ALERT MEMORANDUM

The Corporate Sustainability Reporting Directive

*EU sustainability reporting rules to also impact **non-EU** group parents*

February 16, 2023

On January 5, 2023 – nearly two years after the European Commission's original regulatory proposal – the **Corporate Sustainability Reporting Directive** no. 2022/2464 of December 14, 2022 ("CSRD") entered into force. The CSRD will replace the Non-Financial Reporting Directive ("NFRD") across all EU Member States and gradually apply to all in-scope entities.

Since 2017, the NFRD required certain large "public-interest" entities (mainly: large listed companies, and large credit and insurance institutions) to report on a limited set of non-financial information as part of their annual management report, largely on a comply-or-explain basis.

The CSRD represents a considerable reinforcement of such non-financial reporting obligations, and a significant enlargement of their scope. The new rules should in fact cover over 50,000 European undertakings (compared to the 11,700 that are now subject to the NFRD) – *plus* the **third country parents** of large multinational groups that generate a significant turnover within the EU's internal market.

Annual sustainability reports issued under the CSRD will need to follow common **sustainability reporting templates and standards** and be subject to limited **third-party audit**.

This alert *memorandum* provides an overview of CSRD reporting requirements, and situates them within the wider context of other key EU sustainability-related reforms (such as the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation ("SFDR").

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

Clara Cibrario Assereto
+39 06 6952 2225
ccibrarioassereto@cgsh.com

Amélie Champsaur
+33 1 40 74 68 95
achampsaur@cgsh.com

Maurits Dolmans
+44 20 7614 2343
mdolmans@cgsh.com

Francesca Odell
+1 212 225 2530
flodell@cgsh.com

Helena Grannis
+1 212 225 2376
hgrannis@cgsh.com

Camille Kernevès
+33 6 02 17 05 47
ckerneves@cgsh.com

Chris Macbeth
+971 2 412 1730
cmacbeth@cgsh.com

Andreas Wildner
+44 20 7614 2248
awildner@cgsh.com

I. The current NFRD regime

The NFRD (Directive no. 2014/95/EU) planted the first seeds of "non-financial reporting" within the EU's accounting framework back in 2014.

Starting with the 2017 financial year, the NFRD has applied to the annual reports of large "public interest" entities (PIEs) – essentially: large EU-listed companies, and large European credit institutions and insurance companies. "Large" PIEs would be those with more than 500 employees, plus (alternatively) a balance sheet total over EUR 20 million *or* a net turnover exceeding EUR 40 million, whether on a *solo* or a consolidated basis.[1]

In transposing the Directive under their national laws, Member States were given the possibility to extend the concept of PIE applicable within their borders. Several did so (notably: France, Spain and certain countries in the Northern Baltic region), such as by adding other types of entities (such State-controlled entities and certain financial market service providers), or by lowering the size threshold for "large" (and in several cases, a combination of both). This "gold-plating" brought the number of companies in scope of the NFRD from about 2,000 (which would have been caught by the text of the Directive alone) to about 11,700.[2]

These 11,700 companies today report on both how sustainability issues affect their performance and development (the "outside-in" perspective), and their own impacts on people and the environment (the "inside-out" perspective) – what is often known as the **double materiality** principle. Non-financial reports are expected to cover at least environment, human rights, social and employee matters, and anti-corruption and bribery.

Crucially, NFRD reporting largely applies to PIEs on a comply-or-explain basis, whereby in-scope entities are allowed to provide an explanation as to why they do *not* adopt particular policies or due diligence process in respect of one or more of the above sustainability matters.

This is now set to change.

II. Taxonomy-alignment reporting

Already in 2020, the EU's landmark "Taxonomy Regulation" (no. 2020/852) added certain annual reporting requirements to the NFRD framework. These will be carried over under the CSRD.[3]

The Taxonomy Regulation sets the EU-wide general criteria for considering an activity or investment "environmentally sustainable". In addition to these general criteria, the Taxonomy's implementing framework includes a series of sector-specific "greenness" thresholds (referred to as "technical screening criteria"), that are being progressively set by the Commission with reference to certain "high impact" or "high priority" activities (such as energy, heavy industry and transport).[4]

Although the Taxonomy Regulation so far only addresses environmental sustainability, it is expected that it will similarly regulate social (S) and governance (G) sustainability principles in the future.[5]

Pursuant to Article 8 of the Taxonomy, undertakings that are subject to the NFRD must disclose every year the extent to which their operations were associated with "environmentally sustainable" activities (within the meaning of Taxonomy Regulation) over the particular financial period. This is to be expressed through certain percentage KPIs, which depend on the type of entity that

[1] The text of the NFRD is accessible here. A summary of the legislation by the Commission is accessible here.

