[11] Articles 19a(1) and 29a(1) of Directive 2013/34/EU.

The European Commission's 2018 public consultation "*on the fitness check on the EU framework for public reporting by companies*" showed that the existing non-financial information disclosure practices did not meet the growing investors' demand for data and information, both from qualitative and quantitative standpoints. Furthermore, it emerged that the information was not sufficiently comparable or reliable, making it almost impossible for investors and stakeholders to compare the performance of different organizations (Commission, 2018). The Commission's further public consultation, concluded in June 2020, also identified the need to broaden the NFRD's subjective scope of application.

The growing awareness that sustainability can have an impact on financial performance of companies, and the growing market for investment products which seek to conform to sustainability standards and to achieve sustainability objectives, led to Regulation (EU) 2019/2088 (Sustainable Finance Disclosure Regulation)[12] and Regulation (EU) 2020/852 (Taxonomy Regulation)[13] (Commission, 2021).

Similarly, entities subject to NFRD reporting requirements need clarity regarding the information to be included in reports concerning their suppliers, customers and investee companies (Commission, 2021).

The Communication from the Commission indicates that, according to Article 8 of the Taxonomy Regulation, companies subject to the NFRD, and the additional companies that would be subject under the proposed CSRD,[14] shall disclose in their reports specific indicators on the extent to which their activities are sustainable according to EU Taxonomy. These companies shall, in particular, disclose the proportion of their turnover, capital expenditure and operating expenditure that are originated or associated with economic activities that qualify as "sustainable."[15]

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[12] The SFDR governs how financial market participants (including asset managers and financial advisers) should disclose sustainability information to end-investors and asset owners. To be able to fulfil the requirements of the SFDR – and therefore ultimately to be able to meet the needs of end investors including individuals and households – financial market participants need adequate information from investee companies. Cfr. Proposal for a Directive amending Directives 2013/34/EU, 2004/109/EC, 2006/43/EC and Regulation (EU) No 537/2014 (COM (2021) 189), p. 5, *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

[13] The Taxonomy Regulation defines a classification system for environmentally sustainable economic activities, with the aim of scaling up sustainable investments and combatting the greenwashing of "sustainable" financial products. It requires companies within the scope of the NFRD to disclose certain indicators about the extent to which their activities are environmentally sustainable according to the taxonomy. These indicators are complementary to the information that companies have to disclose according to the NFRD itself, and companies will have to report them alongside other sustainability information mandated by the NFRD. Cfr. Proposal for a Directive amending Directives 2013/34/EU, 2004/109/EC, 2006/43/EC and Regulation (EU) No 537/2014 (COM (2021) 189), p. 5, *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

[14] *See* the "…To the Proposal for a Corporate Sustainability Reporting Directive" section of this Client Alert.

[15] These indicators will be specified in a separate delegated act which will come into force as of 2022.

The mandatory reporting standards to be developed under the CSRD will fully take into account these indicators, and they will build on the screening criteria and 'do-no-significant-harm' thresholds of the EU Taxonomy.[16]

...To the Proposal for a Corporate Sustainability Reporting Directive

The Commission's Directive proposal substantially incorporates and addresses these critical issues.

The CSRD proposal extends the application of the non-financial reporting obligations (*rectius*, the sustainability reporting) to all large companies (listed and unlisted, removing the 500-employee threshold) and, as of January 1, 2026, to all listed SMEs[17] (excluding micro-enterprises).[18] This extension, according to European Commission estimates, will increase from 11,000 to 50,000 the number of entities which will be subject to the reporting requirements at the European level (Commission, 2021).

Furthermore, the entities subject to the reporting requirements will have to disclose in sufficient detail the entity's impact on sustainability issues, *i.e.*, with reference to environmental, social and governance (ESG) factors (Commission, 2021).

In particular, the CSRD proposes to include in the management report the "*information necessary to understand the undertaking's impact on sustainability matters, and information necessary to understand how sustainability matters affect the undertaking's development, performance and position*" (Commission, 2021).

In particular, the management report shall include the following information:[19]

(a) a brief description of **the undertaking's business model and strategy**, including: (i) its resilience to risks related to sustainability matters; (ii) the opportunities related to sustainability matters; (iii) the

[16] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal, *available at*: https://eur-lex.europa.eu/legal-content/IT/TXT/PDF/?uri=CELEX:52021DC0188&from=EN.

