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EU Nears Adoption of Expansive Corporate Sustainability Reporting Requirements

Proposed Directive would apply to public and private companies, including many non-EU companies

SUMMARY

European Union leaders have [reached a provisional political agreement](#) on a revised Corporate Sustainability Reporting Directive (“[CSRD](#)”) that would introduce more detailed sustainability reporting requirements for all “large” EU companies and companies with securities (including low denomination debt securities or depositary receipts) listed on a regulated EU market. “Large” companies are those that meet at least two of the following: (i) total balance sheet exceeding €20 million, (ii) annual net turnover exceeding €40 million and/or (iii) average number of employees exceeding 250. Under the [revised text](#) published on June 30, 2022, non-EU companies would also be required to report on a consolidated basis if they generate more than €150 million of annual net turnover in the EU and have at least one “large” or listed EU subsidiary or at least one EU branch with an annual net turnover exceeding €40 million.

The scope of required reporting covers environmental, social and human rights and governance factors. Environmental factors include not only climate (including scopes 1 and 2 and, where relevant, scope 3 greenhouse gas emissions) but also water/marine resources, circular economy, pollution and biodiversity. Reporting will be subject to the ‘double materiality’ standard, meaning companies must consider not only the material ESG risks facing their own business and operations but also the material risks posed by their operations to society and the environment. Companies also will need to disclose their plans to ensure their business model and corporate strategy are compatible with limiting global warming to 1.5 °C. Companies will be required to obtain third-party assurance over their CSRD disclosures.

The provisional agreement remains subject to final approval by the Council and the European Parliament, although further material changes are not expected. If adopted as proposed, the CSRD would begin

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applying for financial years starting on or after (i) January 1, 2024 for companies already subject to the EU's Non-Financial Reporting Directive ("NFRD") as well as certain large EU-listed non-EU companies, (ii) January 1, 2025 for large companies not presently subject to the NFRD and for all other large EU-listed non-EU companies, (iii) January 1, 2026 for listed small and medium enterprises ("SMEs") and (iv) January 1, 2028 for all other non-EU companies.

BACKGROUND

The CSRD is a key pillar in the EU's ambitious focus on corporate sustainability. The European Commission originally proposed the CSRD in April 2021 and tasked the European Financial Reporting Advisory Group ("EFRAG"), a non-profit advisory group, with developing detailed sustainability standards that companies subject to the CSRD will be required to report against. The latest CSRD draft, published June 30, 2022, follows negotiations among the Commission, the European Parliament and the Council of the EU and significantly extends the scope of non-EU companies which will be required to report.

In addition to the CSRD, the EU has already adopted and begun implementing [the EU Taxonomy Regulation \(\(EU\) 2019/2088\)](#) (the "Taxonomy"), which, among other requirements, requires in-scope entities to report on the extent to which their activities and/or financial products qualify as "environmentally sustainable" according to detailed technical criteria determined by the EU. The EU has also adopted and begun implementing the EU Sustainable Finance Disclosure Regulation ((EU) 2020/852) (the "SFDR"), which requires financial market participants such as banks, insurance companies, pension funds, investment firms and financial advisors to make ESG-related disclosures about their investment decision-making processes as well as specified disclosures about financial products marketed as having sustainable characteristics or objectives.

The EU has also recently released a [draft Directive on Corporate Sustainability Due Diligence](#) ("Due Diligence Directive") that would require EU Member States to adopt implementing legislation requiring in-scope companies (including non-EU companies with significant EU revenues) to both identify and (where relevant) prevent, end and/or mitigate adverse impacts of their operations and activities (extending to their subsidiaries and global value chains) on human rights and the environment (including with respect to climate change).

SCOPE OF CSRD OBLIGATIONS AND IMPLICATIONS FOR NON-EU COMPANIES

Under the new draft CSRD, the following entities would be required to provide new sustainability disclosures:

- **All "large" EU companies and groups:** All EU companies and consolidated groups which meet at least two of the three following criteria: (i) balance sheet total exceeding €20 million, (ii) net turnover exceeding €40 million, and (iii) average number of employees during the financial year exceeding 250.

- **Companies with securities listed on EU regulated markets (except micro-enterprises):** Companies whose securities (including debt securities with denominations lower than €100,000 or equivalent or depositary receipts) are admitted to trading on a regulated market of any Member State, with the exception of micro-enterprises.
- **Non-EU companies with significant EU revenues and an EU-branch or subsidiary:** All companies formed outside the EU with (i) an annual net turnover in the EU exceeding €150 million for each of the last two consecutive financial years and (ii) which have at least one subsidiary (which is either a large EU company, as defined above, or a company listed on an EU regulated market) or a branch in the EU that generated an annual net turnover in excess of €40 million the preceding financial year. The reporting would be required to cover information regarding the consolidated global group, not only the EU subsidiary or branch.

