Comments on the proposed DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting

Introduction

The current activity at EU level on requirements for financial actors and private companies to disclose on extra-financial sustainability issues must be seen as a realization that, in order for EU Member States (MSs) to live up to their international obligations, they need to focus on the activities of economic actors which - perhaps until relatively recently - were seen more as subjects of general legislations governing business, and obviously criminal legislation or legislation on e.g. social contributions, health care etc. within each MS, and not so much as a group for which specific sustainability legislation and attention was directed. This proposal consists of one Directive that would amend four existing pieces of legislation. In the first place, it would amend the Accounting Directive, revising some existing provisions and adding certain new provisions about sustainability reporting. In addition, it would amend the Audit Directive and the Audit Regulation, to cover the audit of sustainability information. Finally, it would amend the Transparency Directive to extend the scope of the sustainability reporting requirements to companies with securities listed on regulated markets, and to clarify the supervisory regime for sustainability reporting by these companies.

The EU (along with many other countries) is aiming to become net zero by 2050 and has also agreed a 55% reduction on 1990 levels of greenhouse gases by 2030. In order to reach these targets, vast amounts of capital (in particular private capital) need to be redirected towards greener, more sustainable activities. Which means investors need more and better information on which to base their investment decisions - not just on climate change, but also on a much wider range of other sustainability issues including diversity and inclusion. One interesting point of the proposed Directive is that there is a clear realization not only that the sustainability aspects of business need to be better and more clearly addressed, but also that such effect cannot be considered “NON financial” – that sustainability (or lack thereof) is a financial aspect even if not quantifiable in the old fashioned way. Many stakeholders have expressed their belief that the term ‘non-financial’ is inaccurate, in particular because it implies that the information in question has no financial relevance. It is recognized with the current proposal that the information in question *does* increasingly have financial relevance. Since many organisations, initiatives and practitioners in this field refer to “sustainability” information, the proposal suggests that it is preferable to use the term “sustainability information” instead of “non-financial information”. This is also in line with using ESG measurements and strategies and investment as a way of working towards the implementation of the SDGs in a way that considers “sustainability” as a 360* issue. The Proposal is thus that Directive 2013/34/EU should be amended to take account of this change in terminology.

The Green Deal also aims to protect, conserve and enhance the Union's natural capital, and protect the health and well-being of citizens from environment-related risks and impacts. The European Green Deal aims at decoupling economic growth from resource use, and ensuring that all regions and citizens of the Union participate in a ***socially*** just transition to a sustainable economic system.

The Green Deal is presented as a framework that will contribute to the objective of building an economy that works for the people, strengthening the EU's social market economy, helping to ensure that it is future-ready and that it delivers stability, jobs, growth and investment. These goals are especially important considering the socio-economic damage caused by the COVID-19 pandemic and the need for a sustainable, inclusive and fair recovery.

It is paramount to note how the EU in its reasoning is clearly linking sustainability (understood not only as environmental sustainability but also as social sustainability and governance in line with the SDGs) to what has always been at the core of the EU: strengthening the social market economy and helping the guarantee that the Union is capable of ensuring stability, jobs, growth and investment on a long-term basis. The fact that COVID-19 exposed the dangers of social inequality and lack of respect for basic rights including in the Global North may well have sped up the process of focusing more on social issues of sustainability and not so exclusively on the environment as hitherto. The need for a "fair" recovery is mentioned in the reasoning for this legislative initiative.

In its Action Plan on Financing Sustainable Growth the Commission set out measures to achieve the following objectives: reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth, manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues, and foster transparency and long-termism in financial and economic activity. The proposed Directive is aiming at making the disclosure of relevant, comparable and reliable sustainability information a tool, since such disclosure has to be considered a prerequisite for meeting those objectives. The European Parliament and the Council adopted a number of legislative acts as part of the implementation of the Action Plan on Financing Sustainable Growth already.

Asset managers and financial advisers are being required to report on a wide range of sustainability issues under new requirements in the Sustainable Finance Disclosure Regulation (SFDR), since March 2021. Besides requiring entities to understand the scope, severity, probability of occurrence and potentially irremediable character of the negative impact on the E that has been caused, compounded by or directly linked to its investment decisions and advice performed, the adverse sustainability impact set forth in the SFDR – mandatory for large entities and large holdings – requires considering the negative, material or likely to be material effects also on the S and the G, including requiring the publication of a statement on the entity's website describing its due diligence policies in respect of these adverse impacts. The SFDR defines mandatory and voluntary adverse sustainability indicators and metrics in relation to social and employee matters, respect for human rights, anti-corruption and anti-bribery. If Asset Managers are to report on these issues, they in turn will need access to the required data and information.

The primary users of sustainability information disclosed in companies' annual reports are investors and non-governmental organisations, social partners and other stakeholders. Investors, including asset managers, want to better understand the risks of, and opportunities afforded by, sustainability issues for their investments, as well as the impacts of those investments on people and the environment. They not only want this to attract Asset Owners and respond to increased societal pressure in the Global North where many Asset Owners are based, but they also need this information to be available in order to live up to their reporting requirements. Non-governmental organisations, social partners and other stakeholders want to hold undertakings to greater account for the impacts of their activities on people and the environment, and the better the information they can get, the better the companies and entities they are holding accountable either legally or in the public opinion can engage in a meaningful and transparent way which will aid them in maintaining their licence – legal or social – to operate.

The SFDR governs how financial market participants (including asset managers and financial advisers) should disclose sustainability information to end-investors and asset owners. To be able to fulfil the requirements of the SFDR – and therefore ultimately to be able to meet the needs of end investors – financial actors need adequate information from investee companies.

The current legal framework does not ensure that the information needs of Asset Managers - who are obliged under the SFDR as well as under pressure from Asset Owner as mentioned above - are met. This is because some companies from which sustainability information is necessary do not report such information, while many that do report sustainability information do not report all the information that is relevant. When information is reported, it is often neither sufficiently reliable, nor sufficiently comparable between companies. Information on intangibles, including internally generated intangibles, is under-reported. The growing awareness of investors that sustainability issues can put the financial performance of companies at risk, the growing market for investment products that explicitly seek to conform to certain sustainability standards or achieve certain sustainability objectives is requiring such information to be available. The COVID-19 pandemic is likely to further accelerate the growth in demand for sustainability information from companies, such as regarding the vulnerability of workers and the resilience of supply chains.

