UNDERSTANDING EVOLVING GLOBAL SUSTAINABILITY REQUIREMENTS - A PRIMER FOR US, UK AND OTHER NON-EU COMPANIES (UPDATED)

Around 50,000 companies (both within and outside the European Union) are subject to mandatory disclosure requirements under the EU Corporate Sustainability Reporting Directive ("CSRD") and the related European Sustainability Reporting Standards ("ESRSs"), with the first tranche of companies reporting next year in respect of this financial year. For global companies subject to the CSRD (regardless of where they are based), climate-related disclosure has moved well past the hypothetical. It is a reality. For global companies headquartered in the United States but seemingly far removed from Europe, there is the patchwork of EU and California requirements, with SEC rules hanging in the balance. While one can debate the impact of the so-called Brussels effect (first coined by Columbia Law School professor Anu Bradford), the reality is that the thought process set in motion by Task Force on Climate-related Financial Disclosures ("TCFD"), created in 2015 (with its focus on governance, strategy, risk management and measurement) and the GHG Protocol (providing the framework for presentation of GHG emissions data in the form of Scope 1, Scope 2 and Scope 3) – both at the heart of the CSRD, has been fully embraced by market participants.

Regulation should be seen not as the driver, but rather the enabler, of consistent, comparable and decision-useful disclosure that the market demands. According to PwC's Global CSRD Survey 2024, close to three-quarters of companies preparing to file under the CSRD, including non-EU companies, say they are factoring sustainability into decision-making to a greater extent, or that they plan to do so. Reporting companies, particularly those with FY2025 reporting obligations, also see myriad business benefits of the CSRD, including better environmental performance, improved engagement with internal and external stakeholders and risk mitigation.

In effect, the CSRD (as the TCFD intended) provides management teams with the tools to understand the impacts of climate change. A separate PwC study of 4,700 CEOs found that corporate action on climate change allays concerns about the future prospect of their companies, with close to 40% in each of 2023 and 2024 saying they believe that if their companies continue on their current paths, they will not be viable in ten years.

Introduction to EU Sustainability Efforts

US, UK and other non-EU companies with operations in the European Union should be aware of ongoing EU efforts to legislate around sustainability, as well as the increasing relevance of the standards adopted by the International Sustainability Standards Board ("ISSB). That awareness is important, in part, because the efforts represent the global direction of travel for disclosure standards tied to sustainability, for both companies as well as financial market participants, but more importantly because, as I have highlighted in previous briefing notes, many of these efforts have extra-territorial reach and perhaps equally important international relevance.

At the heart of the growing web of EU mandated regulatory requirements (some applicable to companies, others to financial market participants) is the green taxonomy, the most ambitious roadmap in the world to meet climate and energy targets for 2030, by directing investment towards sustainable projects and activities. The taxonomy, based at its core on a set of four overarching conditions and six environmental objectives, sets out a complex definition of sustainability and what products can be marketed as sustainable. It does so through the common classification of sustainable economic activities deemed to contribute to environmental objectives via the Taxonomy Regulation and related Delegated and Implementing Acts.

Taxonomy is designed to increase transparency in the financial markets and reduce greenwashing by calling for disclosure of information about the environmental performance of assets and economic activities of financial and non-financial enterprises. The resulting taxonomy-compliant transparency in respect of corporate environmental performance also facilitates green finance.

When the European Union speaks of its corporate sustainability rules, it is referring to:

- the **Corporate Sustainability Reporting Directive** (2022/2464) ("CSRD"), which introduced new sustainability reporting requirements by way of amendments to:
  - Directive 2013/34/EU (Accounting Directive);
  - Directive 2006/43/EC (Audit Directive);
  - Regulation (EU) No 537/2014 (Audit Regulation);
  - Directive 2004/109/EC (Transparency Directive);
- the **Commission Delegated Regulation (EU) 2023/2772)** (representing the first set of European Sustainability Reporting Standards ("ESRSs)), and
- the **Sustainable Finance Disclosure Regulation** (2019/2088) ("SFDR")

On August 7, 2024, the European Commission (the "Commission") published its first set of Frequently Asked Questions on the implementation of these corporate sustainability rules.

There is also the related **Corporate Sustainability Due Diligence Directive** (2024/1760) ("CSDDD"), which was finalized at the EU level as of June 13, 2024, and must now be transposed into national law by July 26, 2026, with staggered phase-in dates.

I set out below, a lexicon of relevant concepts (terminology, legislation, and Delegated and Implementing Acts).

