CLIFFORD

CHANCE

ESG: EUROPEAN COMMISSION PROPOSES CORPORATE SUSTAINABILITY REPORTING DIRECTIVE

– THOUGHT LEADERSHIP

ESG: EUROPEAN COMMISSION PROPOSES CORPORATE SUSTAINABILITY REPORTING DIRECTIVE

What is changing?

- Reporting requirements under NFRD extended to cover a wider scope of companies;
- Greater detail on the information companies are required to report based on new harmonised EU sustainability reporting standards;
- Removal of national discretion to allow companies to report separately from the management report;
- Exempt subsidiaries required to publish the consolidated management report of the parent undertaking;
- Amendments to the Transparency Directive extending sustainability reporting to companies listed on EU regulated markets (other than micro-companies), including non-EU issuers;
- Amendments to the Audit Directive and Audit Regulation to introduce a harmonised EU audit requirement for sustainability reporting;
- All sustainability information to be published in a machine-readable format, with information digitally tagged in accordance with a digital taxonomy, ready for upload to the future 'European Single Access Point'.

The European Commission has published a proposal for a Corporate Sustainability Reporting Directive (CSRD) as part of a package of measures aiming to direct capital flows towards sustainable activities.

Many organisations are already required to carry out non-financial reporting under the Non-Financial Reporting Directive (NFRD). However, current requirements lack detail so levels and standards of reporting vary enormously. As well as making it difficult for organisations to determine what information to report, it makes it almost impossible for investors and stakeholders to compare performance between different organisations. The CSRD also proposes amendments to existing requirements under the Transparency Directive, the Audit Directive and the Audit Regulation.

As the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation begin to impose significant duties upon financial investors and asset managers to disclose information about the sustainability of their investments, it is increasingly important that those investee entities provide the information necessary in order for financial investors and asset managers to comply with their SFDR and Taxonomy Regulation disclosure obligations. The proposed amendments under the CSRD aim to address these concerns.

Expanded list of reporting entities

The CSRD proposes to expand significantly the scope of entities subject to sustainability reporting obligations, with all large companies and all companies with securities listed on EU regulated markets (other than micro-companies) required to prepare management reports in accordance with EU sustainability reporting standards. It achieves this by amending:

- The Transparency Directive (2004/39/EU) so that all issuers with securities (either equity or debt, unless solely wholesale debt) listed on EU regulated markets (including non-EU issuers) are required to report in accordance with EU sustainability reporting standards;
- The Consolidated Accounting Directive (2013/34/EU as amended by the NFRD) so that the following entities will be required to prepare management reports in accordance with EU sustainability reporting standards:
  - All large undertakings (not just those that are public-interest entities, and not just those with over 500 employees);
  - Small and medium-sized undertakings which are governed by the laws of an EU Member State and whose securities (either equity or debt) are admitted to trading on an EU regulated market (from 1 January 2026);
  - Parent undertakings of a large group (not just those with over 500 employees);
  - Credit institutions and insurance undertakings, including those that are not currently within scope as a result of their corporate form (e.g. mutuals and cooperatives).

The proposed amendments therefore remove the 500 employee threshold, and additionally capture un-listed large undertakings (i.e. over 250 employees) and listed SMEs (although listed SMEs will be able to benefit from a proportionate reporting regime – see below). EU-based subsidiary undertakings of third-country parent companies will have to comply with the reporting requirements unless they are included in their parents' consolidated management report, and that management report is deemed to be equivalent to the standards set by the CSRD. This will result in a major expansion of reporting entities from the current 11,700 to circa. 49,000, representing 75% of limited liability company turnover.

Amendments to the NFRD: Greater level of detail prescribed for required sustainability information / new mandatory sustainability reporting standards

The current NFRD requirements to include sustainability related information in a non-financial information statement contain little prescriptive detail (Article 19a Consolidated Accounting Directive 2013/34/EU). The statement is required to contain "*information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum,* ***environmental, social and employee matters****, respect for* ***human rights, anti-corruption*** *and* ***bribery*** *matters*". Information must be included on the organisation's business model, policies, due diligence processes undertaken, principal risks (including in relation to business relationships, products and services) and how they are managed, and relevant non-financial key performance indicators. The Commission has previously published guidelines to assist companies with non-financial reporting, including a new set of guidelines on climate-related reporting in 2019 (**Commission Guidelines**).

Compared with NFRD reporting, the CSRD will bring in two new principal elements: (1) A much greater level of detail is included in the CSRD as to the scope of information required;
(2) Disclosures will also have to be made in line with sustainability reporting standards to be established by the Commission.