The proposed Directive therefore compliments the SFDR in order to ensure that companies from whom investors need sustainability information report this, and that reported information is relevant, comparable, reliable, and easy to access and use. It also aims to reduce unnecessary costs for preparers. By enabling investors to better evaluate the sustainability risks and impacts of investments, it will mobilise private finance in support of the European Green Deal. It will also reinforce the social contract between companies and society, which is becoming ever more demanding on these issues, by making companies more accountable for their impact on society and the environment.

Asset Managers will benefit from better access to comparable, relevant and reliable sustainability information from more companies. This will reduce the risks of investing in the financial system, increase financial flows to companies with positive social and environmental impacts, and make companies more accountable. Accountability and transparency is and will be a major part of being sustainable, and of showing sustainability in both direct and supply chain operations.

There is no doubt that business enterprises can impact the entire range of human rights positively or negatively, including discrimination, health, access to education, labour exploitation, freedom of association and to form unions, freedom of expression, privacy, adequate standard of living (not in poverty), food and water, housing. So, what does it mean to "respect" human rights when one is a private enterprise? It means taking active steps to be in line with human rights obligations, often even if not always enshrined in national laws and regulations. A State has an obligation to exercise due diligence under its obligation to protect. A non-state actor has such an obligation in order to respect rights. That means first of all having internal policies which from an internal governance perspective sets up a regulatory framework safeguarding workers, communities and environment – all the way down the supply chain – as well as the more extended communities in which the enterprise operates.

Being accountable does not mean never having any issues or any problems – but having processes in place that address these issues, provide possibility for redress, and ensure participation and transparency in those processes.

The growth in the number of investment products that aim to pursue sustainability objectives means that good sustainability reporting can enhance an undertaking's access to financial capital. Sustainability reporting can help undertakings to identify and manage their own risks and opportunities related to sustainability matters. It can provide a basis for better dialogue and communication between undertakings and their stakeholders, and it can help undertakings improve their reputation.

Up until now available evidence indicates that existing non-binding guidelines did not have a significant impact on the quality of non-financial reporting by undertakings under current Directive 2013/34/EU. There is a need for mandatory common reporting standards to ensure that information is comparable, and that all relevant information is disclosed. Building on the double-materiality principle, standards should cover all information that is material to users. Common reporting standards are also necessary to enable the audit and digitalisation of sustainability reporting and to facilitate its supervision and enforcement. The development of mandatory common sustainability reporting standards is necessary to progress to a situation in which sustainability information has a status comparable to that of financial information.

The fact that sustainability information is taking on the same importance as financial information may seem a given to those who see the respect for national, regional and thus international law on societal sustainability issues as a given, but it is true that this has up until now not been the case. And that only recently have the benefits of sustainability reporting from financial and private actors come to the attention of those who are responsible for the effective implementation of laws. This has happened due to the need to create new and innovative regulations and reporting requirements for environmental sustainability, and this has shown that creating such requirements based on long-standing rules and standards on societal sustainability will have enormous benefits and assist those responsible for ensuring compliance with laws to actually act when laws are violated, as well as promote understanding and compliance based on clear guidance.

Article 5 requires Member States to transpose Articles 1 to 3 of the Directive by 1 December 2022, and to ensure that its provisions apply to companies for the financial year starting on 1 January 2023 or during calendar year 2023.

This is living up to International Obligations

It is important to understand that many internal violations of rights found in international instruments are dealt with by national institutions; this is why it is so important to respect the due diligence if a violation has been committed and to have effective and fair legislation, law enforcement and an impartial and effective judiciary. In these cases the State is dealing with violations as it is supposed to – taking action to prevent and address (and redress). In these cases the national system is functioning and thus direct international responsibility (as in "liability") for a violation will not follow as it would if the State did nothing to prevent/address/redress violations, or actively participated in them. There is thus a responsibility to prevent/protect from wrong-doing and to act if wrongs have been done, not an expectation that e.g. murder (taking of life) will never occur. It is a question of the responsibility to have in place legislation/regulation that is effective, impartial and non-discriminatory and that is effectively implemented to create a society based on respect for fair rules. This is what the EU and many of its MSs are doing now. Realizing the importance, power, and relevance that private sector actors have on sustainable development, environment and human rights issues, to avoid being in violation of international law, the EU and its MS are regulating what such powerful actors are doing not only indirectly within the complex web of relevant national and EU legislation and standards, but directly with legislative acts addressing the responsibility of these private actors on society and environment.

All private actors are subject to this sort of "horizontal" effect of international law – an individual cannot expect impunity from murder or kidnapping (right to life; right to freedom of movement) or from unlawfully evicting someone from their property (right to housing and a decent standard of living). The implementation of these (and every other right directly enshrined in Human Rights Conventions or derived from other international law) is the obligation of the States that have ratified such Conventions and are bound by said international law, and the first thing they do to live up to these obligations is to enact legislation that protects all of us from their violations and ensures redress if we experience violations. Up until recently, there must have been a presumption that detailed legislation targeting investors and companies specifically was either not desirable or not necessary. Not so now.

The notion that this is the EU putting the "responsibility" of respecting people and climate "on" the investor community or the private sector actors concerned is erroneous. The EU has, as a group of sovereign States all with obligations they have entered upon ratifying Treaties on e.g. human rights and labour standards, the obligation to guarantee adequate legislation for *all subjects* that ensures that any violation of rights of individuals or groups of individuals can be addressed at national/regional level so as not to be in violation of treaty obligations. Putting the obligation on a company to ensure that they guarantee decent labour is no different from putting the legal obligation on me not to murder my fellow man. Putting the obligation on investors to actually ask questions of their investee on how they treat people and planet and having in place sanctions if they either do not do their due diligence, or actively engage in violation of e.g. labour rights when they invest in companies who operate with perceived impunity when exploiting people is no different than obliging me not to sign false cheques. I have a certain power over others and am accountable for my actions to the law – the obligation being put on investors and private actors is proportionate to their power over others. It may be new. But it is not the States or the EU as a regional body "putting THEIR responsibility on others" it is the competent legislative body doing what they are supposed to and requiring relevant entities to follow the law.

