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WHITEPAPER

How ESG Regulation Takes Shape in the EU: Lessons Learned

Environmental, social, and corporate governance practices are gaining momentum as they increase in importance among consumers, investors, and regulators. With many jurisdictions working to introduce legislation on ESG and climate change-related disclosures, the shift from voluntary to mandatory reporting is accelerating. Business leaders, wherever they are in the world, need to rethink their strategies in light of these developments.

Recent research suggests that firms headquartered in Europe are more likely to have an ESG program than their US counterparts. On average, 81 percent of the organisations surveyed by NAVEX Global have a formal ESG program in place, with Germany and France leading the way at 86 percent. The UK is not far behind, at 79 percent. This begs the question: why are European firms are leading the way in ESG?

The implementation speed of ESG programs, whether in the US, Europe, or other regions, largely depends on the pace of lawmakers.

"Across Europe, ESG related legislation at member state level has been here for a few years, notably in France with the so-called French Energy Transition Law passed in 2015 under article 173 that mandates institutional investors to report carbon emissions. The law was intended to be a first step to greater transparency, and since then has been updated to include climate and biodiversity risks under article 29," says Fathia Murphy, ESG Product Specialist at Navex Global.

The ambitious EU-wide initiatives that followed including, the European Green Deal and the EU Commission's Action Plan on Financing Sustainable Growth, introduced further EU-wide legislative measures, bringing sustainability into the spotlight.

Now, the US looks to catch up. The Securities and Exchange Commission (SEC) is currently considering several ESG disclosure regulations in two key areas: climate risk and human capital management. We don't know yet when the new rules will arrive, but it is abundantly clear that mandatory disclosure is coming – and soon. Among other things, the SEC will need to decide the extent to which it will harmonise its ESG disclosure requirements with existing voluntary and mandatory standards in other parts of the world. As the rulemaking process moves forward, it might be most helpful to take a closer look at the EU: its regulations, progress made so far, and the lessons learned on the journey.

EU REGULATORY LANDSCAPE

The Non-Financial Reporting Directive, or NFRD, (Directive 2014/95/EU amending the Accounting Directive, 2006/43/EC) was adopted back in 2014[1]. Companies had to report following its provisions for the first time in 2018, covering the financial year 2017. Today, the reporting under the NFRD is the key source of non-financial information for EU-based asset managers.

1 In 2017 and 2019, the EU Commission published two sets of non-binding guidelines to help entities in scope of the NFRD to report relevant and comparable information.

The NFRD applies to large EU 'public interest entities' including listed companies, banks, and insurance companies, that have more than 500 employees, and either a balance sheet total of more than EUR 20 million or a net turnover of more than EUR 40 million[2]. Currently, 11,700 entities fall within the scope of the Directive.

Companies are required to include a non-financial statement in their annual report providing information both on how ESG issues affect their performance and development (the "outside-in" perspective), and on their impact on people and environment (the "inside-out" perspective). This is known as the **"double materiality"** principle. A non-financial statement should cover at least environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery.

> "Our first attempt at this legislation was deliberately 'light touch', principles-based and enabling of a wide range of different frameworks to be able to comply. This was reasonable at a time when a majority of Europe's large businesses, were being asked to undertake non-financial reporting for the first time"
> **-Richard Howitt, MEP with responsibility for parliamentary negotiation of the Non-Financial Reporting Directive in 2014**

The NFRD allows significant flexibility: companies may rely on various frameworks to produce their non-financial statements and report on a "comply or explain" basis.

Global Reporting Initiative or "GRI" is the most frequently cited reporting framework to meet the NFRD requirements: in 2019, 54% of companies relied on this framework to produce their non-financial statements.

GRI, an Amsterdam-based non-profit organization, was initiated by the Coalition for Environmentally Responsible Economies (CERES) and Tellus Institute in 1997. Since that time, the framework went through several revisions to arrive at the 'first global sustainability reporting – The GRI Standards' effective from 2018.

Reporting frameworks, standards, and guidelines currently used for non-financial reporting

- EU Non-financial Reporting Directive
- EU Commission's guidelines on non-financial reporting
- National member-state level reporting frameworks/requirements
- Integrated Integrated Reporting Council (IIRC)
- Sustainability Accounting Standards Board (SASB)
- OECD Guidelines for Multinational Enterprises and associated OECD guidance(s)
- UN Global Compact (UNGC)
- United Nations Sustainable Development Goals (UN SDGs)
- ISO 26000 Social Responsibility
- Climate Disclosure Standards Board Framework
- CDP environmental reporting system and framework
- International Labour Organization standards (ILO)

Today, GRI Standards cover topics ranging from biodiversity to anti-corruption and can be used by organizations of any size, type, sector, or geographic location. The framework contains general and sector-specific content. To ensure consistency in the standards interpretation the Indicator Protocols and Performance Indicators provide definitions and compilation guidance. In 2021 the standards were aligned to the UN's Sustainable Development Goals.