Lexicon of EU Sustainability Concepts

General

Delegated and Implementing Acts: secondary legislation from the Commission, which in the sustainability area set out technical screening criteria that define thresholds and specific requirements for activities to be considered to be contributing significantly to an

environmental objective. These instruments form a critical part of the Taxonomy Regulation. To date, there are the following Taxonomy Delegated Acts (*see also* EC Summary):

- **Commission Delegated Regulation on Economic Activities** (2023/2486) adopted June 27, 2023 and published November 21, 2023 – which sets out taxonomy criteria for economic activities making a substantial contribution to one or more of the non-climate environment objectives.
- **Taxonomy Complementary Climate Delegated Act** (2022/1214) published July 15, 2022;
- **Taxonomy Disclosures Delegated Act** (2021/2178) published December 10, 2021; and
- **Taxonomy Climate Delegated Act** (2023/2485) adopted June 27, 2023 and published November 23, 2023, amending the initial Taxonomy Climate Delegated Act (2021/2139) published December 9, 2021, which establishes additional technical screening criteria for determining the conditions under which certain economic activities qualify as contributing substantially to climate change mitigation or adaptation, and for determining whether those activities cause no significant harm to any of the other environmental objectives.

In addition, the CSRD empowers the Commission to adopt implementing and delegated acts to specify how competent authorities and market participants are to comply with the CSRD. These are the ESRSs, which became effective January 1, 2024.

DNSH: the acronym for "does not significantly harm" any of the environmental objectives.

EFRAG, previously known as the European Financial Reporting Advisory Group: tasked with developing and promoting European views in the field of corporate reporting. In its sustainability reporting activities, EFRAG provides technical advice to the Commission in the form of draft ESRSs.

Environmental objectives (set out in Article 9 of the Taxonomy Regulation):

Climate-related:

- climate change mitigation (in accordance with Article 10); and
- climate change adaptation (in accordance with Article 11);

Non-climate-related:

- sustainable use and protection of water and marine resources (in accordance with Article 12);
- transition to a circular economy (in accordance with Article 13);
- pollution prevention and control (in accordance with Article 14); and
- protection and restoration of biodiversity and ecosystems (in accordance with Article 15).

EU policy to commit companies to respect human rights and the environment in their global value chains: sets out the principles underlying the CSDDD.

European Green Deal: sets out a series of actions to transform the European Union into a modern, resource-efficient and competitive economy by achieving net-zero by 2050, economic growth decoupled from resource use, and no person or place left behind.

European Sustainable Finance Agenda: part of the broader effort to connect finance with the specific needs of the European and global economy for the benefit of the planet and society. Specifically, the agenda aims to reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth; manage financial risk flowing from climate change; and foster transparency and long-termism.

Extra-territorial impact: the CSRD disclosure requirements apply or will apply (*see* my November 20, 2022 briefing note for the phase-in dates) to:

- all "large undertakings" or "large groups" (whether or not listed on an EU regulated market), which encompasses EU companies (either an EU company or an EU subsidiary of a non-EU parent company) or EU groups on a consolidated basis, in all cases meeting *any two of the following three* criteria: as of the most recent balance sheet date: (i) more than €40 million of annual net revenue, (ii) more than €20 million of total assets, and (iii) average numbers of employees in excess of 250. Note: this could include a large EU subsidiary of a non-EU parent company and an EU parent undertaking of a large group that on a consolidated basis satisfies at least two of the three EU nexus criteria. All undertakings that are parent undertakings of large groups should report at the group level;
- companies (wherever organized) listed on an EU regulated market[1], including SMEs that are not micro-enterprises;
- EU credit institutions;
- EU insurance undertakings; and
- other companies designated as public-interest entities by national authorities.

Finally, groups with non-EU parent companies will be required to comply with certain requirements (with reporting based on the entire group, from the perspective of the parent) if:

- the group, on a consolidated basis, generated EU net revenue of more than €150 million in each of the last two consecutive financial years; *and*
- the group has at least one EU subsidiary that meets the requirements for an EU public-interest entity (*i.e.,* a "large undertaking," or EU regulated market listing (other than a micro-enterprise)); or a branch that generated more than €40 million in revenue in the preceding financial year.

ISSB or the International Sustainable Standards Board: *see* my April 13, 2022 briefing note, available here.

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[1] Listed securities include equity as well as debt securities, and depositary receipts in respect of equity or debt (*see* MiFID (2004/39/EC)). EU regulated markets would not include multilateral trading facilities in the European Union.

Minimum safeguards: set out under the Taxonomy Regulation to ensure that companies that hold themselves out as engaging in sustainable activities meet certain minimum standards in respect of human rights, bribery, taxation and fair competition. Under the Taxonomy Regulation, adherence to minimum standards is one of the four conditions for an economic activity to qualify as environmentally sustainable. These minimum safeguards cut across all of the EU sustainable finance regulations, the SFDR, the CSRD and the CSDDD. Essentially the minimum safeguards are intended to prevent green investments that otherwise meet sustainability standards from being marketed as sustainable if they violate the broader standards covered by the minimum safeguards.