The proposal is intended to respect the fundamental rights enshrined - and adheres to the principles stated - in the Charter of Fundamental Rights of the European Union. It is specified that it will have an *indirect* positive impact on fundamental rights, given that more stringent reporting requirements can influence corporate behaviour for the better. This should not be understood as a "side effect" but it is necessary for the legislator, in this case the EU, to make the point that this is legislation which will regulate the behaviour of non-state actors towards other non-state actors, and thus the effect on human rights is that individuals and communities will benefit from the regulation through the responsibility of private actors to act in accordance with law, not directly from State action. It should serve to make companies more aware of fundamental rights and positively influence how they identify and manage actual and potential adverse impacts on fundamental rights. It ought to also make companies realize that in order to live up to their obligations of effective implementation and respect, they will need the expertise of human rights experts and labour law experts as well as professionals with governance experience. The fact that this should also increase capital flows to companies that respect fundamental rights, and in general make companies more accountable for their impact on fundamental rights, is not to be underestimated nor overlooked.

The Common Market – sustainability, the basic values of the EU and … competition

The proposed directive is not only forthcoming because of the increased focus on sustainability factors, but because without common rules across the EU area there would be a risk of different reporting requirements in different MSs, which would generate additional costs for companies operating across borders and undermine the single market. That means that implementation of it from a Market perspective will improve company resilience, given that better reporting raises companies' awareness of sustainability-related risks and improves risk management. It should also lead to advantages for more sustainable companies, since sustainability front-runners will be more easily identifiable.

The growing gap between users' information needs and the current reporting practices of undertakings makes it more likely that individual Member States will introduce increasingly divergent national rules or standards. Different reporting requirements in different Member States would create additional costs and complexity for undertakings operating across borders and therefore undermine the single market, and would undermine the right of establishment and the free movement of capital across the Union. Those different reporting requirements also make reported information less comparable across borders, undermining the capital markets union.

It is quite interesting and very positive that the EU and therefore its MSs are seeing the clear link between a stable and prosperous market and sustainable companies. This is not only a realization of the fact that there are real risks of not being sustainable from a business perspective, that both consumers and retailers want more sustainable brands – and as social media ever increases in importance, examples of poor "sustainability behaviour" will emerge and result in reputational damage and a financial impact with share price fluctuations and a risk of losing value due to reparation and compensation.[1] It is also a recognition of the fact that operating in a way that truly works towards

[1]Broadly speaking risks of NOT being sustainable – and being able to show it – range from: Penalties/fines as a result of breaches of regulations (e.g. EU SDFR); Litigation - see e.g. Shell having a case litigated in the UK even if the damage was overseas; Loss of social / regulatory licence to operate; Reputational cost in a society where consumers are ever more demanding that the products they have access to are sustainably produced; Competing with firms who will obtain increased revenues/profit from "responsible" products/services and who will have improved risk management as well as improved access to capital compared to those who do not operate and show to be operating sustainably.; There will be risks related to inability to make repayments due to environmental/ social costs and simple loss of value. Potential direct liability for investors – who will want to avoid that risk when they make investment decisions: the

the realization of the SDGs will create prosperity and more reliable markets as well as being about respecting people's inalienable rights.

Under the proposal, in-scope companies would have to report information on the full range of ESG issues relevant to their business, in accordance with **mandatory** EU sustainability reporting standards. This includes information on all "sustainability matters" as defined by the proposal. These are: environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters, and governance matters. More proportionate standards will be developed for listed SMEs.

The proposal is intended to reduce systemic risks to the economy and to improve the allocation of financial capital to companies and activities that address social, health and environmental problems. The accountability issue is a constant in the express desire that it will make companies more accountable for their impacts on people and the environment, thereby building trust between them and society.

There is a recognition that sustainability reporting is the subject of increasing interest and regulatory intervention in jurisdictions around the world and that it is in line with EU fundamental values and underlying principles to develop a coherent and comprehensive approach to sustainability reporting, in order to be able to engage in these debates, and perhaps even be showing commitment to EU and CoE Conventions which for decades have been the underpinning of EU legislation and values on most issues. Compared to individual action by Member States, which is to be expected, as can be seen by e.g. German legislation on human rights due diligence in supply chain, EU intervention can ensure a significant European contribution to global policy developments, in order to better defend the interests of European companies and other stakeholders.

Who is concerned

EU companies risk incurring higher reporting costs than non-EU companies if other jurisdictions do not take an approach similar to the approach outlined in this proposal. This could lead to unequal treatment of EU and non-EU companies and therefore be detrimental to the level playing field in the EU Single Market. To mitigate this risk, EU subsidiaries of non-EU companies, as well as any non-EU company with transferable securities listed on an EU regulated market, are covered by the reporting requirements set out in the proposal.

Stakeholders who were consulted during the draft of the Proposed Directive had a wide range of views about which categories of companies should be subject to mandatory reporting requirements. Most civil society organisations and trade unions support an extension of the scope to a wide range of companies, including large non-listed companies and SMEs. Many financial institutions and asset managers support the introduction of proportionate reporting requirements for SMEs, especially listed SMEs. Mainstream business associations argued mainly against extending the scope of the

danger of damage to reputation through association with polluting, exploitative or 'unethical' investees – which they will want to avoid thus funnelling their investments elsewhere.

reporting requirements. Organisations representing SMEs, and most SMEs themselves, oppose the introduction of mandatory requirements for SMEs but remain open to the idea of proportionate, voluntary standards for them. Various stakeholders group proposed that reporting requirements also apply to non-EU companies.

