Seeking alignment on ESG reporting: the EU advances while the US steps aside

The current momentum in ESG policy-making is unprecedented, and keeping up with the latest developments is increasingly difficult. Datamaran’s Regulatory Snapshot provides a clear and concise overview of the most important policy-related issues worldwide. Continue to monitor these developments via Datamaran with your login.

INTRODUCTION

Efforts continue to grow cohesion in the non-financial reporting space. As standard setters and professional bodies grapple to retain their positions in the non-financial disclosure paradigm, governments and regulators are increasingly weighing in on sustainability objectives. We see two very different policy approaches employed from either side of the Atlantic, with European policy-makers going all-in on realizing their collective sustainability goals, while American policy-makers remain resolute in their laissez-faire approach to ESG.

The European Commission has requested technical advice on the elaboration of EU non-financial reporting standards from a new European Lab Task Force, or EFRAG (of which Datamaran is a member), building on its own NFRD work in a well-suited multi-stakeholder setting. Meanwhile, the European Parliament and Council have ratified the ‘Taxonomy’ Regulation, putting in place legally binding requirements for relevant companies to report on their own positive contributions to six key environmental objectives, and for asset owners to be transparent about the sustainability impacts of their financial products.

Further reinforcing the drive towards sustainable investment, ESMA, EIOPA, and EBA (European regulatory authorities) have issued a joint paper proposing that the sustainability characteristics and/or objectives of financial products should be published periodically by their purveyors, aiming to further enhance transparency in a geared-up push towards true sustainable finance.

While Europe aims for the gold medal in sustainability, America continues to stand back. Despite overwhelming support for the US Securities and Exchange Commission (SEC) to develop a standardized disclosure framework for ESG, embodied in the recommendations of the Investor Advisory Committee (IAC), the SEC chose to side step ESG altogether, watering down the mandate and composition requirements for the IAC, and responding to investor demands with a (paraphrased) regressive mantra of “what we have is good enough.” This was also in the same vein as their response to the US Government Accountability Office (GAO), which conducted a qualitative and quantitative study on the state of ESG disclosure among issuers and offered a few different policy approaches to address current deficiencies, all of which relied upon the SEC.

Finally, the US Department of Labor (DOL) proposed updates to the Employee Retirement Income Security Act of 1974, or ERISA, clarifying that fiduciary duty is focused only on long-term financial returns and that any investment considerations that may jeopardize maximum returns for other purposes, for instance to promote sustainability, would be against the law. There was unprecedented levels of feedback provided to the DOL, whose rule impacts all private industry retirement plans, including 401(k)s, across the United States.
On the standards side, the Global Reporting Initiative (GRI) is consulting on its updated Universal Standards, introducing key features and revisions to existing disclosures. The GRI aims to solidify its position as a necessary tool amidst increasing debate on the relationship between sustainability and financial information, implicit in their proposed updates and further supported by the recent announcement of closer collaboration with SASB.

The International Integrated Reporting Council (IIRC), creator of the <IR> framework, has opened its first public consultation in its 10 year history, aiming to ensure the framework responds to the changing market context and supports robust and effective reporting. Meanwhile, Accountancy Europe (AE) continues to debate the ideal non-financial reporting standard, publishing a follow-up paper to its original proposals (see our March Snapshot for more information).

As a whole, these developments spotlight the growing regulatory and investor demands for more quality corporate disclosure on ESG and ultimately, reinforce the need for senior corporate leaders and Board members to proactively embed ESG issues into their risk management, annual reporting and Board oversight processes.

Click the links below to navigate the relevant summary in this snapshot concerning the latest regulatory developments on corporate disclosures, from there you can access the source documents, all of which are also available in Datamaran.


2. The European Commission Request for Technical Advice on preparatory work for the elaboration of EU non-financial reporting standards by a new European Lab Task Force.