The Commission is also moving away from the term 'non-financial' matters to refer to 'sustainability matters' in particular to reflect that sustainability matters often have significant financial relevance. Sustainability matters will however still encompass the same areas: environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. The new reporting information must be included in the entity's management report, which is a move away from the NFRD approach which allowed Member States to permit disclosure in a separate report.

Greater prescription for reporting requirements (New Article 19a, Consolidated Accounting Directive)

Key differences of CSRD reporting compared with the current NFRD reporting requirement include:

- A clearer separation between reporting on the undertaking's impacts on sustainability matters (i.e. impacts of the organisation on people and the environment), and reporting on how sustainability matters affect the undertaking's development, performance and position (i.e. how sustainability impacts on the organisation itself) - so called 'double materiality'.

- A prescriptive list of reporting elements in relation to the organisation's business model and strategy, governance, targets, risks, opportunities, due diligence, in respect of sustainability matters (the full list is set out in the box below), rather than being left to non-mandatory guidance; this should increase comparability.

- A specific requirement to reference an organisation's plans to align to a sustainable economy and 1.5C global warming target; both forward-looking and historic. The focus is on disclosure of targets – there is no requirement to set a science-based target based on a 1.5C warming scenario, but clearly setting out that you have not done so may be unpalatable in practice.

- Reporting on principal adverse effects connected with the organisation's value chain and action taken to deal with them; this clearly connects with the Commission's Sustainable Corporate Governance Initiative (**SCGI**) launched in October 2020 which would, among other reforms, require companies to carry out due diligence on their operations and supply chain and create corresponding duties and liabilities for associated harm caused.

- The process of reporting must take into account short, medium and long-term horizons. It must also cover how the interests of an organisation's stakeholders are taken into account, as well as considering the impacts of the organisation on sustainability matters. These areas connect with a second theme of the SCGI which is to encourage companies and their directors to move away from short-term decision-making, and take into account environmental and human rights issues in their decision-making while balancing the interests of all stakeholders.

As per the existing NFRD reporting requirements, where companies report in line with the new sustainability requirements, they will be deemed to have complied with the general requirement under the Accounting Directive that management reports "include non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters".

Required information to be reported on Sustainability Matters

a. a brief description of the undertaking's business model and strategy, including:

   i. the **resilience** of the undertaking's business model and strategy to risks related to sustainability matters;

   ii. the **opportunities** for the undertaking related to sustainability matters;

   iii. the plans of the undertaking to 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;

iv. 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;

v. how the undertaking's **strategy** has been **implemented** with regard to sustainability matters;

b. a description of the **targets** related to sustainability matters set by the undertaking and of the progress the undertaking has made towards achieving those targets;

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 **principal actual or potential adverse impacts connected with the undertaking's value chain**, including its own operations, its products and services, its business relationships and its supply chain;

iii. any **actions taken, and the result of such actions, to prevent, mitigate or remediate actual or potential adverse impacts;**

f. a description of the **principal risks** to the undertaking related to sustainability matters, including the undertaking's principal dependencies on such matters, and **how the undertaking manages those risks**;

g. **indicators** relevant to the disclosures referred to in points (a) to (f).

Undertakings shall also disclose information on **intangibles, including information on intellectual, human, and social and relationship capital.**

Undertakings shall report the **process carried out to identify the information** that they have included in the management report … and in this process they shall take account of short, medium and long-term horizons.

EU sustainability reporting standards (New Article 19b, Consolidated Accounting Directive)

Although the Commission Guidelines provided helpful advice on how to include non-financial information in reporting, these were not mandatory. The Commission recognises that there is a growing need for quality of information comparable with financial reporting; and also that financial entities disclosing under the SFDR and the Taxonomy Regulation will need good quality, relevant and reliable information to assist them in complying with their own disclosure and other obligations under those Regulations.

Reporting organisations will therefore have to report in line with new sustainability reporting standards that the Commission will draw up. The standards will set out the information needed in each of the E, S & G elements of sustainability (see the full list in the Annex to this briefing). The European Financial Reporting Advisory Group (EFRAG) will advise the Commission on the standards to be adopted under the following timetable:

- By **31 October 2022**, a base level of information on all reporting areas / sustainability matters necessary to enable financial entities to carry out their disclosures under the SFDR; EFRAG considers these will include key guidelines on double-materiality and information quality; cross-cutting standards covering reporting areas, reporting structure and entity-specific materiality assessment; 'advanced' standards for climate change and 'core' standards for other sub-topic areas; these would be available for organisations' 2023 financial reports (reporting in 2024) – EFRAG aims to have a draft by mid-2022.