The proposed Directive modified the scope of the reporting requirements, extending their application to ***all large companies and all companies with securities listed on EU regulated markets, except micro-companies.***

In the proposed draft the reporting requirements would not apply to SMEs, except listed SMEs. However, simplified reporting standards will be developed for SMEs to use on a voluntary basis. These should enable SMEs to meet information demands from large company clients and banks and will facilitate their contribution to and participation in the transition to a sustainable economy.

Positively, the Proposal includes the extension of the scope of the Directive to cover all large companies, which is important for the success of the sustainable finance strategy, because a vast majority of large European companies are not publicly traded but rely instead on bank financing; and for public accountability, because both private and publicly-traded companies may have severe impacts on people and the environment.

The requirements for SMEs listed on EU regulated markets would apply only 3 years after they apply to other companies, to allow for the relative economic difficulties faced by smaller companies as a result of the COVID-19 pandemic. This phasing-in period would also allow listed SMEs to apply the new requirements when reporting and assurance practices for sustainability information have reached a higher degree of maturity. The disclosure requirements of this proposal would not apply to SMEs with transferable securities listed on SME growth markets or multilateral trading facilities (MTFs). In addition, for reasons of proportionality, they would not apply to micro-enterprises listed on EU regulated markets.

The fact that companies that do not meet the threshold of a large undertaking are left out of the scope of the proposed Directive in contradiction to the EU Parliament’s original clear call for the integration of all companies from high-risk sectors can potentially become problematic. It can be seen as creating a system with two speeds, and it means that investors and relevant stakeholders would not receive sustainability information on medium-sized companies with high actual or potential negative impacts, be it because of the specific sector or the geographical area in which they work. It also paradoxically and potentially counterproductively risks leaving smaller companies behind when trying to attract capital from investors who aim at investing in companies that can prove their sustainability efforts. This may to an extent be mitigated by the possibility to report on a voluntary basis. It is however problematic if the general thought promoted is that SMEs cannot be as responsible for both positive and negative impact on e.g. workers’ rights or communities as big companies and, where there will be challenges for smaller companies, it is also true that they have a potentially smaller scope of data and information to collect so the burden as well as the responsibility could well be seen as proportionate. The focus should be on putting proportionate responsibility on any one entity exercising power over any individual, group of individuals or which has influence on any community or environmental factor. And admittedly that is applicable to all companies. The better road may be to adapt requirements and have mandatory sustainability reporting adapted to SMEs as quickly as possible. While it is true that non-listed SMEs may decide to use on a voluntary basis the sustainability reporting standards that the Commission will adopt as delegated acts for reporting by listed SMEs. The consideration was that SMEs should be enabled to report information cost-efficiently in response to the numerous requests for information they receive from other companies with whom they do business, such as banks, insurance companies and large corporate clients, and to help define the limits for the information that companies can reasonably expect SMEs in their value chain to provide. The idea behind this is that such standards should help SMEs to attract additional investment and funding. The diversification can obviously be understood, and it may be that many SMEs will see the benefit in keeping the sustainability reporting standards on a voluntary basis, but from a perspective of ensuring rights and sustainability it may be a better next step to make adapted mandatory requirements.

One important provision is the recognition that credit institutions and insurance undertakings play a key role in the transition towards a fully sustainable and inclusive economic and financial system in line with the European Green Deal. They can have significant positive and negative impacts via their lending, investment and underwriting activities.

A company can be exempted from consolidated financial reporting obligations but not exempted from consolidated sustainability reporting obligations, where its ultimate parent prepares consolidated financial statements and consolidated management reports in accordance with Union law, or in accordance with equivalent requirements if the undertaking is established in a third country, but does not prepare consolidated sustainability reporting in accordance with EU law, or in accordance with equivalent requirements if the undertaking is established in a third country. However, there is the possibility to submit consolidated sustainability reporting: parent companies of a large group shall include in the consolidated management report information necessary to understand the group's impacts on sustainability matters, and information necessary to understand how sustainability matters affect the group's development, performance and position. It is therefore necessary to require those subsidiary companies to publish the consolidated management report of their parent undertaking and to include a reference in their management report to the fact that they are exempted from reporting sustainability information. That exemption should also apply where the parent company reporting at consolidated level is a third country undertaking reporting sustainability information in accordance with the requirements of this Directive or in a manner equivalent to EU sustainability reporting standards.

This exemption for large companies, which are part of corporate groups, is clearly problematic. The proposed exemption is different from the rules for financial reporting, which do not exempt companies from publishing statutory financial accounts because they are also integrated into consolidated financial accounts. Throughout the EU, some sectors (such as the financial industry) are highly concentrated. Making disclosures subject to the determination of materiality at the group level may lead to non-disclosure of specific information on resilience and significant impacts of subsidiaries of such EU groups, resulting in lack of accountability at national level as well as to investors and stakeholders needing these insights. Considering the general spirit of the proposal as well as the reasons mentioned for this initiative, the exclusion is highly questionable and potentially counterproductive.

What is required?

The clarification of the main reporting areas and the categories of information that companies should disclose is specified in greater detail, which is very positive. The principle of "double materiality" is clarified and properly enshrined in the draft proposal. Double materiality is key so that investors, other finance providers, supervisors and citizens and other stakeholders can understand risks and opportunities stemming from sustainability matters that companies face, as well as the actual and potential adverse impacts of corporate business models and operations on people and planet. This will potentially provide a clear framework for the development of these standards. What is also positive, as well be seen below, is the focus on reporting of implementation e.g. through grievance mechanisms and adequate due diligence on human rights issues. The clarification of "double materiality" helps remove ambiguity about the fact that companies should report information necessary to understand how sustainability matters affect them, and information necessary to understand the impact they have on people and the environment. It specifies in greater detail the information that companies should disclose. Compared to the existing provisions, it introduces new requirements for companies to provide information about their strategy, targets, the role of the board and management, the principal adverse impacts connected to the company and its value chain, intangibles, and how they have identified the information they report. It specifies that companies should report qualitative and quantitative information, forward-looking and retrospective information, and information that covers short, medium and long-term time horizons. The only problematic issue is that this is qualified with an "as appropriate" making one wonder when this is not so.