The proposed CSRD provides that in-scope subsidiaries, other than large listed companies, would be exempted from reporting if their parent company prepares a consolidated group report, subject to the requirement that parent companies must provide additional disclosure related to any subsidiary where there are significant differences between the sustainability risks or impacts of the group and those applicable to the subsidiary.

If a non-EU parent company is outside the scope of the CSRD, its EU subsidiary would be required to report under the CSRD unless its non-EU parent reports consolidated sustainability information under reporting standards that the European Commission has deemed equivalent to the sustainability reporting standards now being developed by EFRAG. It remains uncertain whether the Commission would deem any non-EU standards fully equivalent given the expansive reach of the CSRD's disclosure requirements, which exceed anything proposed by regulators in any other major economy thus far.

SUBSTANTIVE REPORTING OBLIGATIONS

Scope of Reporting

The CSRD would require in-scope companies to disclose how sustainability considerations are integrated into their businesses and how material ESG impacts, risks and opportunities are identified and managed. Companies would be required to report both on the impacts of their activities on people and the environment, and on how various sustainability matters affect the company, which the EU refers to as a 'double-materiality' perspective.

Under the CSRD, companies will be required to disclose information related to environmental factors, social and human rights factors, and governance factors in accordance with new sustainability reporting standards now being developed by EFRAG based on a disclosure framework established within the text of the CSRD:

- Proposed environmental disclosures include information on each of the Taxonomy environmental objectives: climate change mitigation (including Scope 1, Scope 2 and, where relevant, Scope 3 greenhouse gas emissions), climate change adaptation, water and marine resources, resource use and circular economy, pollution, and biodiversity and ecosystems.
- Proposed social and human rights disclosures include information on gender equality, working conditions, and respect for human rights as defined by core UN and EU human rights conventions.

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- Proposed governance disclosures include information on how the company's administrative management and supervisory bodies manage sustainability matters, risk management and internal controls over the sustainability reporting process, business ethics and lobbying activities.

Reported sustainability information is to reflect short-, medium- and long-term horizons and contain information about a company's entire value chain, including its own operations, its products and services, its business relationships, and its supply chain.

Notably, the CSRD will require companies to disclose their plans to ensure that their business models and strategies are compatible with the goal of limiting global warming to 1.5 °C in line with the Paris Agreement and the EU's own European Climate Law, which aims to achieve climate neutrality by 2050. Companies will also be required to disclose the due diligence processes they have implemented with regard to sustainability matters, including any actions they have taken to prevent or mitigate any actual or potential adverse impacts related to their own operations or value chain.

Non-EU companies whose securities are listed on an EU-regulated market will be subject to the same common set of standards to be developed by EFRAG (see below) as for EU in-scope companies. However, other non-EU companies, required to disclose under the EU branch/EU subsidiary extension of CSRD, will be subject to a different set of disclosure standards which EFRAG is currently developing. These disclosure standards will mainly focus on material risks posed by their operations to society and the environment and not on the material ESG risks facing their own business and operations (no 'double materiality' standard). Further detail on how the standards will differ has not yet been announced.

Development of European Sustainability Reporting Standards

The text of the CSRD itself provides only a broad outline of the required reporting. Detailed disclosure requirements are being developed by the technical advisory group EFRAG. In proposing the CSRD, the EU noted that 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.

EFRAG published [initial drafts](#) of these standards, known as European Sustainability Reporting Standards ("ESRS"), in April 2022 for public consultation.

The proposed reporting standards include general standards for disclosing sustainability-related information on a company's strategy, governance, impacts, risks and opportunities, as well as standards for detailed disclosure of specific environmental, social and governance factors. The standards will also include sector-specific disclosure requirements. The exposure drafts released thus far cover only part of the eventual scope of the proposed standards.

The draft ESRS would necessitate significant sustainability-related disclosures relating to corporate value chains, including "gross indirect Scope 3 GHG emissions" and reporting on working conditions, human

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rights and labor issues across the company's value chain. The disclosure requirements under the draft ESRS are aligned with (but go beyond) the governance, strategy and risk management reporting pillars of the Task Force on Climate-related Financial Disclosures (TCFD) framework and the proposed International Sustainability Standards Board (ISSB) climate standard.

Comments on the initial draft EFRAG standards are due August 8, 2022, and EFRAG is expected to submit the first set of proposals to the European Commission by November 2022.

Assurance Obligations

Companies will be required to obtain third-party assurance over their CSRD disclosures. The CSRD includes a progressive approach as to the level of assurance required. Initially, companies will be required to obtain only "limited" assurance, which the CSRD proposal notes would typically be provided as a negative form of confirmation that no matter has been identified that suggests the information is materially misstated.

