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PERSPECTIVES

Crosscurrents: Corporate Sustainability Reporting Directive (CSRD) & ESG Reporting in Europe

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

In mid-November 2022, the European Parliament adopted the Corporate Sustainability Reporting Directive (CSRD), a major expansion of the 2014 Non-Financial Reporting Directive (NFRD). The new rules will quadruple the number of companies required to provide sustainability disclosures and expand the reporting requirements to non-European companies with a significant presence in the EU. The Council of the European Union, the body of national ministers that adopts laws passed by the European Parliament, ratified this final version on November 11, 2022. Implementation of the directive is to start with larger companies by the beginning of 2024, with rollout to smaller companies over the following two years.

The CSRD's disclosure requirements are promulgated in the European Sustainability Reporting Standards (ESRS), a standardized framework of rules for companies that will be subject to the CSRD. As early as 2020, the European Commission delegated the preparation of new sustainability reporting standards to the European Financial Reporting Advisory Group (EFRAG), a private association that is primarily financed by the EU. After an initial draft and feedback period, EFRAG approved the final version in November 2022, which included 12 reporting standards such as Pollution, Climate Change, Workers in the Value Chain, End Users, and Business Conduct.

The following information may be of particular interest to US and other non-EU companies who may be required to comply with this new rule due to financial triggers.

DOES CSRD APPLY TO NON-EU COMPANIES?

Most notably, this decision impacts companies outside of the EU. Companies with a large presence in the EU, which the CSRD defines as having an annual generation of $150 million or more, will be subject to the reporting requirements of the CSRD as laid out in the ESRS. Qualifying companies will have to file the same annual report as European companies. The CSRD does allow the European Commission to accept foreign sustainability reporting standards as equivalent to the European requirements and, therefore, exempt foreign companies from duplicative reporting. However, it appears unlikely that the EU would consider the US's proposed and untested SEC reporting requirements as equivalent to the robust ESRS obligations.

BURDENS OF THE CSRD

Double Jeopardy?

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Perhaps the most burdensome addition to the CSRD is the requirement for companies to have their sustainability reporting independently audited and certified. This obligation, which the EU Council and European Parliament agreed upon in summer 2022, comes amid a global backlash to "greenwashing," the growing practice by companies of overstating their sustainability in order to appease consumers or regulators. Policymakers continue to design ways to curb this practice, especially as sustainability reporting becomes more formalized. The European Securities and Markets Authority (ESMA) recently released draft guidelines that would require any investment fund with an Environmental, Social, and Governance (ESG) related name (as defined in the guidelines) to ensure that 80% of its investments support ESG policies. At the same time, ESMA and other EU financial regulators formally requested help from industry experts to better understand the risks associated with greenwashing, particularly in the financial sector, to guide future policymaking.

Potential Additional Rules

To combat greenwashing, the UK has also proposed rules to require asset managers to back up their sustainability claims. The Financial Conduct Authority ("FCA"), the body that regulates the conduct of the UK's financial industry, is expected to finalize rules by mid-2023 that will restrict ESG-related labels and require consumer-facing disclosures for any investment product that does claim to be sustainable.

This evolving market for sustainability data has created multiple firms and nonprofits that provide ESG data and rate the sustainability of companies. The next tier of greenwashing protection appears to be streamlining and regulating these data providers. Last year, the International Organization of Securities Commissions urged regulators around the world to improve the transparency of ESG ratings providers. The UK's FCA recently announced that it is working on a formalized code of conduct for ratings providers, and it encouraged providers to follow voluntary codes of conduct in the meantime to prevent any conflicts of interest. Time will tell if the EU follows, or if the UK ever sees, the need to make ESG rankings a nationalized service.

CONCLUSION: CSRD CREATES RISK AND REQUIRES PREPARATION FOR COMPLIANCE

In the meantime, companies are at risk. Conflicting requirements across jurisdictional boundaries raise real concerns in the business community. As regulatory authorities impose new obligations without harmonizing between authorities, businesses will file disclosures sometimes addressing identical data sets responsive to slightly different data requests. Combine those slight differences with voluntary sustainability reporting, and companies are unintentionally set up to fail. Conflicting climate-related reporting and disclosures are among the most significant risks facing companies today. Thoughtful preparation, including understanding of the underlying data, is key.

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MORE ABOUT J.S. HELD'S CONTRIBUTOR

John F. Peiserich is an Executive Vice President and Practice Lead in J.S. Held's Environmental, Health & Safety practice. With over 30 years of experience, John provides consulting and expert services for heavy industry and law firms throughout the country with a focus on Oil & Gas, Energy, and Public Utilities. He has extensive experience evaluating risk associated with potential and ongoing compliance obligations, developing strategies around those obligations, and working to implement a client-focused compliance strategy. Mr. Peiserich has appointments as an Independent Monitor through EPA's Suspension and Debarment Program. John routinely supports clients in a forward-facing role for rulemaking and legislative issues involving energy, environmental, Oil & Gas, and related issues.

John can be reached at john.peiserich@jsheld.com or +1 504 360 8373.