The proposal also removes the possibility for Member States to allow companies to report the required information in a separate report that is not part of the management report, clearly signalling that sustainability IS a management matter and not a side issue. It is recognized that publication in a separate report can give the impression, both internally and externally, that sustainability information belongs to a category of less relevant information, which can impact negatively on the perceived reliability of the information. Member States should no longer be allowed to exempt companies from the obligation to include in the management report information on sustainability matters.

Definitions – what is to be reported

Paragraph (2) of Article 1 defines certain terms that are necessary for the proposal. It introduces and defines the terms "sustainability matters" and "sustainability reporting", whereas the existing provisions of the Accounting Directive refer to "non-financial information". It also defines the terms "independent assurance services provider" and "intangibles".

It also specifies what information needs to be included such as a) a brief description of the undertaking's business model and strategy, going into great detail on how that business model and strategy has to be linked to sustainability matters. E.g. the resilience of the undertaking's business model and strategy to risks related to sustainability matters; the opportunities for the undertaking related to sustainability matters; how the undertaking's business model and strategy take account of the interests of the undertaking's stakeholders and of the impacts of the undertaking on sustainability matters; how the undertaking's strategy has been implemented with regard to sustainability matters;

a description of the targets related to sustainability matters set by the undertaking and of the progress the undertaking has made towards achieving those targets; a description of the role of the administrative, management and supervisory bodies with regard to sustainability matters; a description of the undertaking's policies in relation to sustainability matters;

As can be seen, there is a focus on showing that internal governance is geared towards sustainability matters as well as proving real implementation and not simply having two paragraphs in a report saying "we work towards the SDGs". Interestingly there is a need for Senior Management to be supported by sustainability professionals if such governance will ever have any meaning.

There is also a requirement to describe (i) the due diligence process implemented with regard to sustainability matters; (ii) the principal actual or potential adverse impacts connected with the undertaking's value chain, including its own operations, its products and services, its business relationships and its supply chain; (iii) any actions taken, and the result of such actions, to prevent, mitigate or remediate actual or potential adverse impacts; (f) a description of the principal risks to the undertaking related to sustainability matters, including the undertaking's principal dependencies on such matters, and how the undertaking manages those risks; (g) indicators relevant to the disclosures referred to in points (a) to (f). Undertakings shall also disclose information on intangibles, including information on intellectual, human, and social and relationship capital.

Again, it is clear that these requirements will necessitate that companies establish real and functioning internal mechanisms to address (and redress) harm and to establish indicators and KPIs that go well beyond environmental matters and into societal and human rights matters.

In this context it is necessary to mention that for companies this require a realization that there is rarely one single measure of the desired outcome, and a combination of several indicators may give a more accurate measure of a specified objective. Thus, the degree to which the gender discrimination in employment has been reduced may be captured by wage differentials, opportunities for training, prospects for promotion and allocation of work responsibilities. Moreover, the indicators may be either quantitative or qualitative: for instance, quantitative indicators of social security may relate to the proportion of people receiving different types of benefits, while qualitative indicators thereof concern the quality and effectiveness of services. Thus, in order to obtain an accurate picture, it may be necessary to combine several indicators into an overall indicator or index. It will e.g. be necessary to have a robust non-discrimination and inclusion strategy that will have to include reference to redress and grievance mechanisms which in turn will have to be accountable and participatory. Discrimination at work involves the denial of equality of treatment and opportunity to individuals in their own right, or as members of a social group. Four indicators may be used to measure gender discrimination: the labour force participation rate or employment-to-female working age population ratio; the unemployment rate; and differences in earnings (and other benefits) and distribution of skilled jobs. These indicators show disparities between women and men. These indicators can be transported to other reasons for discrimination as well.

The sustainability reporting standards set by the Commission in subsequent instruments shall require that the information to be reported is understandable, relevant, representative, verifiable, comparable, and is represented in a faithful manner. The sustainability reporting standards shall specify the information that undertakings are to disclose about social factors, including information about: (i) equal opportunities for all, including gender equality and equal pay for equal work, training and skills development, and employment and inclusion of people with disabilities; (ii) working conditions, including secure and adaptable employment, wages, social dialogue, collective bargaining and the involvement of workers, work-life balance, and a healthy, safe and well-adapted work environment; (iii) respect for the human rights, fundamental freedoms, democratic principles and standards established in the International Bill of Human Rights and other core UN human rights conventions, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work and the ILO fundamental conventions and the Charter of Fundamental Rights of the European Union.

A valuable provision is that the information mentioned above shall (not should or could) contain forward-looking and retrospective information, and qualitative and quantitative information. Where appropriate, the information referred shall contain information about the undertaking's value chain, including the undertaking's own operations, products and services, its business relationships and its supply chain. This has to be understood and interpreted not as a possibility for a company to declare such information "not appropriate", but as a reference to the fact that not all companies have supply chains. The wording however is problematic, and there is no doubt that it opens up for a reading which could seemingly go against the spirit of the law and that on this the proposal fails to specify the essential aspects that EU standards need to address, in particular with regard to reporting on human rights, including disclosure of important human rights issues, key elements for supply chains disclosures, and quality criteria for KPIs. If this remains in the final version, it could significantly hamper the development of the reporting standard.

Importantly, it is made clear (for now in the preamble 42)/43)) that sustainability reporting standards should also take account of internationally recognised principles and frameworks on responsible business conduct, corporate social responsibility, and sustainable development, including the UN Sustainable Development Goals, the UN Guiding Principles on Business and Human Rights, the OECD Guidelines for Multinational Enterprises, the OECD Due Diligence Guidance for Responsible Business Conduct and related sectoral guidelines, the UN Global Compact, the Tripartite Declaration of Principles of the International Labour Organisation concerning Multinational Enterprises and Social Policy, and the UN Principles for Responsible Investment. Crucially this is elaborated to say that "sustainability reporting standards should specify the information that undertakings should disclose on social factors, including employee factors and human rights. Such information should (not could, even if a "shall" would be better) cover the impacts of undertakings on people, including on human health". The information that undertakings disclose about human rights should include information about forced labour in their value chains where relevant. Reporting standards that address social factors should specify the information that undertakings should disclose with regard to the principles of the European Pillar of Social Rights that are relevant to businesses, including equal opportunities for all and working conditions. The European Pillar of Social Rights Action Plan adopted in March 2021 calls for stronger requirements on undertakings to report on social issues. It is no surprise for anyone working on these issues that it is specified that the reporting standards should also specify the information that undertakings should disclose with regard to the human rights, fundamental freedoms, democratic principles and standards established in the International Bill of Human Rights and other core UN human rights conventions, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work, the fundamental conventions of the International Labour Organisation, and the Charter of Fundamental Rights of the European Union.