- By **31 October 2023**, any necessary 'complementary information' needed for reporting, and sector-based information. EFRAG considers this would cover other key conceptual guidelines and cross-cutting standards, and 'advanced standards' for other sub-topic areas. These would be available for organisations' 2024 financial reports (reporting in 2025) – EFRAG plans a draft by mid-2023.

Knock-on Impacts for Taxonomy Regulation reporting

Organisations reporting under the CSRD will also have to report on their alignment with the Taxonomy Regulation (in accordance with Article 8 – the environmental categories under the CSRD match those in the Taxonomy Regulation). The expanded scope of the CSRD regime means that nearly 50,000 entities would be brought within the scope – including listed SMEs. This knock-on impact could be burdensome.

In setting the sustainability reporting standards, the Commission recognises that it should take into account a wide range of other legislation and initiatives, including the European Green Deal, the work of other organisations that are aiming to consolidate sustainability standards (such as TCFD and the International Financial Reporting Standards Foundation). It anticipates the new standards to be developed will assist in this effort. This would be certainly welcome, although hopefully these new standards will not simply result in further divergence at international level. It will be interesting to see in particular the extent to which the standards mandate full disclosure in line with the TCFD. It is notable that the UK has already implemented obligations requiring TCFD-aligned reporting by premium listed issuers (on a 'comply or explain' basis), and is currently consulting on extending climate-related financial reporting based on TCFD requirements to a much wider range of large companies and LLPs.

A proportionate regime for SMEs – what does this mean for SFDR and Taxonomy Regulation compliance?

Listed SMEs caught by the CSRD will be able to benefit from a proportionate reporting regime that will take into account the capacities and characteristics of SMEs. The Commission will provide this regime by way of delegated acts which are to be adopted by 31 October 2023 at the latest.

The Commission has expressed the intention that non-listed SMEs will comply with this proportionate regime voluntarily.

The key questions for asset managers and other financial market participants trying to comply with their SFDR and Taxonomy disclosure obligations will be whether: (a) this lighter standard for listed SMEs will provide sufficient information for these disclosure purposes; and (b) non-listed SMEs do in fact comply with it voluntarily. If the proportionate approach is too light touch then the existing issue of a lack of data at portfolio company level will remain.

Of course, lack of data will remain an issue for many financial market participants regardless, given the global nature of their investment portfolios and the fact that a significant proportion of their portfolio companies will not be caught by these new rules.

Amendments to the Transparency Directive

The Transparency Directive requires issuers with equity or debt securities listed on EU regulated markets (unless the issuer only has wholesale debt listed) to file regulated information (including financial reports) with their home member state regulator to satisfy their continuing disclosure obligations. The amendments proposed by the CSRD will ensure that the annual financial reports filed by both EU and non-EU issuers are prepared in accordance with the new sustainability reporting standards. The Commission is also mandated to make assessments regarding the equivalence of third country's sustainability reporting standards.

Amendments to the Audit Directive and Audit Regulation: Assurance of sustainability information and digital reporting

Reporting of information under the CSRD requires *limited assurance* by a statutory auditor, although "independent assurance service providers" may carry out the task. It is anticipated that this obligation could change to a *reasonable assurance* requirement at a later stage once the sustainability standards are introduced and following a review by the Commission within 3 years after the Directive comes into force. Detailed rules on professional requirements for auditors on sustainability matters are included to ensure appropriate levels of knowledge and practical experience.This assurance requirement will provide a significant additional burden on the audit profession in an emerging area.

Given the need for comparability of information, and the huge amount of data that is likely to be involved, reporting organisations will have to publish all CSRD information in a digital, machine-readable format. This will help implement the Commission's action plan on the Capital Markets Union under which an EU-wide digital access platform will be created for publication of companies' financial and sustainability information (the European Single Access Point, or ESAP). Organisations will have to digitally tag their information in accordance with a digital taxonomy, aligned to the European Single Electronic Format (**ESEF**), a requirement already applicable to financial information.

Timing and wider context

Reporting in line with the CSRD will commence for financial years beginning on or after 1 January 2023. It will be crucial for the relevant standards and guidance to be in place well before this date.

Given the multi-faceted consultation, legislative and standard-setting process the Commission will now have to go through, it will be challenging to ensure that the first set of sustainability reporting standards will be adopted by October 2022, in time for the beginning of the 2023 financial year when many organisations will need to have their monitoring and reporting structures in place and begin collecting relevant data. Experience with Regulatory Technical Standards under SFDR has shown just how slow-moving the process can be.