[2] For a country-by-country overview of the national scope of NFRD reporting requirements, see Annex I to the the final report of the "Study on the Non-Financial Reporting Directive" for the Directorate-General for Financial Stability, Financial Services and Capital Markets Union of November 2020 (p. 124), accessible here.

[3] The Taxonomy Regulation is accessible here. For our analysis of the Taxonomy, see here.

[4] The relevant "Delegated Acts" (so far issued only with respect to the EU's climate change mitigation and adaptation objectives) can be consulted through the digital "Taxonomy Compass" tool, accessible here.

[5] For our analysis on possible future evolutions of the Taxonomy framework, access our other dedicated alerts here and here.

is making the disclosure.

For non-financial undertakings, this will be the % of

(i) turnover,

(ii) capital expenditure (capex) and

(iii) operational expenditure (opex)

that is derived or otherwise related to green products, services, assets or processes over the year. Analogous KPIs (such as the "green asset ratio" of loans (GAR) for banks, and the "green investment ratio" (GIR) for asset managers) have been set by the Commission with respect to financial sector firms.[6]

Worthy of note is that Article 8 disclosures will only address the high impact activities that are covered by the Taxonomy's technical screening criteria. Because of this, companies that are not engaged in any high impact activities will declare a 0% Taxonomy-alignment.

In 2023, large non-financial issuers of EU-listed securities will be the first to begin reporting under Article 8 (with respect to their 2022 financial year). The requirement will then gradually extend to large financial sector firms (in 2024), then all large EU firms (in 2026), and finally also EU-listed SMEs (in 2027).

III. The CSRD

Overall, the CSRD's aim is to bring sustainability reporting over time on a par with financial reporting.

The European Parliament and Council formally adopted the CSRD (Directive no. 2022/2464) on December 14, 2022. The CSRD will replace the NFRD entirely, by amending the corresponding provisions of the Accounting Directive, the Transparency Directive, and the Audit Directive and Audit Regulation. EU Member States must implement all CSRD provisions into their national laws by July 2024.[7]

a. Scope

As already mentioned, the CSRD significantly broadens the scope of sustainability reporting compared to the NFRD framework. The new rules will concern:

- All "large" European entities (whether or not listed);
- All issuers of securities listed on a EU regulated market (save for micro-enterprises [8]), wherever based; and
- The parent companies of non-EU groups that generate a turnover of at least 150 million Euro within the EU's internal market, where these have either *(a)* an EU subsidiary that is itself in scope of the CSRD (*i.e.* a "large" entity or an issuer of securities) or *(b)* an EU branch[9] that generates at least 40 million Euro in revenues.

To be considered "large" for CSRD purposes, it will suffice for a firm to cross 2 of 3 size thresholds:

(i) 250 employees over the financial year,

(ii) A net turnover of 40 million Euro and

(iii) A balance sheet of over 20 million Euro,

whether on a *solo* or a consolidated basis.

Non-EU domiciled multinational companies with significant EU subsidiaries will need to carefully assess whether they fall in scope, and if so how the CSRD will apply in their reporting regime.

b. Timeline of application

The application of the CSRD will be phased in as follows:

Large[10] EU-listed companies, large EU banks and insurers and other PIEs subject to the NFRD	From 2025 (on 2024 FY)

[6] All KPIs, measurement methodologies and disclosure templates are accessible here.

[7] The consolidated Accounting Directive (recently updated to include the CSRD) is accessible here.

[8] In order to qualify as a "micro-enterprise", a company shall remain below at least two of the following:
(a) a balance sheet total of EUR 350,000;
(b) a net turnover of EUR 700,000; and
(c) 10 employees over the financial year on average.

