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Disclosure: European Sustainability Reporting Standards Approved

December 2, 2022

Disclosure

By Jason Halper
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On November 16, the European Financial Reporting Advisory Group (EFRAG) approved revised versions of the **European Sustainability Reporting Standards (ESRS)**. EFRAG is a private association established in 2001 to, among other things, provide technical advice to the European Commission (EC) on sustainability reporting. The ESRS provides guidance regarding corporate disclosure on climate and other ESG issues as part of the **Corporate Sustainable Reporting Directive (CSRD)**, which received final European Council **approval** on November 28. The CSRD, in turn, requires companies within its scope to report—using a double materiality standard—in compliance with the ESRS. The EC will now consult with its Member States on the standards before adopting final standards in June 2023. It is anticipated that companies initially will have to report consistent with the ESRS for fiscal year 2024 in disclosure published in 2025.

The ESRS provides guidance on disclosure regarding many, if not virtually all, corporate activities and impacts, including, among other things, governance processes, controls, and procedures used to monitor and manage impacts, risks, and opportunities; how the company's strategy and business model interact with material impacts, risks, and opportunities; the processes by which impacts, risks, and opportunities are identified, assessed and managed; and how performance is measured, including toward targets. The ESRS provides further guidance for how to make disclosure with respect to these issues in the areas of climate change, pollution, water and marine resources, biodiversity, and resource use (ESRS E1-5); business conduct (ESRS G1); and workers in value chain, affected communities, and consumers and end users (ESRS S2-4).

Taking the Temperature: The CSRD will significantly expand existing sustainability reporting requirements as well as the number of companies subject to the obligation, from approximately 12,000 to over 50,000. The CSRD is intended to operate consistently with the EU's Sustainable Finance Disclosure Regulation, applicable to financial market participants, and the EU Taxonomy Regulation. Final approval of the CSRD sets the timetable for implementation, starting with the largest businesses. Companies with over 500 employees will be required to report using the CSRD framework for fiscal year 2024 with the first report due in 2025. Companies with over 250 employees will report for fiscal year 2025, with first reports due the following year. The CSRD will begin to apply to listed small and medium enterprises for fiscal year 2026, with reports due in 2027. Notably, the CSRD will also impact non-European companies that generate a net turnover of EUR 150 million in the EU and that have at least one subsidiary or branch in the EU exceeding certain thresholds.

We will have more to say on the actual content of the ESRS in subsequent posts. For now we offer the following high-level observations that the ESRS: (i) addresses many of the same subject areas as non-EU regulatory guidance, including the SEC's proposed climate change disclosure rule—an important step toward achieving regulatory and market consensus on climate-related disclosure; (ii) mandates disclosure of Scope 3 emissions and, consistent with related EU regulation, adopts a double materiality standard (*i.e.*, issuer impact and external impact of issuer activities), which diverges from current U.S. guidance; and (iii) recognizes the need for companies to have sufficient time to comply, therefore adopting a gradual approach to implementation.

Regulation: Pressure on EU to Implement 'One for One' Rule, Raising Financial Institution Capital Requirements

December 2, 2022

Regulation

By Rachel Rodman
Partner | White Collar Defense and Investigations

Activists from Peru, Senegal, Uganda, Mexico, and the U.S. met with Members of the European Parliament last month seeking support for legislation to introduce the 'one for one' rule. This follows a similar request in an **open letter** to the Bank of England sent by academics, economists, and climate campaigners in October.

The 'one for one' rule refers to a bank regulatory concept whereby for each euro/pound/dollar that finances new fossil fuel exploration or production, banks and insurers should set aside a euro/pound/dollar of their own funds against potential losses. The "rule" is based on the idea that fossil fuel assets of financial institutions will diminish in value or become worthless in connection with climate transition and that they will suffer significant losses as a result.

Consistent with this rule, the European Parliament has called for **amendments** to the Capital Requirements Regulation, due to take effect in 2025, in the form of higher capital charges on EU banks' fossil fuel exposures: 150% risk-weight for exposures that received a final investment decision by the end of 2021 and 1,250% for exposures committed to after January 1, 2022.