Whereas standards on environmental reporting has had to be developed by individual states and regional bodies such as the EU over the past decade – when the regulators started waking up to the fact that we needed to save the planet – the standards which are at the basis for societal sustainability and respect for individuals are already existing and have been for decades if not more (for certain ILO standards). Therefore, there is an existing framework on which all requirements related to societal sustainability matters will be based, which States have had the obligation to implement for decades.

It is also important to note that reports will have to specify the information that companies are to disclose about governance factors, including information about: (i) the role of administrative, management and supervisory bodies, including with regard to sustainability matters, and their composition; (ii) business ethics and corporate culture, including anti-corruption and anti-bribery; (iii) political engagements of the undertaking, including its lobbying activities; (iv) the management and quality of relationships with business partners, including payment practices; (v) the internal control and risk management systems, including in relation to the reporting process.

It is quite clear that the time for policies gathering dust on shelves, being shiny but with no real implementation mechanism will have to come to an end and that reporting on actual actions will be required. This in turn requires actual and real knowledge about both internal accountable governance, grievance mechanisms as well as human rights, ILO standards and the operationalization of the SDGs.

That said, where the proposal outlines the need to describe targets related to sustainability matters set by the company, and disclose their progress against those targets and milestones, it is essential to specify that such targets must be linked to the outcomes of the company's double materiality determination. Likewise, requiring companies to report on actions taken - and the result of such actions - to address adverse impacts must be linked to targets and progress against set targets. These connections are not made explicit in the proposal. This may be addressed in subsequent acts by the Commission, but it is critical to ensure meaningful information allowing understanding of how companies manage their sustainability impact (negative and positive).

Due diligence

Due diligence is defined (in the preamble) as the process that undertakings carry out to identify, prevent, mitigate and remediate the principal actual and potential adverse impacts connected with their activities and identifies how they address those adverse impacts. Impacts connected with an undertaking's activities include impacts directly caused by the undertaking, impacts to which the undertaking contributes, and impacts which are otherwise linked to the undertaking's value chain. The due diligence process concerns *the whole value chain* [author's italics] of the undertaking including its own operations, its products and services, its business relationships and its supply chains. In alignment with the UN Guiding Principles on Business and Human Rights, an actual or potential adverse impact is to be considered principal where it measures among the greatest impacts connected with the undertaking's activities based on: the gravity of the impact on people or the environment; the number of individuals that are or could be affected, or the scale of damage to the environment; and the ease with which the harm could be remediated, restoring the environment or affected people to their prior state.

It may be important to note that, while it is legitimate to aim at restoring the environment to its prior state (if we go back long enough or take for granted that that state is its unpolluted state), when it comes to people one thing is to operate on a do no harm basis and make certain that if harm is done redress is available and ensured, which is important. But also, in order to truly implement human rights standards it may fall abysmally short if a company only restore people to their prior state.

Suggested ed indicators to keep in mind for due diligence work:

For sectors where negative impacts on human rights and the environment are common in supply chains, mandatory reporting standards should at a minimum require the disclosure of the following criteria:

Supply chain description: % suppliers by region, preferably by sourcing country; % of suppliers that have collective bargaining agreements in place; access to health care; social security; non-discrimination and inclusion; estimated number of workers per location, disaggregated by gender (job roles and % of women in management positions) and vulnerable groups such as migrants (internal and cross-border) workers broken down by nationality, type of contract and gender; gender pay gap and living wage gap, including details on the calculation methodology adopted; details on whether the supplier has a trade union and if that is not possible due to local difficulties (it is important to guarantee representation but also not to endanger workers) if internal representation and participation is guaranteed; worker committee and all its workers covered by a collective bargaining agreement – or equivalent.

Specific indicators should be developed for specific sectors such as for agriculture: e.g. seize and ownership of suppliers/farmers; engagement with suppliers; promotion of business models and/or governance systems and structures that give greater power to workers, small-scale farmers and local communities; living wage or income; property issues (land grabbing); deforestation; water; educational level including literacy; community engagement.

Inclusion

Article 20 of Directive 2013/34/EU left (currently still leaves) flexibility to companies to decide what aspects of diversity they report on. It does not explicitly oblige undertakings to include information on any particular aspect of diversity. It is stated in the current proposal that "in order to progress towards a more gender-balanced participation in economic decision making, it is necessary to ensure that undertakings with securities listed on regulated markets always report on their gender diversity policies and the implementation thereof". In that context Paragraph (5) of Article 1 amends Article 20 to require listed companies subject to this provision to include a reference to gender in the description of the diversity policy applied in relation to the company's administrative, management and supervisory bodies. A description of the diversity policy applied in relation to the company's administrative, management and supervisory bodies with regard to gender and other aspects such as age or educational and professional backgrounds, the objectives of that diversity policy, how it has been implemented and the results in the reporting period has to be included. If no such policy is applied, the statement shall contain an explanation as to why this is the case.

It is slightly strange that inclusion seems to be focusing on gender and not on a general non-discrimination clause such as the ones found in more recent human rights instruments or the EC's own definition "Any discrimination based on any ground such as sex, race, colour, ethnic or social origin, genetic features, language, religion or belief, political or any other opinion, membership of a national minority, property, birth, disability, age or sexual orientation shall be prohibited".

It further seems strange that it is not specified that this also applies to supply chain and due diligence.