[9] While not defined in the CSRD, a "branch" should be read broadly to include operating units that might not have a local EU jurisdiction of incorporation or legal entity like subsidiaries, but exist as an office or other means of doing business in an EU jurisdiction.

[10] Although – for purposes of this first deadline only – the NFRD's minimum 500-employee size threshold will apply.

All other large EU companies and large issuers of EU-listed securities	From 2026 (on 2025 FY)
Listed SMEs, non-complex credit institutions and captive insurance undertakings	From 2027 (on 2026 FY), with the option of opting-out for a further 2 years
In-scope third-country group parents	From 2029 (on 2028 FY)

c. Consolidated reporting

Similarly to what was done under the NFRD, in-scope entities will be exempt from issuing an individual sustainability report where covered by the consolidated (CSRD-compliant) report of a parent.

d. Sustainability information

Compared to the NFRD, the CSRD also considerably expands on the ESG matters that in-scope companies should be reporting on.

Sustainability reports – which will need to be placed in a dedicated section of companies' annual management report, and made available in electronic format – should address the following:

(a) The firm's business model and strategy, including:
  (i) resilience to ESG risks;[11]
  (ii) opportunities related to the same sustainability matters;
  (iii) a transition plan compatible with the Paris Agreement's 1.5 °C max. global warming objectives;
  (iv) how the firm's business model and strategy takes into account the interests of stakeholders and of the firm's ESG impacts;
  (v) the manner of implementation of the business strategy with regards to ESG;

(b) Other relevant ESG-related targets and progresses made;

(c) The role of the administrative, management and supervisory bodies with regard to ESG;

(d) Any ESG-linked incentive schemes offered to members of the administrative, management and supervisory bodies;

(e) The firm's ESG policies;

(f) A description of:
  (i) ESG due diligence processes in place;
  (ii) the main (actual or potential) negative ESG impacts connected with the company's value chain (*i.e.*, the company's own operations, its products and services, its business relationships and its supply chain);
  (iii) any actions taken to prevent, mitigate or remediate actual or potential adverse impacts (and their effects);

(g) Key ESG risks and how these are managed; and

(h) Indicators relating to all the above.

Reporting line items should include both forward-looking and retrospective, as well as qualitative and quantitative information.

Although details of this will be laid out only under the CSRD's 2nd level rules, mandatory annual GHG emissions disclosure should capture scope 1 and 2 plus, *where relevant*, also scope 3.

The reports of listed SMEs may be more limited.

e. Reporting standards

While the NFRD allows significant flexibility with respect to the way in which non-financial information should be reported, the Commission has been tasked with approving detailed implementing standards and templates that firms will be expected to use for their CSRD reports.

These standards (referred to as European Sustainability

[11] The sustainability matters broadly defined by the CSRD cover environmental (E), social and human rights (S), and governance (G) factors, and also incorporate the "sustainability factors" mentioned in the SFDR (*i.e.*, environmental, social and employee matters, respect for human rights, and anti-corruption and anti-bribery).

Reporting Standards or "ESRS") are being developed in the first instance by the EU's *ad hoc* Financial Reporting Advisory Group (EFRAG).

In November 2022, EFRAG delivered the first batch of draft ESRS to the Commission. These include generic disclosure requirements as well as more specific standards to be applied with regards to certain environmental, social and governance priorities.[12] The second batch of ESRS is expected to include rules specific to certain industry-sectors (following the model of the Global Reporting Initiative (GRI)) and other complementary information.

Dedicated reporting standards will be developed for SMEs (such as to be proportionate and relevant to their capacities and characteristics), as well as for third-country parents.

f. Auditing / Assurance

Companies will be expected to submit their CSRD report to third-party audit.

This will begin with a "limited audit" (*a.k.a.*, "limited assurance"), whereby auditors shall express their opinion as regards the compliance of the sustainability report with the requirements of the CSRD (including the applicable reporting standards). This might be typically provided through a confirmation letter stating that no matter has been identified that suggests the information is materially misstated.

The requirement may, in the future, scale up to the same level of auditing that applies to financial statements.

Dedicated independence and professional competence requirements will apply to those providing assurance services (but is not limited to financial auditors).

g. Responsibility

The members of companies' administrative, management and supervisory bodies will have "collective responsibility" for ensuring that sustainability reports are drawn up and published in accordance with CSRD rules.

