ClientEarth

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Strengthening of the quality of corporate reporting and its enforcement

ClientEarth consultation response: Rectifying sustainability reporting compliance and enforcement gaps

ClientEarth welcomes the opportunity to respond to the European Commission's consultation on strengthening the quality of corporate reporting and its enforcement. Both our response to the consultation questionnaire and the contents of this paper solely address corporate sustainability (non-financial) reporting.

Summary

Failures in sustainability reporting threaten the success EU Green Deal. In this paper, we demonstrate that:

- Rates of compliance with the NFRD are currently extremely poor.
- Despite this, national competent authorities (NCAs) have not been actively enforcing reporting obligations.
- Unless accompanied by robust enforcement, the CSRD will not be able to achieve the transformation to sustainability reporting required without robust enforcement.
- The corporate sustainability reporting compliance and enforcement gaps must be addressed under the existing legal regime, and with urgency.

Context

The availability of consistent, comparable and relevant sustainability information is critical for the transition to climate neutrality and attaining sustainability objectives.[1] Investors are emphatic that private finance – crucial to attaining the EU's current climate and energy objectives[2] – can only be mobilised for sustainability outcomes where relevant information from real economy companies is accessible.[3] This has been fully recognised by the European Commission. Indeed, corporate sustainability information lies at the heart of the EU's Action Plan on Financing Sustainable Growth. Much of the success of the legislation introduced/planned hinges on companies complying with sustainability reporting requirements set by law.[4] Until its replacement by the proposed Corporate Sustainability Reporting Directive (CSRD), planned to come into force in 2023, the relevant legal framework is the Non-Financial Reporting Directive (2014/95)[5] (NFRD).

Stakeholders are overwhelmingly in agreement that sustainability information reported by companies is deficient in terms of comparability, reliability and relevance.[6] Research commissioned by the United Nations Principles for Responsible Investment initiative has found that investors *"were almost unanimous in stating that a lack of necessary data prevents them from contributing to the EU's objectives to their full potential"*. [7]

Widespread failure to comply with NFRD

Analysis of the degree of compliance of non-financial statements with the NFRD reveals an alarming picture. In its 2020 report, 'Falling Short? Why environmental and climate-related disclosures under the EU Non-Financial Reporting Directive must improve',[8] the Climate Disclosure Standards Board concluded that *"reporting often still fails to offer investors a clear understanding of companies'*

[1] *"… Such data is an essential factor in the quality of disclosure, ratings, classification and supply chain monitoring. It is central to the ability of businesses to incorporate climate and environmental risk and opportunities into their strategies and risk management frameworks, and for investors to be able to take account of sustainability considerations when making their investment decisions."* Allen & Overy, 'Corporate Sustainability Reporting Directive', published online 11 May 2021.
[2] The European Commission estimates that €260 billion of private investment will be required each year to achieve the EU's current climate and energy targets.
[3] See, for example, PensionsEurope response to the European Commission's consultation on the revision of the NFRD and EFAMA's response to the European's Commissions Consultation on the establishment of a European Single Access Point for financial and non-financial information publicly disclosed by companies.
[4] *"… the Taxonomy Regulation and the NFRD can be seen to sit at the centre [of the EU ESG regime], with the NFRD providing the raw ESG data*", Ingman B, EU Environmental Social Governance (ESG) Regulations Guide, FactSet 2020
[5] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups
[6] 84% of users of non-financial information reported it to be deficient in terms of comparability, 74% in terms of reliability and 70% in terms of relevance. European Commission, 'Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive', 29 July 2020.
[7] Principles for Responsible Investment, 'Investor Priorities for the EU Green Deal', April 2020, p. 17.
[8] CDSB, 'Falling short? Why environmental and climate-related disclosures under the EU Non-Financial Reporting Directive must improve', May 2020.

development, performance, position and impact, as it lacks the necessary quality, comparability and coherence".[9]

CDSB's analysis was based on the non-financial statements of Europe's fifty largest listed companies, which, as it observed, *"could reasonably be expected to provide the highest quality disclosures"*.[10] Specifically, CDSB found that:

- 30% of companies reported potential immaterial information;[11]
- only 8% of companies applied the double materiality perspective to their disclosures;[12] and
- nearly 50% did not disclose relevant environmental aspects of their business model.[13]

This conclusion was supported by analysis of sustainability reporting of over 300 Central, Eastern and Southern European companies conducted by members of the Alliance for Corporate Transparency (ACT).[14] ACT found that:

- despite the companies being selected on the basis that they were in sectors identified as key to the climate transition, only 40% disclosed risks to their business related to climate change;[15]
- 23% of companies did not report any relevant policies, and 46% do not disclose the outcomes of their policies;[16] and
- 20% of companies did not provide any key performance indicators at all.[17]

The work of ClientEarth programmes frequently entails reviewing corporate sustainability information disclosed by NFRD issuers. This experience leads us to echo strongly the findings of CDSB and ACT: in many cases, the information provided by companies is not sufficient for an understanding of the *"development, performance, position and impact"* of the issuer, which is the overarching obligation contained in the NFRD.[18]

Current status of enforcement of sustainability reporting obligations

Despite the evidence of widespread poor compliance with the NFRD, from the information available, enforcement action taken in respect of corporate sustainability reporting appears to be practically non-existent.