It is noteworthy that minimum safeguards explicitly do not supersede more stringent business conduct standards set out in:

- The OECD Guidelines for multinational enterprises ("OECD-G")
- The UN Guiding Principles for Business and Human Rights ("UNGP")
- The ILO Declaration on Fundamental Principles and Rights at Work
- The UN International Bill of Human Rights

The Platform's October 2022 Final Report on Minimum Safeguards provides guidance on how the minimum safeguards are to flow through the SFDR, CSRD and CSDDD, on substantive topics and compliance. The guidance is non-binding. By virtue of the references to the SFDR, the five mandatory social PAIs set out in the SFDR are carried over.[2] With the CSDDD yet to be applied, and the CSRD yet to produce reports, their implementation is uncertain and, therefore, the impact of the minimum safeguards on that legislation is evolving.

The Final Report breaks down compliance, based on the status under the CSRD, as between in-scope EU companies and in-scope non-EU companies, as well as for SMEs and banks/insurance companies, in each case with alternative tests (meeting one of two criteria of non-compliance) for each of the four core categories of human rights, corruption, taxation and fair competition. For example, in the case of minimum safeguards tied to human rights:

- **for an in-scope EU company**, (i) has it failed to establish an adequate human rights due diligence ("HRDD") process per the UNGP or OECD-G or (ii) are there signals that the company did not adequately implement HRDD and/or did it abuse human rights; and

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[2] Financial market participants are required under the SFDR to disclose the PAI of investment decisions on sustainability outcomes, including environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery. Of the 18 PAI indicators, five are relevant to minimum safeguards: violations of UNGP and OECD-G; lack of process to monitor UNGP and OECD-G compliance; unadjusted gender pay gap; board gender diversity; and exposure to manufacture of controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons).

- **for an in-scope non-EU company**, (i) has it failed to implement an adequate HRDD that follows the six steps of the UNGPs (as audit/assurance of these disclosures will be voluntary, an additional check on implementation is necessary, namely an assessment based, for example, on the World Benchmarking Alliance benchmarks) or (ii) are there signals that the company did not adequately implement HRDD and/or did it abuse human rights?

Non-Financial Reporting Directive (2014/95) ("NFRD"): the predecessor to, and superseded by, the CSRD.

Platform on Sustainable Finance (the "Platform"): set up by the Commission as a permanent expert group to assist in developing sustainable finance policies, particularly the further development of the EU taxonomy as a means of monitoring and reporting on capital flows into sustainable finance. Among its priorities, the Platform provides advice on the technical screening criteria for environmental objectives, called for by Article 19 of the Taxonomy Regulation. The Platform issued a report on methodology in March 2022 and a supplemental report (dated October 2022) in November 2022. In April 2024, the Platform issued an intermediate report on Monitoring Capital Flows to Sustainable Finance.

Taxonomy Climate Delegated Act: sets out technical screening criteria for economic activities having the potential to contribute to climate change mitigation and climate change adaptation, these being the first two environmental objectives set out in the Taxonomy Regulation.

Taxonomy Complementary Climate Delegated Act: sets out technical screening criteria for activities in the gas and nuclear energy sector.

Taxonomy Disclosure Delegated Act, supplementing the Taxonomy Regulation: specifies the content, methodology and presentation of information for both financial and non-financial companies on the share of their respective business, investments or lending activities that are **aligned** with the Taxonomy.

- Non-financial companies are to disclose the share of their revenue, capital expenditure and operational expenditure (Performance KPIs) associated with environmentally sustainable economic activities as defined in the Taxonomy Regulation and the first Taxonomy Delegated Act, as well as any future Delegated Acts on other environmental objectives.
- Financial institutions, mainly large banks, asset managers, investment firms and insurance/reinsurance companies, are to disclose the share of environmentally sustainable economic activities in the total assets they finance or invest in.

This Delegated Act defines, among other concepts,

- **Taxonomy-aligned economic activity**, which is an economic activity that complies with Article 3 of the Taxonomy Regulation.
- **Taxonomy-eligible economic activity**, which is an activity described in Delegated Acts adopted pursuant to the Taxonomy Regulation (subparts of Articles 10-15),

regardless of whether or not the activity meets the screening criteria in those Delegated Acts. A **Taxonomy-non-eligible economic activity** is any activity not described in the Delegated Acts pursuant to the Taxonomy Regulation (subparts of Articles 10-15).

The Commission Delegation Regulation on Economic Activities sets out technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to the sustainable use and protection of water and marine resources, to the transition to a circular economy, to pollution prevention and control, or to the protection and restoration of biodiversity and ecosystems and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. (*See* additional details below.)

The **Regulation to establish a framework to facilitate sustainable investing** (2020/852) (also known as the **Taxonomy Regulation**): establishes the common classification of sustainable economic activities deemed to contribute to environmental objectives. The Taxonomy classification is used in the CSRD and the SFDR. (*See generally* my January 6, 2022 briefing note, available here.) As noted in the introduction, the key to understanding the taxonomy construct is to follow the four criteria for environmentally sustainable economic activities and the six environmental objectives.