They will also be allowed to exceptionally omit from a report certain sensitive information (related to developments or matters under negotiation) where, in their justified opinion, its disclosure would be seriously prejudicial to the firm.

h. Sanctions

Non-compliance with the CSRD will be sanctioned under the Accounting and the Transparency Directives (as relevant to the particular issuer). Both directives generally require Member States to provide for penalties that are "effective, proportionate and dissuasive". Sanctions will therefore likely vary across the EU, depending on national implementing laws.

IV. Wider EU regulatory context

The CSRD is not the only ESG-related transparency reform that has been undertaken by the EU, since the approval of its landmark 2019 "EU Green Deal".

The first of such reforms was perhaps the Sustainable Finance Disclosure Regulation (SFDR), aimed at preventing the "greenwashing" of funds and other financial products marketed as "sustainable" (which are inundating markets globally).[13]

The second was Article 8 of the Taxonomy (above mentioned), aimed at measuring the percentage of larger and listed firms' activities aligned with the EU's environmental goals. This included, as mentioned, a slew of company-specific KPIs and measurement methodologies, with which companies are now starting to grapple.

Finally, implementing rules relating to banks' ESG risk disclosures entered into force on January 8, 2023. The EU Parliament and Council are now nearing the approval of the Commission's October 2021 "Banking Package", generally aimed at aligning the EU's banking capital requirement framework to the global financial stability standards agreed under the label of "Basel III". This will likely extend ESG risk reporting obligations well beyond large listed credit institutions, to all EU banks.

Clearly, the EU is rapidly advancing in the construction

[12] EFRAG's related press release (which includes links to the current draft standards) is accessible here.

[13] The SFDR is accessible here. See our dedicated alert on the SFDR of January 5, 2021, here.

of an information ecosystem rich of fine-grained sustainability-related data on corporate activity.

One thing to note is the perhaps lack of synchronisation between the CSRD and all other ESG-transparency reforms here mentioned, which has resulted in an overall lack of reliable ESG data for those already required to disclose. Entities in-scope of rules already in force (and in particular, banks and fund managers) will be left struggling to comply until a sufficient portion of their counterparties come within scope of the CSRD. This may hinder comparability of disclosures, to the extent that firms use different approaches to fill in information gaps.

V. Comparison to US SEC proposal

Over the course of 2022, the trend of regulators pushing for sustainability reporting has picked up well beyond EU borders – most notably, in the United States.[14]

In March 2022, the US Securities and Exchange Commission issued a proposal which, if adopted, would require registrants to include climate-related information in their registration statements and annual reports. Similarly to EU supervisors, the SEC cited investors' need for "*consistent, comparable, and reliable information*" as the basis for the proposed regime.[15]

Several key differences between the EU and the US approach are however worthy of mention.

- In terms of sustainability coverage: while the CSRD addresses in principle all aspects of E-S-G, US rules are exclusively focused on climate (other SEC and US exchange rules and anticipated rules proposals include disclosure requirements relating to other ESG matters, including human capital management and board diversity);
- Similarly, EU rules address a "double materiality" principle (which looks at both ESG risks and negative impacts), whereas – with the notable exception of emissions reporting – the US would place more focus on "financial materiality" (that is, the ability of ESG risks to ultimately impact the issuers' financials);
- In terms of scope: EU rules would reach all listed companies and all larger companies incorporated in the EU, plus (quite unexpectedly) even third-country group parents that generate a significant turnover within the Union. The SEC's proposals focus so far on US listed issuers (plus, under a separate pending proposal, fund managers);
- Finally, in terms of goals & targets: the CSRD would force larger companies in practice to publish (among other relevant ESG objectives) a Paris-aligned transition plan, with the US leaving setting any such targets as entirely voluntary for firms;
- On relating climate risk to financials: the SEC proposal includes required reporting in the notes to the financial statements as to any financial statement line item impact of climate event or transition, whether positive or negative that had a 1% of greater impact on the metric in the reporting period.

…

CLEARY GOTTLIEB

[14] For Cleary Gottlieb's three "deep dives" in the SEC proposal, access our alerts here. You can also access our views on the proposal's "top 10 issues" for comment here.

[15] The SEC's Fact Sheet on Enhancement and Standardization of Climate-Related Disclosures.