



Proposal for a corporate sustainability reporting directive. International Bulletin of June 2021.

Introduction: On 21 April, the European Commission (EC) presented a package of legislative measures which, in the same line as the Action Plan of March 2018 on financing sustainable growth and the European Green Deal of December 2019, aim to redirect capital flows towards sustainable economic activities.

This package is made up of:

- A delegated act that establishes the technical screening criteria for the environmental objectives of climate change mitigation and adaptation established by the Taxonomy Regulation.
- Six delegated acts that implement obligations in regard to clients' sustainability preferences, fiduciary obligations and those related to the governance of products and financial advice, that affect investment firms, insurance companies and financial and insurance advisers. In the area of securities markets, this implies the amendment of part of the delegated legislation of the Second Directive on Markets in Financial Instruments (MiFID II), the Directive on certain undertakings for collective investment in transferable securities and the Directive on alternative investment fund management companies.
- A proposal for a corporate sustainability reporting directive that would replace the 2014 Non-Financial Reporting Directive (NFRD), which, in turn, amended the 2013 Accounting Directive.

This draft directive is especially important because it contains a series of sustainability reporting obligations for all types of companies, whose publication will enable other companies that provide investment and advisory services in the financial markets sector to draw on the necessary information that they themselves must publish and provide to their clients.

The reason for the proposal to reform the 2014 Directive is that the sustainability information published by companies is not sufficient, comparable or standardised since companies may follow the regulatory framework (CDP, CDSB, GRI, IIRC, SASB, etc.) that best suits their characteristics. It often fails to meet the desirable quality criteria and is not always easy to access, which detracts from the desired transparency in the markets.

The proposed directive adopts a different approach to the previous standard, which is already apparent in the change of name: the expression "non-financial reporting" is replaced by "sustainability reporting", as the former appears to imply that the information reported has no financial relevance when this is not the case, as explained in the recitals of the proposal.

Other key developments, which are described in more detail below, include: extension of the scope of application, emphasis of the principle of double materiality established in the 2014 Directive, creation of European standards by the European Financial Reporting Advisory Group (EFRAG), the requirement to perform assurance of sustainability reporting, digitalisation of reporting and the requirement for Member States to establish a sanctions regime.

Scope of application

It is proposed to broaden the range of companies to which the standard applies. Up until now, under the NFRD, only large public-interest entities with over 500 employees were required to publish information on sustainability.

The new legal text proposes the inclusion of all large undertakings, both listed and unlisted, as well as SMEs listed on regulated markets. The decision to include listed SMEs in the scope of application is due to the growing demand for sustainability reporting from these companies as they are integrated into the sales and supply chains of larger companies. The Commission also considers that the publication of sustainability

information by SMEs will make it easier for them to access financing since credit institutions, which are also subject to the sustainability reporting obligation, need this type of data in order to grant credits. In addition, it is crucially important that investors are provided with this type of information since they are listed companies. For instance, institutional investors, which are also subject to sustainability reporting obligations, must have this information and could exclude companies that do not provide it from their investments.

However, the principle of proportionality must be taken into account and ad hoc standards will be created for SMEs that differ from those developed by EFRAG for other undertakings. The EC must adopt these standards for listed SMEs before 31 October 2023 and they will be applicable as of 1 January 2026. Unlisted SMEs may, on a voluntary basis, also use these standards to publish information on sustainability. Micro-enterprises shall be excluded, in addition to SMEs that are listed in SME growth markets or on multilateral trading facilities.

This change will mean an increase from 11,600 undertakings that publish information on sustainability under the 2014 Directive to 49,000 undertakings pursuant to the EC proposal. This should improve transparency and facilitate decision-making by investors.

Double materiality

The principle of double materiality, which appears for the first time in the 2014 Directive and is explained in detail in the 2019 EC Guidelines on reporting climate-related information, is once again expressly included in order to clarify this obligation which contains a double materiality perspective, since it is considered material, and therefore information on the environment, climate and society that affects behaviour, position and future development of the undertaking must be reported, and also information that describes the impact of the company itself on climate, the environment and society.

Development of European sustainability standards and their relationship with other international standards

This proposal takes as a reference the technical recommendations published by EFRAG in March 2021 for the elaboration of possible European sustainability reporting standards and possible changes to EFRAG's governance system and structure in response to the mandate received from the EC in June 2020.