By 2028, however, the European Commission plans to adopt standards for reasonable assurance analogous to the standard currently required for financial statements, following an assessment to determine the feasibility of reasonable assurance for auditors and companies subject to the CSRD. Once the Commission has adopted reasonable assurance standards, companies will be required to obtain an assurance opinion to that higher standard.

Responsibility, Format and Enforcement

Under the CSRD, EU companies must report information relating to these sustainability matters in their annual management reports, rather than in a separate sustainability report. Both the financial and non-financial statements of in-scope companies will need to be published in a single electronic reporting format with "tagging" of reported sustainability information according to a digital categorization system. It remains unclear where and how non-EU companies within the scope of the CSRD will be required to provide their CSRD-compliant disclosures.

The CSRD notes further that members of a company's administrative, management and supervisory bodies have a "collective responsibility" for ensuring that sustainability information is prepared and published in accordance with the CSRD requirements. EU Member States may provide for penalties applicable for infringements of the implementing national provisions of the CSRD.

TIMING

Once the CSRD is adopted, Member States will have to transpose it into their national laws within 18 months. The CSRD provides for a phased-in entry into force as follows:

- **"NFRD companies" and certain large non-EU companies listed in the EU:** For companies already subject to the NFRD, the CSRD would apply starting for fiscal years beginning January 1, 2024, with the first reports to be published in 2025. This first group represents approximately 11,700 large companies and groups across the EU, including large listed companies, banking institutions

and insurance companies with more than 500 employees. This first group will also include EU-listed non-EU companies within the definition of large undertakings that have an average number of over 500 employees during the financial year.

- **Other large companies:** For large EU companies not yet subject to NFRD and other large non-EU companies listed in the EU, the CSRD would apply starting for fiscal years beginning January 1, 2025, with the first reports to be published in 2026.
- **Listed SMEs:** For listed small and medium enterprises (including non-EU SMEs listed in the EU and certain other EU entities), the CSRD would apply starting for fiscal years beginning January 1, 2026, with the first reports to be published in 2027. In-scope SMEs will have the possibility to opt-out for 2 years after entry into application, *i.e.*, until 2028.
- **Non-EU Companies:** For non-EU companies, other than EU-listed non-EU companies, that fall within the scope of the CSRD, the CSRD would apply starting for fiscal years beginning January 1, 2028, with the first reports to be published in 2029.

COMPARISON TO US AND UK STANDARDS

The US Securities and Exchange Commission has recently proposed [expansive climate-related disclosure obligations](#) that, if adopted, could begin to apply from 2024. The United Kingdom has also mandated increased corporate climate-related disclosure.

The CSRD diverges significantly from the [proposed US SEC climate rules](#), which (i) require disclosure of climate-related information only (and not disclosures on other environmental factors, social or governance factors), (ii) apply only to SEC reporting companies (and not private companies or companies not subject to reporting obligations in the US) and (iii) do not apply a 'double materiality' standard (although the SEC rules, as currently proposed, would require reporting on certain items regardless of whether they are material to the company's business or operations). The proposed SEC climate rules do include a requirement for attestation, but this required attestation would cover only disclosures of scope 1 and scope 2 greenhouse gas emissions.

In addition, the potential for private litigation against companies for misstatements in their disclosures under the CSRD is likely to remain lower than the potential risk under the proposed US climate rules, as the CSRD would not require Member States to impose civil liability for breaches.

The UK's climate disclosure requirements apply to certain large private UK-incorporated companies and all companies with UK listed equity, but unlike the CSRD do not extend to non-UK companies without a UK listing. The UK climate rules also do not require scope 3 greenhouse gas emissions disclosure. The UK Government has indicated it will develop its own broader corporate sustainability reporting standards and green taxonomy but has not yet provided any details on its proposal.

IMPLICATIONS

If the CSRD is implemented as expected in its currently proposed form, it will require wide-ranging, attested corporate ESG reporting. The CSRD's effects will extend well beyond the EU both because it will eventually

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cover non-EU companies and because it will more immediately apply to EU companies' global subsidiaries and value chains and to EU subsidiaries of non-EU multinationals. Notably, the thresholds for qualifying as a "large" EU company captured by the CSRD are low, and many major non-EU groups operating in the EU will be at least partially captured by the CSRD.

Companies may want to begin assessing whether and when any of their subsidiaries and/or their entire consolidated group will become subject to the CSRD requirements and planning for compliance. Many significant unknowns about the substantive obligations under the CSRD remain, including what the full package of detailed reporting requirements will include and what the attestation standards will entail. Companies also may want to review the proposed EFRAG exposure drafts and consider providing comments to EFRAG.

Even companies without direct EU sales or activities may want to consider whether they are part of the value chain of one or more EU companies and hence are likely to be subject to increased ESG reporting and audit/verification requests and requirements from such EU companies.

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