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ESG Disclosures: The Push for Consistent and Comparable Standards – Europe

Key Takeaways

- *The European Union has taken a leading role in advancing ESG disclosure requirements across the full spectrum of sustainability topics. Some of the initiatives are focused largely on climate issues, while others address the broader sustainability landscape.*
- *In the absence of international consensus on ESG disclosure requirements, EU regulations and guidance could begin to shape disclosure in other jurisdictions.*

Overview

This client memorandum, part of a series that reviews developments in the environmental, social and governance ("ESG") disclosure landscape, provides an introduction to the current ESG regulatory disclosure frameworks of the European Union. Over 60 governments and international institutions, including the United Nations, have developed guidelines and regulations that require a range of market participants to improve non-financial reporting in order to quantify and disclose ESG issues.[1] The European Union has emerged as a leader in ESG, and more and more companies may begin to follow its standards whether or not they are required to do so by their local jurisdictions.

We provide below a high-level overview of EU ESG disclosure frameworks.

Non-Financial Reporting Directive

In 2014, the European Union adopted the Non-Financial Reporting Directive[2] ("NFRD") to assist "large companies" in disclosing non-financial information in a more consistent and comparable manner.[3] The 2014 directive required national implementing legislation to be adopted in 2016 that would be mandatory (though member states were free to impose more stringent conditions). In 2017, the European Commission issued Guidelines on Non-Financial Reporting.[4]

Action Plan: Financing Sustainable Growth

In 2018, the European Union set out an Action Plan on sustainable growth.[5] The Action Plan, among other things, contemplates guidelines on how companies should disclose climate-related information in line with the Task Force on Climate-related Financial Disclosures ("TCFD") and climate-related metrics to be developed. In 2019, as part of the Action Plan, the European Commission issued further non-binding disclosure guidelines in the form of a supplement.[6] The supplement is to be read together with national legislation transposing the NFRD as well as the text of the NFRD, where necessary. Companies are also encouraged to consider the TCFD recommendations.

Disclosure is seen as also advancing various other elements of the Action Plan, including regulations to establish a taxonomy to facilitate sustainable investment, regulations on sustainability disclosures by institutional investors and asset managers, and regulations on carbon-related benchmarks. The guidelines are not intended to call for standalone disclosures, but rather encourage companies to integrate climate-related information with existing financial and non-financial disclosures. While the default location under the NFRD is the management report, some countries permit standalone reports.

The guidelines build on the NFRD paradigm of focusing on climate-related risks (risks of negative impacts on climate and risks of negative impacts on the subject company, both physical and transition risks); dependence on natural capital (*i.e.*, renewable and non-renewable resources (plants, air, water, soil, minerals) that combine to yield benefits to people),[7] human capital and social capital; and climate-related opportunities. This should be done throughout a company's value chain. The guidelines call for disclosure of the following (based on the NFRD reporting areas):

- **Business Model**: Disclosure explaining how climate change could affect the business model and strategy, and how the company's activities could affect the climate (both negatively and positively), over the short-, medium- and long-term. Disclosure should address resilience of the business model and strategy, taking into consideration different climate-related scenarios over different time horizons, including at least a 2°C or lower scenario and a greater than 2°C scenario.

- **Policies and Due Diligence Procedures**: Company policies related to the climate, including any climate change mitigation or adaptation policy; climate-related targets the company has set, especially any greenhouse gas ("GHG") emissions targets, and how targets relate to national and international targets and to the 2015 Paris Agreement on Climate Change (the "2015 Paris Agreement") in particular; the board's oversight of climate-related risks and opportunities; and management's role in assessing and managing such risks and opportunities.

- **Outcomes**: Company outcomes related to climate change policies, including the performance of the company against the indicators used and targets set to manage climate-related risks and opportunities; and development of GHG emissions against the targets set and the related risks over time.

- **Principal Risks and Their Management**: Processes for identifying and assessing climate-related risks over the short-, medium- and long-term and how the company defines these time periods for purposes of this disclosure (which will depend on the business and life cycle of assets and liabilities); principal climate-related risks the company has identified throughout the value chain; and any assumptions that have been made when identifying these risks. This description should include the principal risks resulting from any dependencies on natural capital threatened by climate change, such as water, land, ecosystems or biodiversity. Disclosure should also cover processes for managing climate-related risks (if applicable, how decisions are made to mitigate, transfer, accept or control those risks), and how the company is managing the particular climate-related risks that it has identified. In addition, disclosure should cover how processes for identifying, assessing and managing climate-related risks are integrated into the company's overall risk management (including how the company determines the relative significance of climate-related risks in relation to other risks).

- **Key Performance Indicators (KPIs)**: Measures to support other climate-related disclosures, such as those related to outcomes or principal risks and their management, and to allow for aggregation and comparability across companies and jurisdictions. Indicators should be integrated with other disclosures to support and explain the narrative. Subject to the company's materiality assessment and in order to facilitate greater comparability of disclosures of non-financial information by companies, a company should consider disclosing KPIs on GHG emissions, energy consumption and efficiency, assets covered by physical risks, products and services contributing to mitigation or adaptation, and green bonds or green debt instruments issued.

The guidelines address materiality, by reference to the definition in the NFRD, which calls for disclosure on ESG matters, respect for human rights, and bribery and corruption, to the extent the information is necessary for an "understanding of the company's development, performance, position and impact of its activities." The guidelines note that there is, in effect, a double materiality perspective, in that "development, performance [and] position" refer to financial materiality (*i.e.*, what affects the "value" of the company), while the reference to "impact" refers to environmental and social materiality (*i.e.*, the external impacts of the company). The guidelines note that the first perspective would be of greater relevance to investors, while the second perspective would be of greater relevance to other stakeholders, although investors increasingly are focused on this second perspective as well. The TCFD recommendations have a financial materiality perspective only.

