European Securities and Markets Authority

The Chair

8 August 2022
ESMA32-334-549

Ms Kerstin Lopatta
Acting Chair
Sustainability Reporting Board
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: Consultation on first set of draft European Sustainability Reporting Standards

Dear Ms Lopatta,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to respond to EFRAG's consultation on the first set of draft European Sustainability Reporting Standards (ESRS). We are pleased to provide you with our comments with a view to promoting reporting standards that can result in relevant, reliable, comparable and understandable information on how undertakings take into account sustainability-related impacts, risks and opportunities.

ESMA emphasises that while the Non-Financial Reporting Directive (NFRD) already provides some common basis for sustainability reporting in the EU, increased transparency is needed to more effectively promote investor protection and combat greenwashing and to help detect, on a timely basis, ESG-related risks which may undermine financial stability.

In this respect, ESMA welcomes the political agreement recently reached by the co-legislators on the Corporate Sustainability Reporting Directive (CSRD). The CSRD will replace the NFRD and require, amongst other important innovations, the establishment of mandatory reporting standards, which will need to be as consistent as possible with international initiatives. It will also widen the scope of companies required to report and create a common and clearer regime for assurance and supervision of sustainability reporting.

The CSRD also mandates the European Commission to request each individual ESA to express an opinion on the final technical advice on the draft reporting standards developed by EFRAG prior to their adoption by the Commission in delegated acts. ESMA has, therefore, prepared its response to the consultation taking into account four main criteria which we intend to use to prepare our opinion on EFRAG's final technical advice to the Commission at a later stage. These criteria aim at ensuring that the ESRS:

- promote disclosure of material sustainability information of high quality;
- are conducive to consistent application in terms of both content and format;
- are consistent and interoperable with other EU legislation; and
- promote, to the greatest extent possible and taking account of the EU sustainability requirements and objectives, interoperability with relevant international standards.

By applying these criteria as ‘guiding principles’ for our consultation response as well as for our opinion, we aim to raise any important remarks to EFRAG as early as possible and, as such, hope to facilitate a timely finalisation of the ESRS. In providing these comments, ESMA has also taken into account the views of the ESMA Securities and Markets Stakeholders Group (SMSG)[1]. Nevertheless, ESMA's consultation response is delivered without prejudice to its future opinion on the final version of the ESRS.

ESMA notes that several stakeholders have highlighted the limited time available for EFRAG's finalisation of the ESRS for submission to the European Commission. While timely entry into application of the ESRS is important, in light of the volume of the draft standards and the comments EFRAG is likely to receive, ESMA encourages EFRAG to ensure that adequate preparation and discussion time is catered for in the re-deliberation process to ensure that the consultation feedback is properly taken into account.

Our comments on the consultation are set out as follows: this letter highlights the most important of our remarks, while the annex includes detailed responses to a number of questions in EFRAG's online survey. The responses in the annex are preceded by a table to clearly identify which questions ESMA addressed. Please note that we have not filled in any of the tables requiring a quantitative evaluation of the proposed requirements.

With reference to the four criteria referenced above, our main comments on EFRAG's consultation are set out hereafter.

The ESRS should promote disclosure of material sustainability information of high quality

ESMA is strongly supportive of the CSRD's goal of enhancing the quality of sustainability reporting and ensuring relevant, reliable, comparable and understandable disclosure. Subject to our comments further below on the rebuttable presumption, ESMA strongly supports the fact that the ESRS are built around the principle of double materiality, as set out in the NFRD and further clarified in the CSRD, which implies that undertakings take a holistic view in assessing sustainability-related risks, opportunities and impacts. While in practice matters that are under scrutiny by most stakeholders, such as climate, will most likely always result in material information, we nevertheless think that a rigorous materiality assessment needs to be the basis for reporting information that is relevant for the decision-making of investors and other stakeholders. In this respect, it is important that EFRAG provides adequate guidance to issuers on how to implement the materiality process, including how to determine any entity-

[1] ESMA22-106-4135 - SMSG advice to ESMA on EFRAG Consultation on Sustainability Reporting standards

specific qualitative and quantitative materiality criteria and how to distinguish between impact materiality and financial or enterprise value creation materiality.

It is also important to ensure that users of the sustainability reporting can properly focus on material information, both across all sectors and within individual sectors, and to avoid that material information is obscured by an overload of disclosure points and consequent voluminous reports. It is, therefore, particularly important that EFRAG carefully assesses whether, due to their granularity, some of the proposed topical requirements are relevant mainly for certain sectors. In this respect, ESMA notes that EFRAG's prioritisation assessment will be important to strike the right balance between promoting an adequate level of comparability across all undertakings and ensuring that only the requirements that are most relevant for virtually all or for a significant number of undertakings in scope (as it would be the case, for example, for SFDR-related information) are set out as sector-agnostic requirements. Other information that is more specific to selected sectors should be set out in sector-specific requirements.