The EC must take into account the work carried out by EFRAG in the implementation of the delegated acts for a European sustainability standard and, as established in the proposal, will do so within the following deadlines:

- By 31 October 2022: the standards that specify the information that companies will have to publish on the reporting areas and the environmental, social and governance (ESG) factors mentioned in paragraphs 1 and 2 of Article 19a of the proposal, so that market participants subject to Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (Disclosure regulation) can, in turn, comply with the obligations imposed by the most recent standard.

- By 31 October 2023: complete the reporting requirements on ESG factors established in Article 19a (2) of the proposal, as well as information that undertakings shall report that is specific to the sector in which they operate.

To implement these standards through delegated acts, the EC must take into account not only the technical advice of EFRAG, but also any relevant international events or developments that occur, as well as the work and initiatives of international standard setters in the field of sustainability, and with respect to European regulations:

- The information that must be reported by market participants subject to the SFDR and implementing RTS.
- The technical screening criteria established in the delegated acts implementing the Taxonomy Regulation.
- The reporting requirements established in the Regulation on climate benchmarks and its implementing regulations.
- EC Recommendation 2013/179/EU on the use of common methods to measure and communicate the life cycle environmental performance of products and organisations.
- Directive 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading within the Community.
- Regulation (EC) No 1221/2009 on the voluntary participation by organisations in a Community eco-management and audit scheme (EMAS).

The content of the delegated acts will refer to formal and substantive aspects. Thus, the information reported on the undertaking must be understandable, relevant, representative, verifiable, comparable and represented in a faithful manner. In regard to substantive aspects, information must be included on the six environmental objectives developed by Taxonomy regulation, on social factors related to equal opportunities, working conditions, respect for human rights, fundamental freedoms and democratic principles as established by different international bodies such as the United Nations International Bill of Human Rights, agreements of the International Labour Organization or the Charter of Fundamental Rights of the European Union (EU), among others, and lastly, matters related to the governance of the undertaking (the role of the undertaking's administrative, management and supervisory bodies in matters of sustainability, its business ethics, political engagements, internal control processes and risk management systems).

It should be mentioned that numerous sustainability initiatives have emerged in recent months, put forward by international organisations and other institutions. The initiative of the International Financial Reporting Standards Foundation should be highlighted, which on the back of the support received during the public consultation carried out at the end of 2020 to assess interest in the creation of international sustainability standards and the establishment of an independent board to operate in parallel to the existing board dedicated to this task, is currently carrying out another public consultation to modify its structure and governance. The objective is to present the new board at the COP26 summit, alongside its work plan for the coming months. The Foundation is currently carrying out the preparatory work to draw up these standards, taking as a starting point the Prototype climate-related disclosure standard published in December 2018 by a group of standard setters in the area of sustainability (CDP, CDSB, GRI, IIRC and SASB), which is based on the pillars established by the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) sponsored by the Financial Stability Board. The EC is also aware of this key initiative and mentions it in its proposal for the directive, in addition to the need for the European standard to take this international standard into account, to prevent the negative consequences of market fragmentation, and to ensure that Europe contributes to international convergence.

Assurance of sustainability reporting

The proposal would for the first time introduce a general EU-wide audit (assurance) requirement for reported sustainability information by auditors or auditing companies, which will help ensure that the information is reliable and meets quality standards. However, the Commission is proposing to start with a limited assurance requirement as it considers that given the current lack of sustainability assurance standards (such standards may be implemented by the Commission but until that time Member States may do so at national level) and in order to make it less costly for undertakings, the most prudent course of action is to not require full assurance until such standards exist. Member States will be able to choose to allow firms other than the usual auditors of financial information to assure sustainability information.

Digitalisation

It is also proposed that the information published by the undertakings be provided in digital format, so that both the financial statements and the management report are presented in XHTML format and the sustainability information is tagged according to the categorisation system established by Delegated Regulation (EU) 2018/815 on the specification of a single electronic reporting format.

Sanctions regime

The Member States will be responsible for establishing the penalties to be applied for non-compliance with the obligations established by the new directive. These penalties must be effective, proportionate and dissuasive. They may vary in type (from public statements to orders the natural person or the legal entity responsible to cease the conduct constituting the infringement and lastly to administrative pecuniary sanctions) and must address the specific circumstances of each case.

Conclusion

This proposal is expected to be another piece of the new EU regulatory regime that lays the foundations of sustainability reporting and contributes to the objective of having a financial system that supports and promotes a sustainable real economy. Thus, in the coming months, the European Parliament and the Council, together with the Member States, will discuss this proposal until a final agreement is reached. In parallel, EFRAG will prepare the sustainability standards entrusted to it and ESMA, for its part, will issue guidelines for the supervision of corporate information by Competent National Authorities.

Useful link:

[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](#)