Auditors

Article 3 amends Directive 2006/43/EC (the Audit Directive). Paragraph (1) of Article 3 amends Article 1 of the Audit Directive, its subject matter, in order to include the assurance of annual and consolidated sustainability reporting, where carried out by the statutory auditor or audit firm carrying out the statutory audit of financial statements. Paragraph (2) of Article 3 amends and inserts certain definitions, necessary for the proposal, in Article 2 of the Audit Directive. It amends the definitions of 'statutory auditor' and 'audit firm' in order to take into account their potential work in assuring sustainability reporting, where applicable. It also introduces and defines the term 'assurance of sustainability reporting' and 'sustainability reporting'. Paragraphs (3)–(7) of Article 3 amend Articles 6-11 of the Audit Directive, containing the rules on the approval, c*ontinuing professional education and mutual recognition of statutory auditors and audit firms, in order to ensure that statutory auditors have the necessary level of theoretical knowledge of subjects relevant to the assurance of sustainability reporting and the ability to apply such knowledge in practice.*

Paragraph (7) of article 3 amends Article 14 to ensure that where the Member State decides that the applicant seeking approval should be subject to an aptitude test, this test also covers the statutory auditor's adequate knowledge of the laws and regulations of the host Member State relevant to the assurance of sustainability reporting. Member States should ensure that already approved statutory auditors acquire the necessary knowledge in sustainability reporting and the assurance of sustainability reporting via the continuing education requirement of Article 13 of the Audit Directive.

It is encouraging to see that the auditing of sustainability matters is recognized as a competence in itself. An ever-present concern these days when everyone is starting to turn towards "sustainability" and "ESG" but with very few people in the investment sector actually having any professional experience in what the extra-financial implications and complexities are when an investment is made based on "sustainability concerns", is that advisers and asset managers lack guidance on how to obtain, be faithful or even start to think about their clients' impact objective. In the conventional investment world, everyone understands fiduciary duty, an obligation of money managers to act in the best interests of their clients—typically centred on financial performance. But without the integration of substantial and substantive professional support from the many areas of "sustainability" which is needed to understand the sustainability dimension of choices made regarding where, when and how much to invest, there will likely only be an ever-increasing amount of money invested in "ESG" product – and the paradoxically, or not so paradoxically, increase in gap between that and the amount needed to reach the SDGs.

This concern increases when considering that human rights, and rights derived from other relevant branches of law, is by no means a professional competence integrated in the senior teams of most asset managers or investees. In order to be able to do due diligence on human rights issues, as well as in order to set strategic objectives and report on them it is crucial to understand what human rights are about, where they stem from, what effective and meaningful implementation means, including in complex sectors and settings. If this knowledge is not in house – and with a level of seniority which makes it robust, most efforts will at best be futile, at worst damaging.

It is however slightly disconcerting to see that the proposal subsequently mentions that in Article 11, point (a) is replaced by the following: '(a) that he or she has, for 15 years, engaged in professional activities which have enabled him or her to acquire sufficient experience in the fields of finance, law and accountancy, and sustainability reporting and has passed the examination of professional competence referred to (…). The "and" seems to suggest that instead of pooling experts who can contribute with a variety of specific areas of necessary expertise, the proposal would not only allow but encourage that sustainability reporting and auditing is done by people who knows a bit about everything. And one knows how that saying goes.

Paragraph (10) of Article 3 amends Article 25 to require Member States to put adequate rules in place to prevent the fees for the assurance of sustainability reporting from being influenced or determined by the provision of additional services to the audited entity or being based on any form of contingency. Paragraph (11) of Article 3 inserts Article 25b to extend Audit Directive rules on the professional ethics, independence, objectivity, confidentiality and professional secrecy required of auditors of financial statements to their work on the assurance of sustainability reporting. Paragraph (1) of Article 4 amends Article 5 of the Audit Regulation to prohibit the provision of consulting services for the preparation of sustainability reporting in the time periods specified in Article 5 of the Audit Regulation, when statutory auditors or audit firms carrying out the statutory audit are also carrying out the assurance of sustainability reporting. Paragraph (2) of Article 4 amends Article 14 in order to require statutory auditors and audit firms to annually inform the competent authority in question of which revenues, among the revenues from non-audit services, were generated from the assurance of sustainability reporting.

The proposal also mentions the risk of further concentration of the audit market, which could risk the independence of auditors and increase audit or assurance fees.

This is clearly addressing the issue when there may be a conflict of interest and is welcome in order to ensure that sustainability advisory services focus on sustainability and not on obtaining subsequent rating or better reporting – where this should be a result of any improvement, sustainability professionals should be results driven, not report driven. And the improved report a result of better practices. This hopefully will also address concerns of various coloured "washing".

Penalties

Since this is a Directive and it need transported into national legislation, MSs shall provide for penalties applicable to infringements of the national provisions adopted in accordance with the Directive and shall take all the measures necessary to ensure that those penalties are enforced. The penalties provided for shall be ***effective, proportionate and dissuasive.***

In case of a breach of the national provisions transposing the Directive, MSs shall provide for at least the following administrative measures and sanctions: (a) a public statement indicating the natural person or the legal entity responsible and the nature of the infringement; (b) an order requiring the natural person or the legal entity responsible to cease the conduct constituting the infringement and to desist from any repetition of that conduct; (c) administrative pecuniary sanctions.

Furthermore, MSs shall ensure that, when determining the type and level of penalties, administrative sanctions or measures, all relevant circumstances are taken into account, including: (a) the gravity and the duration of the breach; (b) the degree of responsibility of the natural person or legal entity responsible; (c) the financial strength of the natural person or legal entity responsible; (d) the importance of profits gained or losses avoided by the natural person or legal entity responsible, in so far as such profits or losses can be determined; (e) the losses sustained by third parties as a result of the breach, in so far as those losses can be determined; (f) the level of cooperation of the natural person or legal entity responsible with the competent authority; (g) previous infringements by the natural person or legal entity responsible.'.

While it may have been desirable to have specific penalties set, it is impossible to do so and take into consideration all national conditions and development. It is quite clear though that penalties should be considerable enough to be not only punitive but dissuasive – including for big companies.