Article 3 sets out that whether or not an investment is environmentally sustainable, the four relevant criteria being whether the underlying activity:

- **contributes substantially** to one or more of the six **environmental objectives** set out in Article 9 (in accordance with Articles 10-16) – where **substantial contribution** means directly enabling other activities to make a substantial contribution to one or more of the objectives, provided the economic activity does not lead to lock-in of assets that undermine the long-term environmental goals and has a substantial positive environmental impact on the basis of life-cycle considerations (Article 16);
- does **not significantly harm** ("DNSH") any of the other environmental objectives set out in Article 9 (in accordance with Article 17);
- is carried out in compliance with **minimum safeguards** set out in Article 18; and
- complies with screening criteria established by the Commission (as contemplated by Articles 10-15, and meeting the requirements of Article 19).

The Taxonomy will have other applications in the future.

A visual representation of the Taxonomy is available on the Taxonomy Compass.

EU Corporate Disclosure - CSRD

The CSRD amended the NFRD as well as the Audit Directive (2006/43), the Transparency Directive (2004/109) and the Accounting Directive (2013/34). (*See* my November 20, 2022 briefing note, available here.) The CSRD entered into force January 5, 2023 and its rules were being phased in beginning January 1, 2024 for certain large EU and EU-listed

companies (with reporting in 2025 on 2024 data), and for all in-scope companies by January 1, 2028.

The CSRD covers a range of **disclosable information** (the first five being carryovers from the NFRD):

- environmental matters;
- social matters and treatment of employees;
- respect for human rights;
- anti-corruption and bribery;
- diversity on company boards (in terms of age, gender, educational and professional background);
- "sustainability matters," which encompasses environmental, social and human rights, and governance factors, including the factors set out in the SFDR, which would pick up anti-corruption and anti-bribery matters; and
- "key intangible resources," which encompasses resources without physical substance on which the business model fundamental depends that are a source of value creation.

The key **disclosure topics** are:

- business model and strategy;
- time-bound targets related to sustainability;
- the role of the board and management regarding sustainability matters;
- policies relating to sustainability;
- incentive arrangements linked to sustainability;
- the due diligence process in respect of sustainability matters and, where applicable, in line with EU due diligence requirements;
- the principal adverse effects connected to the reporting company and its value chain;
- the principal risks related to sustainability matters;
- actions taken to prevent, mitigate, remediate or bring to an end actual or potential adverse impacts; and
- indicators relevant to the foregoing disclosures.

Note that since the CSRD is a Directive, it must be transposed into national law of each of the Member States. The deadline was July 6, 2024, and not all Member States have completed their transposition processes (*see* PwC Tracker and EUR-Lex). The CSRD is not a "maximum harmonization" Directive, meaning that as part of the transposition process, Member States may set stricter standards (so-called "gold-plating"), for example, in respect of the scope of reporting entities, sanctions for non-compliance and assurance providers, but Member States cannot provide less strict standards.

The European Sustainability Disclosure Standards

The specific disclosure requirements applicable under the CSRD are set out in the ESRSs, which were developed by EFRAG, were adopted by the Commission as a Delegated Act on July 31, 2023, were finalized December 12, 2023 and entered into force January 1, 2024.

The ESRSs cover general principles of sustainability reporting (ESRS 1), general disclosure principles (ESRS 2) and themed topics, including:

- climate change (ESRS E1);
- pollution (ESRS E2);
- water and marine resources (ESRS E3);
- biodiversity and ecosystems (ESRS E4);
- resource use and circular economy (ESRS E5);
- business conduct (ESRS G1);
- own workers (ESRS S1):
- workers in the value chain (ESRS S2);
- affected communities (ESRS S3); and
- consumer end users (ESRS S4).

Note that ESRS 2 and the topical ESRS are structured along four reporting lines:

- Governance (GOV): the governance processes, controls and procedures used to monitor, manage and oversee impacts, risks and opportunities;
- Strategy (SBM): how strategy and business model interact with material impacts, risks and opportunities (IROs), including how the entity addresses those impacts, risks and opportunities;
- IRO management: the process(es) by which the undertaking identifies IROs and assesses their materiality, and how it manages material sustainability matters through policies and actions.
- Metrics and targets (MT): the entity's performance, including targets it has set and progress towards meeting them.

The standards are set out in Annex 1 to the Commission Delegated Regulation and definitions of relevant terms are set out in Annex 2 to the Commission Delegated Regulation. These ESRSs themselves are sector-agnostic. The Commission was required to adopt sector-specific standards by June 2024 – that date has been postponed to June 2026 to give companies more time to comply with the horizontal standards set out in the ESRSs.