2 Some Member States have enlarged the notion of "public interest entities" – for example, Denmark, France, and Spain have extended the NFRD to non-listed entities that exceed certain size thresholds. Other Member States (like Spain) have similarly decided to apply lower size thresholds. For further details refer here.

The key regulations adopted more recently include the Sustainable Finance Disclosure Regulation or "SFDR" and the EU Taxonomy. These new laws are a part of the EU plan to achieve ambitious sustainability targets.

The SFDR (Regulation [(EU) 2019/2088]) came into effect on March 10, 2021. The SFDR applies to financial market participants, financial products, and financial advisers operating in the EU and sets specific rules on how and what sustainability-related information they need to disclose. The Regulation aims to avoid "greenwashing" of financial products and financial advice by requiring additional ESG-related disclosures, integrating sustainability risks in investment decision-making, and steering the flow of capital towards sustainable investments. The SFDR takes a phased approach to implementation with different provisions applying over an extended timeframe with the Level 2 measures – known as Regulatory Technical Standards – still work in progress. That said, the EU Commission has made it clear that firms must comply with the SFDR's Level 1 requirements from March 2021 onwards.

The EU Taxonomy (Regulation [(EU) 2020/852]) is a classification tool introduced on July 12, 2020, designed to support the transformation of the EU economy to meet its European Green Deal objectives. The Taxonomy aims to determine what is actually sustainable, with the definition of a sustainable economic activity at its core.

Although primarily a classification system, the Taxonomy also introduces additional disclosure requirements. Companies subject to the NFRD now have to report the proportion of Taxonomy-aligned economic activities (through turnover, CapEx, and OpEx indicators). SFDR scoped entities will need to disclose information on Taxonomy-alignment of their financial products.

The Taxonomy will have major implications for investors and entities in the EU and beyond as it is expected to be referenced throughout EU laws on sustainability-related aspects. Its scope can be further expanded in the next two years to cover biodiversity, water and marine resources, and circular economy.

THE EU TAXONOMY AS A BACKBONE OF THE EC ACTION PLAN OF FINANCING SUSTAINABLE GROWTH

The EU Taxonomy and Its Connection with Other EC Action Plans

1. Establishing an EU Classification System for Sustainability Activities (i.e. the EU Taxonomy)
2. Creating Standards and Labels for Green Financial Product
3. Fostering Investment in Sustainable Projects
4. Incorporating Sustainability when Providing Investment Advice
5. Developing Sustainability Benchmarks
6. Better Integrating Sustainability in Ratings and Research
7. Clarifying Institutional Investors and Asset Managers' Duties
8. Incorporating Sustainability in Prudential Requirements
9. Strengthening Sustainability Disclosure and Accounting Rule-Making
10. Fostering Sustainable Corporate Governance and Attenuating Short-termism in Capital Markets

Source: EY, The EU Taxonomy and its implications for your business, 2020

EU REPORTING: LESSONS LEARNED

In 2019, The Alliance for Corporate Transparency conducted the largest study to date covering 1,000 European companies and their non-financial reporting under the NFRD. The key learning is that the reporting is indeed happening in 19 out of 20 companies assessed. However, newly implemented obligations for ESG disclosures bring additional challenges. The well-established "Collect – Report – Assure" approach now has to be looked at through the lens of the Taxonomy. Businesses will now have to map their economic activities to the Taxonomy thresholds to assess if they contribute to or at least Do No Significant Harm ("DNSHs") for each of the Taxonomy's environmental objectives. They will have to ensure compliance with the minimum social safeguards as well.

Regarding the assurance, currently, the NFRD only requires that [financial statement] auditors check that the non-financial information has been provided, but the audit requirements are likely to be strengthened. In some of the Member states including France, Italy, and Spain the external assurance is already mandatory.

On the flip side, there are some important lessons learned from how companies have been reporting under the NFRD all these years.

First, as the Alliance's study has revealed, the NFRD's initial intent to 'link policies, risks, and results' is falling short with companies mostly reporting on policies, but not outcomes. For instance, 57 percent of companies do report on human rights risks, but measurement of actions to manage those risks are only provided by less than 4 percent. On climate change, 82 percent of companies have policies, but only 35 percent have targets, and even fewer - 28 percent - report on their outcome.