Initiatives required by the Commission

The proposed Directive identifies certain instruments and initiatives that the Commission should take particular account of when deciding the content of the delegated acts, including certain EU legislation, the work of global standard-setting initiatives for sustainability reporting, and existing standards and frameworks for natural capital accounting, responsible business conduct, corporate social responsibility, and sustainable development.

It requires the Commission to adopt a first set of standards by 31 October 2022. This set of standards should specify information that companies should report about all sustainability matters and all reporting areas. These delegated acts should at least specify the information that companies should report to serve the needs of financial market participants subject to the disclosure requirements of Regulation (EU) 2019/2088. A second set of standards should be adopted at the latest by 31 October 2023. This set of standards should specify complementary information that companies should report about sustainability matters and reporting areas listed where necessary, and information specific to the sector in which a company operates. Finally, Article 19b requires the Commission to review the standards at least every 3 years to take account of relevant developments, including developments in international standards.

Article 19c requires the Commission to adopt sustainability reporting standards for small and medium sized companies by 31 October 2023.

It is recognized that companies operating in the same sector are often exposed to similar sustainability-related risks, and they often have similar impacts on society and the environment. Comparisons between undertakings in the same sector are especially valuable to investors and other users of sustainability information. Sustainability reporting standards adopted by the Commission should therefore specify both information that undertakings in all sectors should disclose and information that undertakings should disclose depending on their sector of activity. Standards should also take account of the difficulties that undertakings may encounter in gathering information from actors throughout their value chain, especially from SME suppliers and from suppliers in emerging markets and economies.

This clearly shows that there is a firm intention to continue the trend of requiring - if not more - better and more in-depth reporting, and clearly seeing sustainability as an integral part of the EU's values including in financial and business matters, competition, and market concerns.

What do you, as a subject of this legislation, need to consider?

Does your entity fall with its scope? As mentioned above, for now, it is mandatory for to large organisations and all publicly listed SMEs.

Can you demonstrate that you can carry out effective due diligence with respect to actual and potential adverse impacts on human rights and the environment?

Do you have a due diligence strategy that includes a right-based as well as risk-based monitoring methodology that takes into account the likelihood, severity and urgency of potential and actual impacts on human rights, communities and/or the environment?

Do you have a system to monitor new risks to update the statement that has to be published? And does that system feed into internal governance that address such risks and offer redress when necessary?

Have you mapped and evaluated your value and supply chain to identify risks as well as areas that need specific attention to avoid violations of rights or negative environmental impact?

Can you, legitimately and with certainty, based on in-house or externally contracted specific expertise on e.g. human rights issues be in a position to publish a statement that you have not caused, contributed or is not directly linked to a potential or actual adverse impact on human rights or the environment?

Do you have policies and strategies in place that indicate measures that are being taken to prevent or mitigate potential or actual adverse impacts including internal governance, grievance mechanisms and possibility for redress?

Is your business strategy in line with your sustainability and human rights due diligence strategy? And can do you have mechanisms to enforce these? Can you verify that subcontractors and suppliers comply with such obligations?

Do you have the capacity and expertise to engage in discussions with relevant stakeholder, including workers, communities and regulators, and when and if necessary, ensure that these stakeholders are not put at risk due to participating in discussions? E.g. in cases where freedom of expression or participation is generally not respected, do you have an internal mechanism in place that guarantees this without putting your workers or suppliers at risk?

Does your sustainability strategy include measures that ensure participation such as e.g. clauses and measures on worker representatives, enabling them to contribute to it? Does your strategy include communication to provide information on rights issues and the due diligence necessary to ensure that rights are respected to workers, partners, communities etc.?

Does your grievance mechanism encompass an early warning mechanism for risk awareness, and does it serve as a mediation system?

Can you ensure that your grievance mechanism is legitimate, accessible, transparent, safe and developed with the input of stakeholders, do you protect whistle-blowers, and do you ensure communication around rights of workers and communities and your requirements for your suppliers?

Are you ready to evaluate effectiveness and appropriateness of your sustainability strategy, including on human rights due diligence and implementation on an annual basis, including your stakeholder engagement?

Do you have inhouse or external support with the capacity and expertise to cooperate with the remediation process where it is linked to an adverse impact on human rights or the environment? Is the mechanism able to influence decisions to prevent any additional harm being caused by providing guarantees that the harm in question will not be repeated and that redress will be provided to those harmed?

What do Member States need to do?

The draft directive provides that each Member State should designate one or more competent authorities to be responsible for the supervision of the directive. The competent authorities will have the power to carry out investigations to ensure that undertakings comply with their obligations. The competent authority will be authorised to carry out checks on company and interviews with affected or potentially affected stakeholders or their representatives.

Competent national authorities are required to put in place proportionate sanctions and are given the authority to impose proportionate fines calculated on the basis of an company's turnover.

Member States are to ensure that they have a liability regime in place under which company can be held liable, and remediation can be provided for any harm arising out of potential or adverse impacts on human rights, the environment or good governance where they have caused or contributed to the harm. This responsibility extends to companies under the control of Member States.

Liability is prevented if the company can prove that they took all due care in line with the directive.

Timings and next steps

The next step is for the European Parliament and the Council to negotiate a final legislative text on the basis of the Commission's proposal.

The average length of the EU legislative procedure is around 18 months. The final timetable will depend on how the Parliament and Council progress in their negotiations. If they reach agreement in the first half of 2022, then the Commission should be able to adopt the first set of reporting standards under the new legislation by the end of 2022. That would mean that obligated companies would apply the new CSRD standards for the first time to reports published in 2024, covering financial year 2023.

The CSRD proposal says that the Commission should adopt a **first set of reporting standards by 31 October 2022**, specifying the information that undertakings should disclose with regard to all reporting areas and sustainability matters and that financial market participants need in order to comply with the disclosure obligations in the SFDR. The Commission should adopt a **second set of reporting standards at the latest by 31 October 2023**, specifying complementary information that undertakings should disclose about sustainability matters and reporting areas where necessary, and sector-specific information.

The Commission would then review the standards every 3 years to take account of relevant developments, including the development of international standards.