3. The Accountancy Europe (AE) Follow up paper: interconnected standard setting for corporate reporting, which follows up on Cognito project Interconnected standards-setting for corporate reporting previously covered by Datamaran, build the case for interconnected global standards for non-financial reporting.


5. The International Integrated Reporting Council (IIRC) 2020 Revision: <IR> Framework, has called for feedback until 19th August, to ensure the framework responds to the changing market context and supports robust and effective reporting.

6. The Global Reporting Initiative (GRI) Review of GRI’s Universal Standards (GRI 101, 102 and 103), was open for consultation until 9th September to ensure greater clarity and promote consistent application of the GRI standards across reporting organisations.

7. The Investor Advisory Committee (IAC) of the Securities and Exchange Commission (SEC) Recommendations relating to ESG disclosure, requesting SEC to develop a standardised disclosure framework for ESG reporting.

8. The U.S. Government Accountability Office (GAO) report on PUBLIC COMPANIES: Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them, seeking to answer why investors need ESG disclosures; public companies’ disclosures of ESG factors;
and the advantages and disadvantages of ESG disclosure policy options.

9. The U.S. Department of Labor (DOL) proposed rule on Financial Factors in Selecting Plan Investments, aiming at updating DOL’s investment duties regulation in detriment of ESG investment considerations.

Regulation on the Establishment of a Framework to Facilitate Sustainable Investment

On 22 June 2020, Regulation (EU) of the European Parliament and of the Council, on the establishment of a framework to facilitate sustainable investment also called Taxonomy Regulation or Green taxonomy, was published, substantially changing the sustainability landscape. Europe now has its first ever legal criteria to determine whether an economic activity qualifies as environmentally sustainable.

The Taxonomy is dependent on six environmental objectives and each activity must comply with three requirements: The activity must substantially contribute to at least one of the six environmental objectives; the activity does not significantly harm any of the other five objectives; and the activity complies with minimum protective safeguards.

Companies already disclosing under the NFRD are required to further disclose in alignment with the Taxonomy, and explain how, and to what extent, their activities relate to Taxonomy-relevant activities. Company disclosures must include the proportion of turnover aligned with the Taxonomy, related capital expenditure, and operating expenses in alignment with the Taxonomy. Financial market participants have their own disclosure requirements to be transparent on the alignment of portfolios with the Taxonomy.

What’s next?
The first disclosures on activities related to climate change mitigation will be expected by 2022, with disclosure on all environmental objectives by 2023. By June 2021, the European Commission will adopt legislation specifying how companies will comply with disclosure obligations in practice.

DLA Piper’s expert view

Creating alignment through finance and investment is key to enabling transition to a decarbonised economy and central to delivering the EU Green Deal. The EU’s Taxonomy Regulation is for now the most advanced instrument providing a classification system for environmentally sustainable activities and serving as a benchmark for the relevant criteria. It is important to recognise that this is a well-developed starting point - the technical details around screening and assessment are vitally important to implementation and work in this area will be an ongoing dynamic process. More work is also needed to develop criteria for the remaining four environmental objectives of the regulation, however, the regulation will also allow the Commission to consider the possibility of extending the Taxonomy to social objectives and to include performance criteria for activities that are significantly harmful to the environment (‘brown’ Taxonomy).

¹They are 1) climate change mitigation, 2) climate change adaptation, 3) sustainable use and protection of water and other marine resources, 4) transition to a circular economy, 5) pollution prevention and control, 6) protection and restoration of biodiversity and ecosystems.
As well as providing standardised criteria for classification of activities, it is recognised that universal standards around disclosure are also of core importance. The EU’s public consultation on improving the NFRD, including with reference to reporting sustainable finance and investment activities, closed in the summer with key themes identified around harmonisation, extension of scope and strengthening of the requirements. Getting the reporting right is clearly another important piece of the regulatory jigsaw and we expect that the consequential revisions to the Directive will be published in Q1 2021.