Second, the significant flexibility under the NFRD results in reduced comparability and transparency of the information. Entities can rely on international, European, or national frameworks to produce their non-financial statements, oftentimes patchy and piecemeal. With companies leaning to the metrics that show them in the best light, the quality of their sustainability reporting is not sufficient to understand their risks, impacts, or even plans.

EU ESG NEXT STEPS

Two areas of development are likely to have widespread repercussions for companies: the long-awaited revision of the NFRD and the forthcoming mandatory human rights, environmental and governance due diligence. Let's look at both of them in more detail.

At the time it was passed, the NFRD was labeled as "the world's foremost legislation on corporate transparency". However, for reasons discussed above (and many others) there is a growing concern that it doesn't correspond to the evolving expectations. The EU Commission's Proposal of the revised NFRD – soon to become the Corporate Sustainability Reporting Directive ("CSRD") - is much more in line with the EU Green Deal ambition.

The CSRD is expected to reinforce considerably the reporting requirements, as well as expand their scope to cover around 50,000 entities (compared to the 11,700 currently subject to the NFRD). Significant changes will include the duty to comply with EU-wide sustainability reporting standards and a general EU-wide assurance requirement for reported sustainability information. Importantly, the Proposal aims to reduce reporting costs for companies over the medium to long term to encourage wider uptake.

The new EU sustainability reporting standards are developed by The European Financial Reporting Advisory Group (EFRAG) in close cooperation with the GRI. Janine Guillot, CEO of the SASB Foundation, believes that this is a right approach that could lead to a global system of standards for non-financial disclosure: "A revised NFRD can lay a foundation for a global

ESG disclosure solution. […] SASB appreciates the EU Commission's leadership role in addressing this global challenge." Ultimately, the SEC will have to decide the extent to which it wants to align its regulations with these new standards.

> "Biodiversity is another important topic to watch. Businesses are now starting to realise the interdependency between climate, natural and human capital. A lot of work is taken place to figure out how to measure and integrate biodiversity and the recently established TNFD, Taskforce on Nature-related Financial disclosures is a first step towards a framework for reporting nature-related risks"
> **-Fathia Murphy, ESG Product Specialist at NAVEX Global**

"On the supply chain front, the EU Directive on Corporate Due Diligence and Corporate Accountability (expected to follow in the coming months) will require companies to identify, address and remedy ESG risks in their supply chains. As we know from the draft, the directive will apply to all large companies, as well as listed and high-risk small and medium-sized businesses, based in the EU. Entities will have to establish and implement a due diligence strategy to identify and assess in an ongoing manner whether their operations "cause, contribute to or are directly linked to any potential or actual adverse impacts on human rights, the environment or good governance". This unprecedented legislation is a huge step forward to create more supply chain accountability. However, as with other EU-wide directives, there will be a two-year transposition period before it finally comes into effect.

Also, the recently adopted proposal for a new Carbon Border Adjustment Mechanism ("CBAM") is sought to prevent the so-called "carbon leakage" out of the EU. This mechanism will put a carbon price on imports of a targeted selection of products so that companies based in the EU won't move their carbon-intensive production to other jurisdictions with less stringent environmental and climate policies. The mechanism will encourage businesses to green their production processes throughout their supply chains and further highlight the importance of GHG scope 3 emissions management and disclosure. A simplified CBAM will apply from 2023.

CONCLUSION

With the EFRAG currently working on a set of binding, EU-wide sustainability reporting standards, Europe seeks a leadership role in the ESG standardisation debate.

But the US is not far behind – the chances are that the TCFD framework backed by Michael Bloomberg may soon become a global standard in climate change reporting. Some countries (including UK and Switzerland) are very close to making it a mandatory framework. The SEC may opt for it as well.

Much less is known about the US human capital management disclosures, although SEC chairman Gary Gensler has listed several potential metrics. It would be interesting to see to what extent this regulation will be aligned with the social taxonomy draft currently discussed in the EU.

The stakeholders in the US are increasingly asking for ESG. In August 2019 the CEOs of major US corporations signed the Business Roundtable statement on the Purpose of the Corporation committing to meet stakeholder needs and expectations. Two years later, the actual progress made is limited. But this is not the end – this is a beginning, and those who move fast will be rewarded. As they say, it's better to be proactive and ready than reactive and caught off guard.

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