CORPORATE SUSTAINABILITY REPORTING: **A REAL GREEN DEAL**

BY
ANGELA LUCAS

&
MARIA FOLQUE

Angela Lucas, Advisor and lecturer on Sustainability & ESG for Católica Lisbon School of Business & Economics - Center for Responsible Business & Leadership. Founding partner of the LAND fund, a real estate sustainable investment fund, classified as a Dark Green fund, under the terms of the European Union's Sustainable Finance Disclosure Regulation.

Maria Folque, Managing Associate of the Social Economy and Human Rights Practice Area & Pro Bono Manager at Vieira de Almeida & Associados.

TechREG CHRONICLE
JUNE 2023

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By Angela Lucas & Maria Folque

The European Union's Corporate Sustainability Reporting Directive ("CSRD") is a central piece in the cascade of regulation put in place to operationalise the European Green Deal, articulating with the EU Taxonomy Regulation and setting a new paradigm as regards to reporting obligations applicable to corporations operating in Europe, including foreign companies. The fundamental role of finance as a driver for sustainability is why the EU triggered this procedure by enacting the Sustainable Finance Disclosure Regulation ("SFDR") setting the scene for the legal frameworks that followed and some that are yet to come. The role of technology has also not been forgotten as an important enabler for transparency and comparability of the data provided. The double materiality approach followed by the CSRD, works as a major enabler for companies to comprehensively assess, understand and use ESG factors in setting their corporate strategies. Finally, the importance of incorporating human rights in the strategy, policies and relevant internal decision-making processes of the company is also of paramount relevance to the success of the business, in particular in the selection and performance assessment of suppliers, the acquisition of companies or sale/closure of industrial units or investment projects in infrastructure in developing countries. Companies should take a holistic approach to this novel legal framework to effectively tackle and manage their ESG risks while making the best of its opportunities.

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In recent years, there has been an increased focus on sustainable and responsible investing, which has led to the emergence of the ESG (Environmental, Social, and Governance) regulatory framework in the European Union ("EU"). This framework is intended to guide companies and investors in their decision-making processes to take into account environmental and social factors, as well as governance considerations, when making investments and conducting business operations.

01

CORPORATE REPORTING: A PIECE OF THE PUZZLE

The Green Deal[2] – the EU's comprehensive plan to make the Union's economy sustainable and climate-neutral by 2050 – sets out a number of initiatives to address climate change and environmental sustainability, including reducing greenhouse gas emissions, increasing the use of renewable energy, promoting sustainable food systems, and protecting biodiversity.

The central piece in this comprehensive framework is the EU Taxonomy Regulation,[3] providing a classification system for environmentally sustainable economic activities. By setting out criteria to identify activities that contribute to climate change mitigation, adaptation, and other environmental objectives, the EU Taxonomy establishes a common language that helps all stakeholders identify the economic endeavors which are consistent with the EU's sustainability goals.

Recognizing the crucial role of finance in driving sustainability by influencing investment decisions, corporate behavior and the allocation of resources towards sustainable activities, the EU triggered the cascade of legislation underpinning the European Green Deal by approving the Sustainable Finance Disclosure Regulation[4] ("SFDR"). It came into effect in March 2021, establishing the rules on transparency and disclosure requirements for financial market participants and financial advisers with regard to the integration of sustainability risks and factors in their investment decisions and financial products. This was the first piece of legislation to be enacted, setting the context for the legal frameworks following suit, some of which are still to come.

Another pillar of this framework is the Corporate Sustainability Reporting Directive[5] ("CSRD"), published just as 2022 was coming to an end. The CSRD's aim is to establish a comprehensive EU sustainability reporting framework, setting out new disclosure requirements for companies to report on ESG factors and non-financial information. Its objective is to increase transparency and accountability in corporate reporting on sustainability issues, which is critical to achieving the goals of transitioning to a more sustainable and resilient economy. Companies operating in the EU – including, as of 2028, foreign corporations with a turnover surpassing 150 million Euro (around 165 million USD) – will have to report on their sustainability performance in line with the EU taxonomy, making it easier for investors to identify sustainable investments and companies that are aligned with the EU's sustainability objectives.

Companies will have to report according to the European Sustainability Reporting Standards[6] ("ESRS"), which are being developed by the European Financial Reporting Advisory Group ("EFRAG"), in response to the European Commission's mandate for the development of a comprehensive set of sustainability reporting standards for companies operating in the EU.

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The ESRS aim to provide a standardized reporting framework for environmental, social, and governance information that is comparable, consistent, and reliable. The standards are expected to cover a wide range of issues, including climate change, resource depletion, social inequality, and human rights.