Moreover, it is necessary that in developing the ESRS, materiality considerations are not confused with proportionality measures. ESMA notes that the CSRD requirements will enter into application with a phase-in approach that distinguishes between NFRD, non-NFRD and SME undertakings, thereby already facilitating a gradual incorporation of the new requirements. The CSRD furthermore envisages a review of the ESRS every three years which could be used to further fine-tune the requirements. In addition to striking the right balance between sector-agnostic and sector-specific requirements as described above, ESMA recommends that EFRAG's prioritisation is centred around a sound understanding of the extent to which reliable data is available to fulfil the proposed requirements.

ESMA does not support the proposed rebuttable presumption which we believe provides counterproductive and sometimes even conflicting incentives which may decrease the disclosure quality. The draft ESRS foresee that while all mandatory disclosure requirements shall be presumed material, this presumption is rebuttable if undertakings have reasonable and supportable evidence. When undertakings decide to rebut this presumption and avoid providing certain disclosures, they shall produce ad hoc explanations to back up this decision. There are a number of issues that, in our view, make this approach problematic.

Firstly, we are concerned it may be conducive to a 'checklist' approach. ESRS 1 refers to materiality *of the disclosure requirements* and not to materiality *of the information* relating to sustainability-related risks, opportunities and impacts. Coupled with the overall complexity of the proposed requirements, this focus on material *disclosure requirements* may lead some undertakings to consider which disclosure requirements can be avoided by producing supporting documentation to justify that choice. This is the opposite of a proper materiality assessment, i.e., starting from the identification of the sustainability-related impacts, risks and opportunities and assessing the materiality of the information that would result from the reflection of these events through the application of the disclosure requirements included in the ESRS.

Secondly, providing a structured 'non-disclosure route' through the set-up of this rebuttable presumption may incentivise undertakings to interpret the ESRS as a 'menu' of disclosure requirements they can choose from through a form of 'comply or explain' mechanism. This would ultimately be contrary to the spirit and the letter of the CSRD. ESMA agrees that it is certainly important to require undertakings to report only material information. However, in financial reporting this is done by setting out a simple requirement not to disclose immaterial information. The proposed rebuttable presumption departs from this simple principle and places more emphasis on the possibility for entities to decide not to disclose certain information.

Thirdly, the basis for conclusions of ESRS 1 explains that the rebuttable presumption was considered "*necessary and appropriate <u>to manage the amount of mandatory disclosure requirements</u> under ESRS*" (emphasis added). ESMA believes that combining the materiality assessment with cost-benefit or proportionality considerations may distract undertakings' focus from preparing high-quality sustainability reporting for investors and other stakeholders. Here as well, the experience of financial reporting standards may be useful, as in this domain materiality considerations are never intended to have reduction of the reporting burden as their primary objective. Furthermore, ESMA notes that some stakeholders have also raised the possibility that in some cases this requirement may even be counterproductive and further complicate the disclosure "overload problem" as some undertakings may tend to disclose immaterial information to avoid the development of more burdensome supporting documentation necessary to justify the non-disclosure of that information.

ESMA would therefore recommend that EFRAG,

a) removes the rebuttable presumption and avoids requiring explanations about the lack of materiality of certain disclosures, which would in itself amount to immaterial information and contribute to the disclosure overload problem;

b) emphasises the importance of the materiality assessment, including stakeholder mapping and engagement, to ensure that only relevant information is reported;

c) clarifies that the materiality assessment is not intended to pursue proportionality purposes; and

d) focuses on pursuing proportionality objectives, as mentioned earlier, via other means, such as allowing for the gradual phasing-in of certain requirements, reducing the complexity of the requirements themselves and / or deferring some disclosure requirements to the later development of industry-specific standards.

The ESRS should be conducive to consistent application in terms of both content and format

ESMA supports the broad spectrum of topics addressed in the ESRS to reflect the requirements of the CSRD. However, ESMA notes that the architecture of the requirements which distinguishes between cross-cutting and topical standards may result in implementation complexities. Therefore, we recommend that EFRAG considers improving the interplay between cross-cutting and topical requirements. We also suggest that the wording of the standards is carefully reviewed and made more concise to mitigate against divergence in implementation.

ESMA furthermore recommends that the ESRS remain focused on setting out requirements to provide for material information to fulfil the disclosure obligations set out in the CSRD. The ESRS should avoid entering into the domain of conduct obligations, for example in the area of due diligence (e.g., Appendix C of ESRS 1 should be removed). Further, in relation to governance, we observe that the interaction between the governance requirements under ESRS 2 and ESRS G1 could benefit from further clarification. In ESMA's view, it would be preferable to have the two addressed together, with sustainable corporate governance being a sub-topic of general corporate governance disclosures.