[9] Ibid. p. 1.
[10] Ibid.
[11] Such as "*detailed disclosure on topics not stated to be material to the company by its own materiality assessment, or on subjects not linked to its stated policies or principal risks"*. Ibid. 23
[12] Ibid., p. 23.
[13] Ibid., p. 8.
[14] Frank Bold/ACT, '2020 Research Report: An analysis of the climate-related disclosures of 300 companies from Central, Eastern and Southern Europe pursuant to the EU Non-Financial Reporting Directive', 2020
[15] Ibid., p. 14.
[16] Ibid., p. 51
[17] Ibid., p. 11.
[18] Article 1 NFRD.

ESMA's 2020 Report on Enforcement of Corporate Disclosure found that across the EU enforcement action was taken in respect of 42 non-financial statements in 2020, representing an action rate of 5%.[19] By striking contrast, the action rate in respect of financial statements was 38%.[20]

Following ACT's 2020 research referred to above, NGO and ACT coordinator, Frank Bold, submitted notifications to national competent authorities in respect of 31 companies that it found to have *"failed to provide any information"* or to *"[have] provided clearly insufficient information"* in their non-financial statements. Frank Bold reported the following results: [21]

- most Member States do not provide a transparent procedure that gives any rights to the stakeholders submitting the notification or that allows examinations of the actions of authorities;
- a number of authorities claimed a lack of competence in either: (i) supervision of compliance with the NFRD, (ii) supervision of public interest entities, or (iii) taking actions as corrective measures;
- several authorities stated that procedural confidentiality prevented them from sharing any information regarding the outcome of the notification with Frank Bold; and
- none of the authorities indicated it would take any action that could lead to sanctions for the companies.

In November 2021, ClientEarth submitted a notification to the Dutch Authority for the Financial Markets (the AFM) in respect of systematic breaches of the NFRD by listed grocery retail group, Ahold Delhaize.[22] Our experience corresponds with the findings of Frank Bold:

- the AFM did not have in place a clear, formal process through which an external stakeholder could notify it of a potential breach of the law; and
- the AFM was unable to provide ClientEarth with any further information regarding the outcome of the notification beyond confirmation that it had received the notification due to confidentiality obligations.

The result of this is that ClientEarth and other interested parties (shareholders, employees, customers, and other issuers) would only be able to access information regarding the outcome of the notification in the event that the AFM takes public enforcement action. We are not aware that the AFM that it has taken public enforcement action in respect of non-financial statements to date.

Together with Frank Bold's findings, and the low action rate indicated by ESMA, this strongly suggests that the NFRD not being effectively enforced by NCAs at present.

[19] ESMA, 'Report: Enforcement and regulatory activities of European enforcers in 2020', April 2021, p. 9
[20] Ibid., p. 8.
[21] Frank Bold, 'Enforcement activities: Summary report EUKI Research 2020', January 2020
[22] ClientEarth, 'Notification to the Dutch Authority for the Financial Markets in respect of Ahold Delhaize N.V.' November 2021.

Robust enforcement cannot wait

We support the endeavour to overhaul corporate sustainability reporting obligations, and have been active in the consultations on the NFRD and CSRD.[23] We recognise that the CSRD (particularly, mandatory disclosure standards) will facilitate improved compliance with sustainability reporting obligations by issuers, and improved supervision by NCAs.

However, we also consider that enforcement action must be stepped-up urgently if sustainability reporting is to fulfil the essential role that it has been assigned in the EU's transition to a more sustainable economy and society for the following reasons:

- As evidenced in this paper, compliance rates are currently so poor that the CSRD alone cannot realistically be expected to address the problem without ensuring that the law is actively enforced.
- Under the current CSRD proposal, the scope of companies subject to sustainability reporting will be increased dramatically - from approximately 11,000 entities to 49,000.[24] Naturally, the task of supervising many more issuers will present greater demands on NCAs. Where NCAs have little practical experience of enforcement, or lack formal processes (internal and external) to do so, meeting these demands will be highly challenging. This may negatively affect the impact of the CSRD.
- Companies will not be publishing sustainability information pursuant to the CSRD until 2024. The full set of mandatory disclosure standards will not apply until a year later. In the context of the multiple sustainability crises that we face, time is of the essence. Waiting for the new legal framework to apply before taking action to address the enforcement gap will result in losing critical time.

NCAs, with the support and facilitation of ESMA should be preparing for this now by ramping up enforcement of the existing legal framework and mobilising for robust enforcement of the CSRD when it comes into force. Action to rectify the sustainability reporting compliance and enforcement gaps must start now.

Interaction between corporate sustainability reporting and corporate due diligence

Stakeholders need a full picture of the steps taken by companies to address their adverse environmental impacts. Corporate sustainability reporting significantly contributes to this, but it cannot be the only tool to achieving a sustainable economy. A clear framework on corporate due diligence with respect to environmental and human rights impacts is essential and information on corporate due diligence

[23] ClientEarth response to the roadmap consultation for the inception impact assessment of the revision of the Non-Financial Reporting Directive and ClientEarth's feedback on the Corporate Sustainability Reporting Directive.
[24] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 'EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary duties: Directing finance towards the European Green Deal', COM(2021), p.9.

processes must be reported publicly. A requirement to conduct due diligence will support the effectiveness of the NFRD/CSRD by ensuring the quality of sustainability disclosures.