2 A European Green Deal (europa.eu).

3 EUR-Lex - 32020R0852 - EN - EUR-Lex (europa.eu).

4 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088.

5 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464.

6 First Set of draft ESRS – EFRAG.

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Following a public consultation, the EFRAG submitted the draft of its first set of cross-cutting ESRS standards (sector agnostic) to the European Commission for endorsement and subsequent adoption and implementation across the EU. The European Commission has reviewed the EFRAG's proposal and submitted to public consultation (open until July 7) a draft delegated regulation which will approve the standards (expected mid-2023). The timeline for the EFRAG to present a second set of standards (sector specific and initially expected for the first semester 2024) has recently been postponed by one year, as the European Commission requested the EFRAG to focus attention on providing additional guidance for companies to apply the first set of horizontal standards[7].

The development of the ESRS standards is being guided by a technical expert group as well as a stakeholder group which includes representatives from business, civil society, investors, and academia. This is an important aspect of the development process, aimed at ensuring that the standards reflect the needs and expectations of a diverse range of parties.

Once adopted, the ESRS standards are expected to have a significant impact on corporate reporting practices across the EU. Investors and other stakeholders will gain access to new data with greater transparency and comparability regarding a company's sustainability performance and this, in turn, will encourage companies to take a more proactive approach in this front.

02
REPORTING & TECHNOLOGY

Following its approach with the EU Taxonomy Regulation and the EU Taxonomy Navigator – a simple and practical guide for users of the EU Taxonomy Regulation[8] – the European Commission acknowledges that technology plays an increasingly major role in getting consumers, end users and, ultimately, all company key stakeholders in the civil society to actually understand and be able to differentiate one company´s sustainability performance from another's.

One of the key requirements of the CSRD is that companies must provide their sustainability information in a machine-readable format that can easily be processed by computers, including artificial intelligence ("AI"). To achieve this, the CSRD requires companies to provide their sustainability information in XHTML format – a markup language that is similar to HTML but follows stricter rules and is designed to be machine-readable.

In addition, companies are required to use the European Single Electronic Format ("ESEF") to publish their financial statements in XHTML format. The ESEF is a standard format that was introduced by the European Securities and Markets Authority ("ESMA") to make financial reporting more transparent and accessible. This ensures that the information can be easily integrated and analyzed together with the financial information, in line with the CSRD's requirement that both financial and sustainability data are to be conveyed under a single annual report.

Finally, the CSRD requires that sustainability information must be incorporated into the European Single Access Point[9] ("ESAP") – an online portal that provides easy access to regulatory information from across the EU, thus making it possible for investors, analysts, and other stakeholders to assess it using AI or other tools.

03
DOUBLE MATERIALITY

Based on the premise that companies must be evaluated on a dynamic basis, addressing the overall outbound and inbound effects of their activity, the CSRD follows a double materiality assessment approach, by providing a framework that holistically evaluates the financial and non-financial impacts that external sustainability factors have on the company's performance (internal or financial materiality), and how the company's operations have an environmental and social impact on the external world (external or impact materiality).

By incorporating the concept of sustainable development that underpins the materiality assessment – based ultimately on the United Nations 2030 Agenda and its Sustainable Development Goals –, companies will be better equipped to understand and manage the impact of their activities on the environment and society and vice versa. The intention is ultimately to incentivize companies to create a robust and

7 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en.

8 EU Taxonomy Navigator (europa.eu).

9 Carriages preview | Legislative Train Schedule (europa.eu).

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effective corporate strategy that incorporates ESG factors and balances the interests of all their stakeholders, including shareholders, employees, customers and clients, suppliers, and the broader society. Such a strategy will be paramount for a company to survive and thrive in the long run.
It is worth noting that the International Sustainability Standards Board ("ISSB") – a standard-setting organization formed under the International Financial Reporting Standards ("IFRS") Foundation in 2021 – aims to develop a comprehensive set of reporting standards to be used globally as a common framework for measuring and disclosing ESG information. The ISSB's approach to materiality focuses essentially on a unidirectional outside-in assessment of the potential impacts of sustainability issues on a company's operations and financial performance and their significance considering the company's specific circumstances (e.g., size, sector, geography).