As part of the materiality discussion, the guidelines note that companies should consider a longer-term horizon than typically is the case for financial information. Companies should not conclude that climate-related risks are not material simply because they are long term in nature. A materiality assessment should consider the entire value chain, including upstream in the supply chain, and downstream. The guidelines advise companies that conclude that climate is not material to make a statement to that effect, and explain how that conclusion was reached.

Financial Services Sector

In November 2019, the European Union adopted Regulation 2019/2088 on sustainability-related disclosures in the financial services sector (the "SFDR").[8] Under the SFDR, the European Supervisory

Authorities (the European Banking Authority, the European IOPA and the European Securities and Markets Authority) are mandated to develop regulatory technical standards ("RTS") related to ESG disclosures by "financial market participants" and "financial advisers," which disclosures should include information related to the climate and the environment, social and employee matters, human rights, and anti-corruption and anti-bribery matters.[9] Six draft RTSs will be issued by December 30, 2020, and an additional draft RTS will be issued by December 30, 2021. The obligations under the SFDR apply from March 10, 2021.

The SFDR is an essential part of European Union efforts to enlist the financial sector in addressing climate change and meeting the related United Nations ("U.N.") Sustainable Development Goals (adopted in 2015 by all U.N. member states as part of the 203o Agenda for Sustainable Development[10]) and the 2015 Paris Agreement goals. The SFDR will require covered firms to disclose how they integrate "sustainability risks" in their investment decision-making or investment- or insurance-related advice, as the case may be. Financial market participants will be required to disclose, where they consider principal adverse impacts of investment decisions on sustainability factors, a statement on due diligence policies with respect to those impacts, and if they do not consider such impacts, the reasons why they do not. Financial advisers will have similar disclosure obligations in the context of their investment- or insurance-related advice. The SFDR distinguishes between adverse sustainability impacts at an entity level and at a financial product level (subjecting both to separate requirements). Sustainability risks for purposes of the SFDR are environmental, social or governance events or conditions that, if they occur, could cause an actual or potential material negative impact on the value of an investment.

In April 2020, the European Commission launched its consultation[11] on the renewed sustainable finance strategy, which is to "provide a roadmap with new actions to increase private investment in sustainable projects and activities to support the different actions set out in the European Green Deal and to manage and integrate climate and environmental risks into our financial system. The initiative will also provide additional enabling frameworks for the European Green Deal Investment Plan."

EU Taxonomy on Sustainable Finance

As part of the Action Plan, the European Commission established a Technical Expert Group ("TEG") on sustainable finance in July 2018. On March 9, 2020, the TEG published its final report on EU taxonomy. The EU Taxonomy is a tool to help investors, companies, issuers and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy.[12] The taxonomy sets performance thresholds (referred to as "technical screening criteria") for economic activities that make a substantive contribution to one of six environmental objectives, do no significant harm to the other five and meet minimum safeguards.

Looking Ahead

In the absence of international consensus on ESG disclosure requirements, the rapid expansion of ESG disclosure requirements in the European Union may begin to fill that void. The impact of the General Data Protection Regulation (GDPR) over the last two years beyond Europe serves as an example of how this could happen.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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1 Virginia Harper Ho and Stephen Kim Park, "ESG Disclosure in Comparative Perspective: Optimizing Private Ordering in Public Reporting," *U. Pa. J. Int'l L.*, vol. 21: 2 (2019): 252-53.

2 Legislation in the European Union can take various forms. Directives do not have the direct force of law, but rather impose requirements on member states to implement the substance of the directive in national law. Regulations have the direct force of law.

3 *See* Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014, amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (available here).

4 *See* European Commission, "Guidelines on non-financial reporting (methodology for reporting non-financial information)" (2017) (available here). These guidelines set out six principles for non-financial reporting: material; fair, balanced and understandable; comprehensive, but concise; strategic and forward-looking; stakeholder-oriented; and consistent and coherent.

5 *See* European Commission, "Action Plan: Financing Sustainable Growth" (March 2018) (available here).

6 *See* Guidelines on non-financial reporting: Supplement on reporting climate-related information (available here). Companies are encouraged to disclose information in accordance with widely accepted reporting standards and frameworks to maximize comparability for their stakeholders. To contribute to convergence at the EU and global level, these guidelines refer to a number of recognized reporting frameworks and standards. In particular, they incorporate the recommended disclosures of the TCFD, which are themselves aligned with other principal frameworks. The disclosures recommended by the TCFD are separately identified in the guidelines. In addition, the guidelines take account of the standards and frameworks developed by

the Global Reporting Initiative (GRI), the CDP, the Climate Disclosure Standards Board (CDSB), the SASB, the International Integrated Reporting Council (IIRC) and the EU Eco-Management and Audit Scheme (EMAS).

7 *See* Natural Capital Coalition, "Natural Capital" (available here).

8 The SFDR is available here. The covered entities would already be subject to regulation under existing EU regulations. The scope of the regulations is broad – sustainable investment is defined as:

> investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

9 *See* European Supervisory Authorities, "Joint ESA Consultation on ESG Disclosures" (April 23, 2020) (available here).

10 *See* United Nations, "The Sustainable Development Agenda" (available here).

11 *See* European Commission, Consultation on the Renewed Sustainable Finance Strategy (available here).

12 *See* EU Technical Expert Group on Sustainable Finance, "Financing a Sustainable European Economy: Technical Report" (March 2020) (available here).