Moreover, ESMA notes that it will be important to ensure consistency in the way undertakings create connectivity between their sustainability reporting and the other parts of their annual financial report (and possibly also connectivity with information outside the annual financial report, where this is necessary and feasible in light of the CSRD framework). We therefore recommend that EFRAG considers how to best set out the regime for incorporation by reference of material information in the sustainability statement. Such a regime should ensure that the information that may be incorporated is published at the same time and made subject to the same conditions, notably for assurance, as the information included directly in the sustainability statement. It should furthermore make sure that the information is conveyed in the most effective way to investors and other stakeholders, including for what concerns digitisation, while avoiding repetitions vis-à-vis other well-established sources of corporate information, such as the corporate governance statement.

Finally, ESMA also calls on EFRAG to carefully consider how to best reflect in the ESRS the CSRD requirements on reporting on risks, opportunities and impacts relating to value chains. In particular, we highlight the need to ensure the proportionality of the relevant data collection efforts required from reporting undertakings as well as of any indirect reporting burden that may be imposed on entities in the value chains. The consideration of these factors may suggest that the use of some approximations and estimates is necessary in some cases to fulfil the relevant disclosure requirements. When this is the case, we recommend that EFRAG ensures that any such estimates and approximations are allowed for under clear conditions and that they fulfil quality characteristics relating to their relevance, reliability, comparability and timeliness.

The ESRS should be consistent and interoperable with other EU legislation

Subject to some more detailed comments, ESMA welcomes the fact that the ESRS largely take into account the disclosure requirements applicable to financial market participants under the Sustainable Finance Disclosure Regulation (SFDR). Ensuring this consistency is very important as it will help financial market participants meet their obligation to disclose principal adverse impact indicators and contribute to reducing the risk of greenwashing across the sustainable investment value chain. The ESRS also contain many disclosure points which will permit benchmark administrators to disclose the ESG factors required by Commission Delegated Regulation (EU) 2020/1816. Lastly, ESMA encourages EFRAG to ensure full consistency when it comes to terminology and definitions in other areas of EU legislation, such as the Taxonomy Regulation and the SRD II.

The ESRS should, to the greatest extent possible and taking account of the EU sustainability requirements and objectives, promote interoperability with relevant international standards

The CSRD requires that, taking account of the necessary alignment with EU legislation and objectives, the ESRS take into account *to the greatest extent possible* the work of global standard-setting initiatives for sustainability reporting. In light of these requirements, ESMA emphasises that without lowering the EU's sustainability ambition, global comparability of sustainability reporting requirements should be a key objective of the ESRS. ESMA therefore strongly encourages EFRAG to continue its efforts to build convergence with international initiatives. In this respect, ESMA has identified two notable areas where it would be beneficial to increase alignment between the ESRS and international reporting standards, most importantly the future IFRS Sustainability Standards of the ISSB and the GRI standards (the latter of which currently constitute the most frequently used reporting framework under the NFRD and are especially relevant for the impact materiality perspective).

Firstly, EFRAG should engage in further discussion with the ISSB and GRI to achieve a better mutual alignment of the respective terminology and definitions. Alignment on terminology and definitions would be important for users consuming sustainability information under both EU and international standards, as this would enable them to more easily compare the information. Such alignment would also help preparers navigate the different sets of standards when compiling their reporting. ESMA also notes that for what concerns the architecture of the reporting standards, while both EFRAG and the ISSB built on the TCFD structure, EFRAG has decided to depart from it and develop a more complex architecture. If this architecture is retained, the reconciliation between ISSB standards and the ESRS will not be seamless which may be to the disadvantage of users and preparers. ESMA encourages EFRAG to undertake the necessary work to minimise the differences in architecture while recognising the fact that the TCFD structure was originally developed for financially material information on climate-related issues and that it may, therefore, need adaptations to reflect the European specificities.

Secondly, it should be clarified how the assessment of the impacts that undertakings generate on the people and the planet (i.e., the impact materiality perspective) shall be filtered through the lens of the risks and opportunities for the entity (i.e., the financial materiality perspective). The relationship between these two aspects of materiality would merit more clarification in the ESRS and also in the IFRS Sustainability Standards. A consistent approach on this point would help bring the two sets of standards closer together. In this regard, EFRAG could also consider basing the definition of 'financial materiality' on that of 'enterprise value creation materiality' and consider changing the naming convention to further align with that of the IFRS Sustainability Standards.

More detailed comments on the draft ESRS are set out in Annex to this letter. In case you have any questions or comments, please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Verena Ross