[17] Listed SMEs will be able to benefit from a proportionate reporting regime, the details of which will be provided, according to the stated intentions of the European Commission, by means of delegated acts to be adopted by October 31, 2023 at the latest. Unlisted SMEs, on the other hand, will be able to voluntarily adopt such a proportionate regime.

[18] Cfr. Proposal for a Directive amending Directives 2013/34/EU, 2004/109/EC, 2006/43/EC and Regulation (EU) No 537/2014 (COM (2021) 189), pp. 41-42, *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

[19] Art. 1(3) of the Proposal for a Directive amending Directives 2013/34/EU, 2004/109/EC, 2006/43/EC and Regulation (EU) No 537/2014 (COM (2021) 189), *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

plans to ensure that the business model and strategy are compatible with the transition to a sustainable economy and with the global warming objective in line with the Paris Agreement; (iv) how the entity is taking into account the interests of its stakeholders and its impact on sustainability matters; and (v) how the entity's strategy has been implemented with regard to sustainability matters;

(b) a description of **the sustainability targets** set by the entity and of the progress it has made towards achieving them;

(c) a description of **the role of the administrative, management and supervisory bodies with regard to sustainability matters**;

(d) a description of the **undertaking's policies in relation to sustainability matters**;

(e) a description of: (i) **the due diligence process implemented with regard to sustainability matters**; (ii) the main **actual or potential adverse impacts on the entity's value chain**, including its own operations, its products and services, its business relationships and its supply chain; and (iii) **any actions taken**, **and their results, to prevent, mitigate or remediate actual or potential adverse impacts**; and

(f) a description of **the main risks related to sustainability matters**, including the entity's main dependencies on such matters and how it manages them.

Moreover, the sustainability reporting process must take into account short-, medium- and long-term horizons, consistent with the 2020 European Commission Sustainable Corporate Governance Initiative (SCGI) to encourage companies and their directors to promote a long-term decision-making approach in lieu of a short-term one (Commission, 2021).

In order to meet the need for data comparability and reliability, the proposal requires that the information be drafted in a single electronic format. The electronic drafting format requirement clearly contributes to the implementation of the Action Plan for the creation of the Capital Markets Union. One of the objectives of the Action Plan is the creation of a sole EU digital access platform for the publication of companies' financial and sustainability information (so-called "single European access point") (Commission, 2020).

The definition of a common reporting methodology at the EU level, together with the introduction of specific audit requirements to ensure information accuracy and

reliability[20] – as opposed to the current use of various reporting standards and frameworks – would also ensure alignment with the EU ESG regulatory framework, with the SFDR (Regulation EU 2019/2088), and the Taxonomy (Regulation EU 2020/852) (Commission, 2021).

The CSRD, which still needs to be approved by the European Parliament, should – in principle – be transposed by the Member States by December 1, 2022, and its provisions should come into force from January 1, 2023.[21]

Conclusion

Sustainability reporting will be a main focus of European legislative activity in the upcoming years.

There is a growing interest in climate-related data and social factor disclosure – including the treatment of employees and respect for human rights along the supply chain – as well as governance disclosures, which include corporate culture and approach to business ethics, anti-corruption and anti-bribery, and political engagements, including lobbying activities (Commission, 2021).

To meet these information needs in a timely manner, the Commission has envisaged the following action plan:

- by October 31, 2022, adoption of a first set of standards that will specify the information necessary to comply with the reporting requirements indicated in (a) to (f) above and that will enable financial market participants to comply with the disclosure obligations provided for by Regulation (EU) 2019/2088 (*Ibidem*);

- by October 31, 2023, adoption of a second set of standards that will indicate complementary information to the reporting requirements indicated in (a) to (f) above including specific information for different industries; and

- the Commission should review the standards every three years to take into account relevant developments, including the development of international standards (*Ibidem*).

Considering the continuous growth of financial products that aim to pursue sustainability objectives, good reporting can be pivotal in helping entities to identify

[20] Cfr. Proposal for a Directive amending Directives 2013/34/EU, 2004/109/EC, 2006/43/EC and Regulation (EU) No 537/2014 (COM(2021) 189), p. 59, *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

[21] Cfr. Article 5 of the Proposal for a Directive amending Directives 2013/34/EU, 2004/109/EC and Regulation (EU) No 537/2014 (COM(2021) 189), p. 64, *available at*: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

and manage their risks and opportunities related to sustainability matters and in providing access to the financial capital market.

Curtis' multijurisdictional team of professionals has recognized international experience in all ESG areas and is well positioned to assist international companies and investors and guide them to "*climb to ESG Everest*."

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