04

CORPORATE SUSTAINABILITY DUE DILIGENCE DIRECTIVE (CSDDD): ANOTHER PIECE OF THE PUZZLE IN THE MAKING

When looking at key regulatory developments that took place in the first quarter of 2023 and are expected later in 2023, due diligence is undeniably one of them. Corporate due diligence is definitely not a new legal concept, however, having to apply it to the specific context of environment and human rights issues and across businesses´ value chain will certainly represent a paradigm shift, that will require companies trading in the EU to rise up to the challenge if they want to ensure risk mitigation, regulatory compliance, and, overall, reinforcement of their social license to operate.

About the social license to operate requiring companies to step up and help fix the climate change issue there is also no way in denying that, today, that is not enough and for companies to claim that license they need also to address, what some call, the social impact imperative – i.e., the need to underpin social issues such as human rights, equality, safe working conditions and a living wage and to actively engage with their full supply chains in these issues.

This is what the Corporate Sustainability Due Diligence Directive[10] ("CSDDD") is all about and this is why it will be such a game changer for companies and the bad (good) news is that all of them – big and small – will be affected by this new piece of legislation, no one will be left behind. Although scope of application is still being discussed as this article is being written, in its proposal, the European Commission suggested that companies with 500+ employees on average and a net turnover greater than 150 million Euro in the last financial year, as well as companies with 250+ employees on average and a net turnover greater than 40 million Euro in the last financial year, if at least 50 percent of this turnover is connected with one or more of the listed high impacts sectors,[11] be directly subject to the obligations of the directive. However, for these companies to comply with the abovementioned obligations they will need small and medium enterprises in their value chain to do so too and this is why this piece of legislation has such a huge potential of affecting the economy as a whole. Finally, it´s worth mentioning that the Directive will also apply to non-European Union companies if they fulfill the abovementioned turnover thresholds, when they are generated in the EU. In itself this rule has the potential to create a level-playing field for all companies doing business in the EU, regardless of the fact that they are incorporated there or in a third-party country.

> *When looking at key regulatory developments that took place in the first quarter of 2023 and are expected later in 2023, due diligence is undeniably one of them*

After the favorable vote from the European Parliament on June 1, trialogue discussions between the Parliament, the European Council and the European Commission are expected to begin in the coming weeks and a final approval is expected by the end of 2023 or early 2024. As soon as this piece of legislation is approved and transposed into the member states (in the following couple of years), companies directly covered by these obligations will be expected to:

- Integrate due diligence into their policies, with an updated due diligence policy that is published annually where they: (i) describe the company's approach

10 Corporate sustainability due diligence (europa.eu).

11 In its original proposal, the following were listed as High Impact Sectors: Manufacture of textiles, leather and related products (including footwear), and wholesale trade of textiles, clothing and footwear.

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in the long term, (ii) have in place a code of conduct describing the rules and principles that the company's employees and subsidiaries must follow, and (iii) describe the processes put in place to implement due diligence;
- Identify actual and potential adverse impacts arising from their own operations or those of their subsidiaries and, where related to their value chains, from their established business relationships;
- Prevent and minimize potential adverse impacts, and ending actual adverse impacts, as well as mitigating their extent in accordance with the Directive;
- Establish and maintain a complaints procedure for (i) the ones who have been affected or have reasonable ground to believe they might be affected by an adverse impact, (ii) trade unions and other workers' representatives of individuals working in the value chain concerned, and (iii) civil society organizations active in the areas related with that value chain;
- Monitor the effectiveness of their due diligence policy and measures, by carrying out periodic assessments; and
- Publicly communicate the due diligence results.

In addition, companies with 500+ employees on average and a net turnover greater than 150 million Euro in the last financial year, will also need to have a plan to ensure that their business strategy contributes towards limiting global warming to 1.5°C, in line with the Paris Agreement.

Moreover, among its obligations the Directive also requires that company directors take into account the interests of those affected by the company's decisions as part of a broader, integrated commitment to long- and short-term sustainability strategies.

Unlike the case with the SFDR and the CSRD, the CSDDD will actually force companies to do more than just report on what they do that has an impact on Human Rights and the Environment and require them to actually make some changes to their *governance* models and internal processes to ensure that businesses are not thriving at the cost of human beings´ rights and lives, and of the environment, namely, in their operations and value chains. For companies this also means that these topics are slowly but surely moving out from the voluntary and best practices (efforts) field and becoming a whole new set of obligations in the compliance arena.

Until then companies that wish to remain ahead of the game, and that start now and start smart by tackling these challenges and identifying their salient risks according to their business context will surely see rewards in the long term by gaining a competitive advantage over their competitors, before this approach effectively becomes a new whole set of corporate obligations.