Among the most significant of the aspects of the ESRSs are the perspective of "double materiality," requiring reporting companies to report both on their impact on the people and the environment (known as "impact materiality"), and on how social and environmental issues give rise to financial risks and opportunities (affecting financial position, financial performance and cash flows over the short, medium and long term) for the reporting company (known as "financial materiality"). *See* below for more detail.

EU Financial Services Sector Disclosure Requirements - SFDR

The SFDR became applicable as of March 10, 2021 (with certain requirements to be phased in). It introduced disclosure requirements for financial market participants that fit within existing disclosure regimes, and established the concept of a "sustainability risk," which it

defines as an ESG "event or condition that, if it occurs, could cause a negative material impact on the value of the investment."

In brief, the SFDR (as supplemented by the April 6, 2022 Delegated Act) sets out sustainability disclosure obligations:

- for market participants (asset managers, institutional investors and other entities that offer financial products while managing client money, which it refers to as "financial market participants"), as well as financial advisers in all investment processes, and for financial products that pursue objectives of sustainable investing; and
- as to adverse impacts of investment decisions on sustainability factors (referred to as "principal adverse impacts" or "PAIs") at entity and financial product levels. Among other things, financial market participants are to disclose the indicators related to PAIs of their investment decisions on sustainability factors and the actions taken/planned to be taken to avoid or reduce the PAIs identified. Financial market participants also are required to describe their policies to identify and prioritise PAIs on sustainability factors and how those policies are kept up to date and applied.

The Delegated Act (April 6, 2022 - 2022/1288), supplementing the SFDR, sets out technical standards specifying:

- the details of the content and presentation of the information in relation to the principle of DNSH;
- the content, methodologies and presentation of information in relation to sustainability indicators and PAIs; and
- the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports.

The indicators of PAIs of investment decisions on sustainability factors are:

- GHG emissions;
- Carbon footprint;
- GHG intensity of investees;
- Exposure to fossil fuel sector;
- Share of non-renewable energy consumption/production;
- Energy consumption intensity;
- Negative impact on biodiversity;
- Emissions to water;
- Hazardous waste and radioactive waste ratio;
- Violations of UNGP and OECD-G;
- Lack of process to monitor UNGP and OECD-G compliance;
- Unadjusted gender pay gap;
- Board gender diversity;
- Exposure to manufacture of controversial weapons;

- GHG intensity;
- Investees subject to social violations;
- Exposure to fossil fuels through real estate; and
- Exposure to energy-inefficient real estate.

In November 2022, the European Supervisory Authorities ("ESAs," being the European Banking Authority ("EBA"), the European Securities and Markets Authority ("ESMA") and the European Insurance and Occupational Pensions Authority ("EIOPA")) published their Q&A on the SFDR Delegated Regulation. The Commission had published a separate Q&A on SFDR matters.

As noted above, the criteria for determining whether an economic activity qualifies as environmentally sustainable, for purposes of the SFDR, is set out in the Taxonomy Regulation.

EU Corporate Sustainability Due Diligence - CSDDD

The CSDDD establishes a duty of due diligence for companies within its scope. The core elements of the corporate duty are to ensure that companies active in the European Union contribute to sustainable development and the sustainability transition of economies and societies by respecting human rights and the environment. It does this through the identification, prevention and mitigation, bringing to an end, remediation and minimization, and where necessary, prioritization, of potential or actual adverse human rights and environmental impacts connected with their own operations, and the operations of subsidiaries and value chains, and ensuring that those affected by a failure to respect this duty have access to justice and legal remedies.

CSDDD obligations are tied to the OECD Due Diligence Guidance for Responsible Business Conduct, and thus include:

- integrating due diligence into policies and management systems;
- identifying and assessing adverse human rights and environmental impacts;
- preventing, ceasing or minimizing actual and potential adverse human rights and environmental impacts;
- verifying, monitoring and assessing the effectiveness of measures;
- communicating; and
- providing remediation.

On December 1, 2022, the European Council cleared the way (having adopted its "general approach") for the Council presidency to begin negotiations with the European Parliament over the terms of the CSDDD. Separately, the Committee on Economic and Monetary Affairs of the European Parliament proposed to the Committee on Legal Affairs to expand the scope of the CSDDD to include institutional investors and asset managers, which would have obligations under the directive in respect of their investee companies. The Commission published its proposed directive on February 23. On June 1, 2023, the European Parliament

adopted its own set of amendments. The CSDDD is now final, and must be transposed into national law.