These new reporting / transparency proposals are just one aspect of the wider EU push for corporate sustainability which is moving beyond pure information disclosure and towards greater pro-active duties to carry out due diligence and the imposition of duties of care for harms caused to the environment and people. Having started this effort with conflict minerals, the Commission is now working on other proposals including a broader requirement for mandatory Human Rights and Environmental Due Diligence.

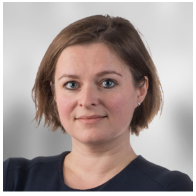
We will shortly be publishing a further briefing on the six amending Delegated Acts published by the Commission which incorporate ESG-related changes into the UCITS, MiFID II, AIFMD and Insurance regimes which were published alongside the proposed CSRD Directive.

Link: Commission Proposal for Corporate Sustainability Reporting Directive

CONTACTS

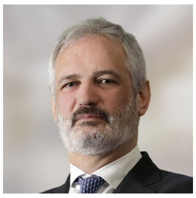
Nigel Howorth
Partner
London
T: +44 207006 4076
E: nigel.howorth@
cliffordchance.com

Clare Burgess
Partner
London
T: +44 207006 1727
E: clare.burgess@
cliffordchance.com



Caroline Dawson
Partner
London
T: +44 207006 4355
E: caroline.dawson@
cliffordchance.com

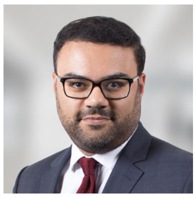
Michael Coxall
Knowledge Director
London
T: +44 207006 4315
E: michael.coxall@
cliffordchance.com



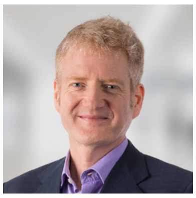
Charles Adams
Regional Managing
Partner for CE
Milan
T: +39 02 8063 4544
E: charles.adams@
cliffordchance.com

Liesbeth Buiter
Partner
Amsterdam
T: +31 20 711 9326
E: liesbeth.buiter@
cliffordchance.com

Dr. Moritz Keller
Partner
Frankfurt
T: +49 69 7199 1460
E: moritz.keller@
cliffordchance.com



Daud Khan
Partner
London
T: +44 207006 6069
E: daud.khan@
cliffordchance.com



Roger Leese
Partner
London
T: +44 207006 8710
E: roger.leese@
cliffordchance.com

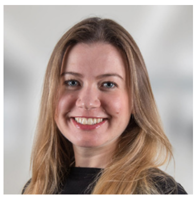
Angela McEwan
Partner
Amsterdam
T: +31 20 711 9142
E: angela.mcewan@
cliffordchance.com

Gail Orton
Head of EU
Public Policy
Paris
T: +33 1 4405 2429
E: gail.orton@
cliffordchance.com

Dr. Thomas Voland
Partner
Dusseldorf
T: +49 211 4355 5642
E: thomas.voland@
cliffordchance.com

Michel Petite
Avocat of Counsel
Paris
T: +33 1 4405 5244
E: michel.petite@
cliffordchance.com

Jessica Walker
Knowledge Director
London
T: +44 207006 2880
E: jessica.walker@
cliffordchance.com



Amy Watt
Senior Associate
Knowledge Lawyer
London
T: +44 207006 1987
E: amy.watt@
cliffordchance.com

Jose Luis Zamarro
Partner
Madrid
T: +34 91 590 7547
E: joseluis.zamarro@
cliffordchance.com

Annex

Areas in which Sustainability Reporting Standards will be set (New Article 19b Accounting Directive)

Environment (matching the Taxonomy):

- climate change mitigation
- climate change adaptation
- water and marine resources
- resource use and circular economy
- pollution
- biodiversity and ecosystems

Social

- **equal opportunities for all**, including gender equality and equal pay for equal work, training and skills development, and employment and inclusion of people with disabilities
- **working conditions**, including secure and adaptable employment, wages, social dialogue, collective bargaining and the involvement of workers, work-life balance, and a healthy, safe and well adapted work environment
- **respect for the human rights, fundamental freedoms, democratic principles and standards** established in the International Bill of Human Rights and other core UN human rights conventions, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work and the ILO fundamental conventions and the Charter of Fundamental Rights of the European Union

Governance

- the role of the undertaking's administrative, management and supervisory bodies, including with regard to sustainability matters, and their composition
- **business ethics** and **corporate culture**, including anti-corruption and anti-bribery
- **political engagements** of the undertaking, including its lobbying activities
- the **management and quality of relationships** with business partners, including payment practices
- the undertaking's **internal control and risk management systems**, including in relation to the undertaking's reporting process

NOTES

NOTES

C L I F F O R D

C H A N C E

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

2104-002579