Taking the Temperature: Despite widespread coverage, it is uncertain whether the 'one for one' rule will be approved by the European Parliament, and even if it is, whether EU member states would in turn adopt the measure. Nor is it apparent that such a bright-line rule would be an effective method for achieving financial stability. The rule assumes financial risk associated with a particular category of assets in isolation, without considering the particular institution's overall risk exposure based on all applicable material factors, including industry exposure, strategy, and customer base. The rule also runs counter in spirit to the thrust of global prudential regulatory guidance, which is to not seek to compel financial institutions to abandon all emissions financing, but to devote appropriate efforts to assessing climate-related risks and opportunities and disclosing such assessments. This view was reflected in an October 21, 2022 letter from Sam Woods, Deputy Governor for Prudential Regulation of the Bank of England, providing feedback on how banks are faring with respect to meeting regulatory expectations. Regarding capital in particular, Woods stated that "some firms were holding capital for climate risks. The most effective firms had undertaken a methodical consideration of how climate risks could impact capital. This had allowed them to explain why they are, or are not, holding specific capital for those risks. A number of firms demonstrated effective practice by capturing climate in their macroeconomic

scenarios or using specific climate scenarios to evidence their assessment of risk." In our view, such a nuanced approach makes more sense in being tailored to the individual institution and consistent with global regulatory guidance on risk assessment.

Investors: Study of Asset Managers Finds Growing Consensus on Approach to Climate Change

December 2, 2022

By Sara Bussiere
Associate | Global Litigation

A **recent study** conducted annually of the world's 50 largest asset managers examines how these institutions are factoring sustainability considerations into their investment process.

The study shows that as of July 2022, all but one of the top 50 asset managers are signatories to the United Nations Principles of Responsible Investing. This was unchanged from the 2021 study. Furthermore, 48 of the managers now have dedicated responsible investment teams in place, up from 46 in 2021. 49 of the managers now have stewardship teams, up from 45 the previous year. 48 of the 50 asset managers surveyed now offer investment products that focus on specific sustainability issues. Notably, 45 of the top 50 asset managers are developing proprietary ESG ratings, with 26 of these asset managers utilizing information from over four or more different third-party ratings and data providers.

Despite the apparent consensus on the need to focus on climate and other ESG issues as part of their businesses, differences remain. One area of divergence involves whether to publicly disclose discontent with companies in their portfolios. As of 2022, 20 of the top 50 asset managers have registered their public disagreement with their portfolio companies. This nearly even split suggests that private engagement by institutional investors remains an often-preferred way to dialogue with company management.

Another area of divergence involves approaches to communicating their overall stances on various issues, with 35 of the asset managers publishing position papers on environmental or social topics. That is an increase from 24 in 2019, but still leaves a sizeable minority not taking public positions on these matters.

Taking the Temperature: Although perhaps not surprising given how vocal the asset management industry has been for years over the need for better issuer governance and disclosure regarding climate change, the results of this survey firmly underscore that ESG is a mainstream aspect of the asset management industry. Also understandable is that, by and large, these firms are developing propriety ESG ratings. As we have previously discussed, it is difficult if not impossible to make sense of ESG ratings, which vary among providers in terms of results, methodologies, weightings, and inputs. Until there is greater market consensus on how to produce ratings (not to mention industry consolidation), we expect that consumers of ratings information will continue to develop proprietary assessment tools, not use the ratings, or use them as one of many inputs to assessing a particular company's sustainability profile.

Disclosure: Switzerland to Require Climate Reporting for Public Companies and Financial Institutions

December 2, 2022

Disclosure

By Duncan Grieve
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The newly adopted "Ordinance on Climate Disclosures," effective on January 1, 2024, will require large Swiss public companies, banks, and insurance companies to report climate risks using a similar approach to the EU regulatory framework. This announcement follows a consultation that ran from March to July 2022 and is in line with the recommendations published by the Task Force on Climate-Related Financial Disclosures (TCFD). In its **press release** announcing the adoption of the rules, the Swiss Federal Council stated that "large companies' transparency on the climate impact of their activities is a key aspect for the markets to function well and for climate sustainability in the financial sector. To date, Switzerland has lacked clear and comparable climate-related disclosures. The Federal Council intends to make that possible with the new ordinance."

The newly announced Swiss rules will require "public companies, banks and insurance companies with 500 or more employees and at least CHF 20 million [$21 million] in total assets or more than CHF 40 million [$42 million] in turnover" to report publicly on climate issues and publish reduction targets for their direct and indirect greenhouse gas emissions and give details on how they intend to implement them.

Taking the Temperature: This development from Switzerland is in line with recent regulation or legislation—either planned or already implemented—in various jurisdictions across the globe. The UK has made TCFD reporting mandatory for large listed companies, with New Zealand and Singapore introducing TCFD-aligned reporting for large financial service companies. The TCFD therefore potentially may become the market-standard if the trend continues. Our prior in-depth discussion of the TCFD (and other leading disclosure frameworks) can be found in our prior article on the subject. It should be noted that the Swiss Ordinance is more limited than some comparable regulation. For instance, the EU's CSRD applies to social factors in addition to climate factors. The double materiality principle remains a controversial topic—especially in the United States—where the SEC appears likely to adhere to the existing single materiality approach. As we have observed, however, there may be less of a distinction in practice between the single and double materiality standards.