Covered companies (under Article 2) include (based on prior-year turnover) any of the following, provided the threshold are met for two consecutive years (and cease to apply if a company fails to meet the conditions for each of the two preceding years):

- (a) any EU-based company with more than 1,000 employees on average and net worldwide turnover of more than €450 million and (b) any EU-based company that did not reach the foregoing thresholds but is the ultimate EU-based parent company of a group that had at least 1,000 employees and a net worldwide turnover of more than €450 million;
- (a) any non-EU company (regardless of number of employees) if it had net EU turnover of more than €450 million and (b) any non-EU company that did not reach the foregoing threshold but is the ultimate parent company of a group that had net EU turnover of more than €450 million; and
- (c) any EU or non-EU company that entered into, or are the ultimate parent company of a group that entered into, franchising or licensing agreements in the European Union in return for royalties with independent third-party companies, where those agreements ensure a common identity, a common business concept and the application of uniform business methods, and where those royalties amounted to more than €22.5 million, provided that the company had or is the ultimate parent company of a group that had a net worldwide turnover of more than €80 million.

There are no sector-specific thresholds. EU companies are regulated for purposes of the CSDDD in the Member State in which their registered office is located. Non-EU companies are regulated in the Member State where they have a branch; if there is no branch in the European Union or there are multiple branches, the Member State where the highest turnover is generated in the preceding year is generated.

In brief, the CSDDD requires Member States to ensure that covered companies conduct risk-based human rights and environmental due diligence by doing the following:

- integrating due diligence into their policies and risk management systems in accordance with Article 7;
- identifying and assessing actual or potential adverse impacts in accordance with Article 8 and, where necessary, prioritizing actual and potential adverse impacts in accordance with Article 9;
- preventing and mitigating potential adverse impacts, and bringing actual adverse impacts to an end and minimizing their extent in accordance with Articles 10 and 11;
- providing remediation for actual adverse impacts in accordance with Article 12;
- carrying out meaningful engagement with stakeholders in accordance with Article 13;
- establishing and maintaining a notification mechanism and a complaints procedure in accordance with Article 14;

- monitoring the effectiveness of their due diligence policy and measures in accordance with Article 15;
- publicly communicating on due diligence in accordance with Article 16 (by posting an annual statement of the corporate website). Non-EU companies must also include in the annual statement information about their authorized representative in the European Union (Article 23).

All covered companies (and not just larger ones, as initially proposed by the Commission) will be required (Article 22) to adopt and implement a transition plan, compatible with reporting obligations under the CSRD, to ensure that the business strategy and the business model are aligned with: the transition to a sustainable economy, limiting global warming to 1.5°C and the objective of achieving climate neutrality, including 2030 climate targets and 2050 climate neutrality targets (under the European Climate Law). The plan would be required to address:

- time-bound targets related to climate change for 2030 and in five-year steps up to 2050 based on conclusive scientific evidence and, where appropriate, absolute emission reduction targets for Scope 1, Scope 2 and Scope 3 GHG emissions for each significant category;
- a description of decarbonization levers identified and key actions planned to reach the targets referred to in the previous bullet, including, where appropriate, changes in the product and service portfolio of the company and the adoption of new technologies;
- an explanation and quantification of the investments and funding supporting the implementation of the transition plan for climate change mitigation; and
- a description of the role of the administrative, management and supervisory bodies with regard to the transition plan for climate change mitigation.

These plans must be updated every 12 months, and the update must describe the progress made towards achieving the time-bound targets referred to above.

Companies reporting on transition plans for climate mitigation under the CSRD, or that are included in such a transition plan by reason of being part of a group that complies with the CSRD, are deemed to have complied with Article 22.

The CSDDD sets forth penalties for non-compliance (Article 27) and provides for civil liability for damage caused to a natural or legal person where (and for full compensation for damage):

- a company intentionally or negligently failed to comply with the obligations laid down in Articles 10 and 11, when the right, prohibition or obligation listed in the Annex to this Directive is aimed at protecting the natural or legal person; and
- as a result of the failure referred to above, damage to the natural or legal person's legal interests that are protected under national law was caused.

Companies cannot be held liable if the damage was caused only by their business partners in their supply chains.

There are phase-in provisions:

- from July 26, 2027 for EU companies ((a) and (b)) with more than 5,000 employees on average and net worldwide turnover of more than €1.5 billion (except Article 16, which applies on or after January 1, 2028);
- from July 26, 2028 for EU companies ((a) and (b)) with more than 3,000 employees on average and net worldwide turnover of more than €900 million (except Article 16, which applies on or after January 1, 2029);
- from July 26, 2027 for EU companies ((a) and (b)) with net EU turnover of more than €1.5 billion (except Article 16, which applies on or after January 1, 2028);
- from July 26, 2028 for EU companies ((a) and (b)) with net EU turnover of more than €900 million (except Article 16, which applies on or after January 1, 2029);
- from July 26, 2029 for all other EU and non-EU covered companies, including those covered in (c) (except Article 16, which applies on or after January 1, 2029);

Related Developments

Corporate Disclosure - CSRD

Phase-in: Appendix C to the ESRSs provides a list of compliance extensions (ranging from one to three years) in some cases for undertakings with fewer than 750 employees and in other cases for all reporting companies. For example,:

- undertakings with fewer than 750 employees may omit scope 3 GHG emissions data and total GHG emissions data (ESRS E1, E1-6) for the first year;
- all undertakings may omit anticipated financial effects from material physical and transition risks and potential climate-related opportunities (ESRS E1, E9) in the first year, and if reporting: quantitative data is impractical, may provide qualitative data for the first three years;
- all undertakings may omit anticipated financial effects from pollution-related impacts, risks and opportunities (ESRS E2, E6) for the first year;
- all undertakings may omit anticipated financial effects from water and marine-related impacts, risks and opportunities (ESRS E3, E3-5) for the first year;
- undertakings with fewer than 750 employees may omit biodiversity and ecosystem disclosure (ESRS E4) for the first two years:
- all undertakings may omit anticipated financial effects from biodiversity and ecosystem-related impacts, risks and opportunities (ESRS E4, E4-6) for the first year and may provide qualitative data for the first three years;
- undertakings with fewer than 750 employees may omit "own workforce" data (ESRS S1) for the first year and all undertakings may omit certain other data points under ESRS S1 for the first year;
- undertakings with fewer than 750 employees may data on workers in the value chain (ESRS S2), affected communities (ESRS S3) and consumer end-users (ESRS S4) for the first two years.

Impacts, risks and opportunities (IROs): for purposes of the ESRSs, the term "impacts" refers to positive and negative sustainability-related impacts that are connected with a business, as identified through an impact materiality assessment. It refers both to actual impacts and to potential future impacts. The phrase "risks and opportunities" refers to sustainability-related financial risks and opportunities, including those deriving from dependencies on natural, human and social resources, as identified through a financial materiality assessment.

***Stakeholders and their relevance to the materiality assessment process*:** there are two groups of stakeholders that can be affected by a business: those whose interests are affected positively or negatively by business activities and direct/indirect business relationships across the value chain, and the users of the disclosure. Engagement with affected stakeholders is central to the on-going due diligence process and sustainability materiality assessment. This includes its processes to identify and assess actual and potential negative impacts, which then inform the assessment process to identify the material impacts for the purposes of sustainability reporting. These in turn tie to double materiality.

Materiality: The ESRSs provide that all standards and all disclosure requirements and data points within each standard will be subject to materiality assessments, except for disclosures required by ESRS 2. The basis for all sustainability disclosures is double materiality (paragraph 3.3), which covers impact materiality (paragraph 3.4) and financial materiality (paragraph 3.5).

- A sustainability matter is material from an **impact perspective** when it pertains to material actual or potential, positive or negative impacts on people or the environment over the short-, medium- or long-term. Impacts include those connected with own operations and upstream and downstream value chain, including through products and services, as well as through its business relationships. Business relationships include those in the upstream and downstream value chain and are not limited to direct contractual relationships.
- The scope of **financial materiality** for sustainability reporting is an expansion of the scope of materiality used in the process of determining which information should be included in the undertaking's financial statements. The financial materiality assessment corresponds to the identification of information that is considered material for primary users of general-purpose financial reports in making decisions relating to providing resources to the entity. In particular, information is considered material for primary users of general-purpose financial reports if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that they make on the basis of the undertaking's sustainability statement.

  A sustainability matter is material from a financial perspective if it triggers or could reasonably be expected to trigger material financial effects on the undertaking. This is the case when a sustainability matter generates risks or opportunities that have a material influence, or could reasonably be expected to have a material influence, on

the undertaking's development, financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium- or long-term. Risks and opportunities may derive from past events or future events. The financial materiality of a sustainability matter is not constrained to matters that are within the control of the undertaking; it includes information on material risks and opportunities attributable to business relationships beyond the scope of consolidation.

The materiality of risks and opportunities is assessed based on a combination of the likelihood of occurrence and the potential magnitude of the financial effects.

Impact materiality and financial materiality assessments are interrelated and the interdependencies between these two must be considered. The starting point is the assessment of impacts, although there may also be material risks and opportunities that are not related to impacts. A sustainability impact may be financially material from inception or become financially material, when it could reasonably be expected to affect financial position, financial performance, cash flows, access to finance or cost of capital over short-, medium- or long-term. Impacts are captured by the impact materiality perspective regardless of whether or not they are financially material. In identifying and assessing IROs in the value chain to determine their materiality, the focus it to be on areas where IROs are deemed likely to arise, based on the nature of the activities, business relationships, geographies or other factors concerned.

A materiality assessment may lead to the identification of situations in which actions to address certain impacts or risks, or to benefit from certain opportunities in relation to a sustainability matter, might have material negative impacts or cause material risks in relation to one or more other sustainability matters. In this case, the existence of material negative impacts or material risks must be disclosed together with the actions that generate them, with a cross-reference to the topic to which the impacts or risks relate; and description of how the material negative impacts or material risks are addressed under the topic to which they relate must also be provided.