— Bryony Widdup, Partner & Steven Gray, Counsel, DLA Piper, London

The EC Request for Technical Advice on Non-Financial Reporting Standards

In a letter from the Executive Vice-President of the European Commission (EC), Valdis Dombriskis, to the Chairman of the European Lab, the EC called upon Technical Advice on recommendations on the scope, content, and structure of potential European non-financial reporting standards to support the implementation of the NFRD.

The European Commission sees an urgent need to tackle the lack of comparability, reliability, and relevance of information disclosed by corporates under the NFRD, as well as a lack of digital accessibility. There is no need to reinvent the wheel, however. The Task Force should work upon existing standards and frameworks.

Standards should be built in alignment with the requirements of the Taxonomy, particularly the six environmental objectives of the Taxonomy and the concept of double materiality. The standard should cover the demand of the SFDR (EU Regulation 2019/2088) and consider existing requirements in NFRD.

What’s next?
The Task Force should present a progress report by 31 October 2020 and a final report no later than 31 January 2021, accompanied by a tentative work program for the development of the standards which are expected by no later than June 2022

Interconnected Standard Setting for Corporate Reporting

The Accountancy Europe (AE) Follow up paper findings show unanimous agreement that a ‘systemic solution’ connecting financial and non-financial information will improve corporate transparency, and can be delivered by interconnected standards setters that harmonize current ESG initiatives. The results showed consensus on the following topics:

Materiality: The materiality lens should be expanded to include issues that affect long-term value creation, and extending the materiality definition is in alignment with the concept of double materiality included in the NFRD.

Interconnected Standards: The majority support the case for a ‘standard-setting approach’ as opposed to legislated or voluntary standards. Developing European standards is a more practical and faster initial solution, but must consider future global integration, and digitalisation should
be embedded in the process. There should be one single set of taxonomies to facilitate comparable NFI digital disclosures.

**Non-Financial Reporting Standards:** There’s a need for non-financial reporting standards, but no single clear path to achieving that yet. Key respondents including CDP, CDSB, GRI, and SASB have committed to working together to develop a globally harmonized system and support the IFRS Foundation goal.

As standards setters are working on the base of TCFD framework (in alignment with NFRD & taxonomy), it will be interesting to see if their work collaborates with the future work of EFRAG Task Force or if, rather, it overlaps.

**DLA Piper’s expert view**
The imperative for a global standard of ESG-related reporting is hard to refute, whether from the perspective of value creation or litigation defence. The challenges of developing such a universal reference point are numerous, complex and systemic. But we cannot afford to accept those challenges as a reason not to undertake the journey. The Accountancy Europe initiative on the Interconnected Standard Setting for Corporate Reporting may or may not be the ideal methodology - and it may or may not lead to the ideal solution. But it is a well-organised, authentically supported and data rich programme which we can confidently expect will add significant value to the search for a global disclosure framework, whatever its ultimate shape.

—Alex Tamlyn, Partner, Head of Capital Markets EMEA, DLA Piper, London

**Joint Consultation Paper on ESG Disclosures**
The ESMA, EIOPA, and EBA have launched a Consultation Paper (CP) to ask for feedback on proposed ESG disclosures under Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial sector (SFDR).

The SFDR empowers the three European Supervisory Authorities (ESAs) to develop Regulatory Technical Standards (RTS) on the content, methodology, and presentation of sustainability-related disclosures at both entity and product level. The Consultation also contains proposals in alignment with the Taxonomy Regulation on the ‘do no significant harm’ principle.

The RTS requires financial market participants to post a statement on their websites regarding policies around the adverse impacts of their investment decisions on sustainability factors, particularly climate and other environment-related impacts.

The sustainability characteristics and/or objectives of financial products should be published by purveyors in pre-contractual documentation and periodic reports, including:

- How a product with ESG characteristics and/or objectives meets them
- Whether/how an index designated as a reference benchmark is consistent with those characteristics/objectives
- If no index has been designated as a reference benchmark, an explanation of how that