05

EU TAXONOMY, CSRD AND CSDDD: CONNECTING THE DOTS OF THE PUZZLE-PIECES…

Despite its differences and although at first sight it might not seem so, the EU Taxonomy Regulation, the CSRD and the CSDDD are, nevertheless, closely related and, above all, very coherent pieces of legislation, with the central piece of the puzzle being the Human Rights Due Diligence ("HRDD") process.

The Final Draft Report on the requirement of Minimum Safeguards ("MS") of the EU Taxonomy regulation, by the Sustainable Finance Platform,[12] recommends that (i) failure to implement adequate Human Rights Due Diligence Processes, and (ii) lack of proper implementation of due diligence processes resulting in human rights violations to be considered as the relevant criteria to assess (non) compliance with the MS. Let´s not forget that a company considered as non-compliant with the MS, rules out the possibility of any of the economic activities it carries being considered as "environmentally sustainable" under the EU Taxonomy Regulation.

The CSRD reporting requirements will make companies identify and report on their ESG risks and opportunities, which, in turn, will inform their due diligence efforts. Conversely, the due diligence process required by the CSDDD can help companies identify areas for improvement in their ESG performance, which will make it possible to report more satisfactorily on their ESG performance, which, in turn, will facilitate access to ESG ratings, labels, sustainable financing and related advantages.

12 Final Report on Minimum Safeguards (europa.eu).

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06

SOME OF THE PUZZLE-PIECES STILL TO COME...

At this point it becomes clear how the ESG regulatory framework in the EU is still a puzzle in the making, a complex and evolving landscape with many moving frameworks that work together to promote corporate transparency and sustainability. Companies should take a holistic approach to this framework to effectively manage their ESG risks and make the best of its opportunities.

Many claim social concerns are now as unescapable to tackle by companies in their day-to-day business as environmental concerns have been for a while now. In the EU regulation landscape, the Final Report on Social Taxonomy,[13] by the Platform of Sustainable Finance, suggests that companies could have to face in the upcoming years a whole new/ different EU Taxonomy Regulation, that complements and further extends the goals of the existing one.

A social taxonomy would represent a change of course for sustainable finance in Europe as it would bring a classification of economic activities that significantly contribute to social goals and provide for a common code for investors, businesses and regulators regarding what is sustainable from a social perspective and what is not, rewarding those activities.

Another very interesting and up-to-date topic that should be followed up closely by companies, particularly from the financial sector, is the one concerning EU labels for benchmarks (climate, ESG) and benchmarks' ESG disclosures[14], as well as credit rating agencies regulation[15] - which feels increasingly more and more necessary in order to combat greenwashing risks.

On this topic it is worth mentioning that unlike the case in the UK and the U.S., the EU does not (yet) have a labelling regime, since the SFDR was designed not as a labelling regime but as a disclosure regime, to assist the market in identifying products that have environmental and social characteristics or have sustainable investment as an objective. However, the market has been using the SFDR more as a labelling regime than as a disclosure which has been contributing to some legal uncertainty and finally resulted on the publication of a public consultation, on November 18, 2022 by ESMA on "Guidelines on Funds' Names Using ESG or Sustainability-related Terms"[16] adding rules on the use of fund names that are related to ESG or sustainability to the SFDR framework ("Guidelines"). According to the Guidelines only if there is material evidence that they meet the sustainability characteristics and investment objectives described in the fund documentation based on quantitative thresholds could the funds be permitted to have ESG and sustainability related names. The consultation closed on February 20, 2023 and ESMA plans to release final guidelines by Q2/Q3 2023.

> *Many claim social concerns are now as unescapable to tackle by companies in their day-to-day business as environmental concerns have been for a while now*

All the above leads us to conclude that the future EU sustainability-related regulatory landscape is still unclear in many aspects but the need for companies to start working on a strong ESG due diligence process that is adequate to their business context and enshrined in a strong governance model, seems to be one of the clear key learnings so far, to surf the EU regulatory tsunami successfully and ensure long term value creation for all stakeholders involved.

But then again… as someone once said: "There is no need to change, survival is not mandatory." [17]

13 Platform on Sustainable Finance's report on social taxonomy (europa.eu).

14 EU labels for benchmarks (climate, ESG) and benchmarks' ESG disclosures (europa.eu).

15 finance-2022-esg-ratings (europa.eu).

16 https://www.esma.europa.eu/press-news/consultations/consultation-guidelines-funds%E2%80%99-names-using-esg-or-sustainability-related.

17 William Edwards Deming (1900-1993), widely acknowledged as the leading management thinker in the field of quality. He was a statistician and business consultant whose methods helped hasten Japan's recovery after the Second World War and beyond.

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