If a reporting entity concludes that climate change (ESRS E1) is not a material topic and, therefore, that it does not report in accordance with that standard, it is to provide a detailed explanation of the conclusions of its materiality assessment with regard to climate change, including a forward-looking analysis of the conditions that could lead it to conclude that climate change is material in the future. This provision was included, according to the Commission, "in recognition of the widespread and systemic effects of climate change on the economy as a whole." If the reporting entity concludes that a topic other than climate change is not material and therefore it omits all the disclosure requirements in the corresponding topical ESRS, it may briefly explain the conclusions of its materiality assessment for that topic.

ESRS Appendix E provides a useful flowchart for determining how to approach disclosures under the ESRSs

Certain voluntary disclosures: The Commission has converted a number of the mandatory datapoints proposed by EFRAG into voluntary datapoints. This includes, for example: biodiversity transition plans; certain indicators about "non-employees" in the undertaking's own workforce and an explanation of why the reporting entity may consider a particular sustainability topic not to be material.

Further flexibility: There are additional flexibilities in the disclosure requirements on the financial effects arising from sustainability risks and on engagement with stakeholders, and in the methodology to use for the materiality assessment process. The Commission also has modified datapoints regarding corruption and bribery and regarding the protection of whistle-blowers that might be considered to have infringed on the right not to self-incriminate.

Regulation of ESG Ratings Providers

The European Union likely will be the first jurisdiction to formally regulate EGS ratings providers. The Regulation on the Transparency and Integrity of Environmental, Social and Governance Ratings Activities was approved by the European Parliament in April 2024. ESG ratings providers that publish ratings publicly and operate in the European Union will be required to be authorized by ESMA, comply with governance requirements and make disclosures on their websites as to methodologies, models and key ratings assumptions. The Regulation must still be approved by the Council, after which it is published in the *Official Journal* and would apply 18 months and 20 days after that.

Regulation of Greenwashing

The European Union is tacking greenwashing from various angles, including through:

- the Empowering Consumers Directive (2024/825), which would embed commercial greenwashing practices in the Unfair Commercial Practices Directive and the Consumer Rights Directive (*see* March 2022 proposal and Fact Sheet); and
- the Green Claims Directive (*see* March 2023 proposal and Fact Sheet*)*.

In May 2024, ESMA published its final guidelines for the use of names of funds with ESG or sustainability-related terms. These guidelines are not intended to interfere with the requirements of the SFDR or the Taxonomy Regulation. The objective of the guidelines is to counter the risk of greenwashing by funds. The guidelines become applicable on November 21, 2024 (*see* ESMA timetable).

Global Standards – ISSB

The ISSB formally issued its inaugural corporate disclosure standards – IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures) (collectively, the "Standards") in June 2023. The Standards respond to longstanding demands from investors and other stakeholders for consistent, comprehensive and comparable, decision-useful information to enable them to gain an understanding of a company's performance and prospects from a sustainability standpoint. In the words of the ISSB, these Standards establish a global baseline for sustainability disclosure

– a common language for disclosing the effects of climate-related risks and opportunities on a company's "prospects." Ultimately, the Standards are designed to provide users of corporate financial reporting with information relevant to investment decisions in the subject reporting companies. (For more details, *see* my June 28, 2023 briefing note, available here.)

In September 2024, the IFRS Foundation announced the publication of its Guide for Preparers to help companies voluntarily apply IFRS S1 and IFRS S2. The guide highlights two elements of the Standards that are designed to support implementation:

- transition relief so that preparers can use a phased-in approach to the requirements, which includes "climate-first" reporting, the timing of reporting, comparative disclosures and relief around the disclosure of GHG emissions; and
- proportionality mechanisms to provide adequate measures to address the range of capabilities and circumstances of companies.

Concluding Thoughts

That there are multiple Directives, Regulations and Delegated Acts, including significant modifications to one Directive (the NFRD amended by the CSRD), are a testament to the complexity as well as the scope and ambition of the EU's sustainability initiatives. While the SEC climate rules (currently in suspended animation pending legal challenges) are set out in a single release, focused only on climate and only on disclosures by SEC reporting companies (in effect, listed companies in the United States), the EU effort is far broader. First, the effort targets disclosure across a far broader range of ESG themes; second, the effort covers far more than listed companies; and, third, the effort focuses not only on corporate obligations but also on financial market participant obligations.

The benefit of the EU approach is that it integrates, though that common classification system, the entire ecosystem of players that have a role in transitioning to net-zero. This is a dynamic area, with multiple moving pieces. In some cases, the changes are broadening coverage (*e.g.,* the CSRD modifications to the NFRD) and in others retrenching somewhat (*e.g.,* the scope of the CSDDD and the director duty of care thereunder). As the CSRD transposition process allows for enhancements my Member States (gold-plating), each relevant Member State's national laws do need to be consulted.

All to say that close attention to legislative and regulatory developments remains necessary.

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