



ADVICE TO ESMA

SMSG advice to ESMA on EFRAG Consultation on Sustainability Reporting standards

I. Executive summary

The SMSG provides this advice to ESMA in the context of the public consultation by EFRAG on the first set of Exposure Drafts on the European Sustainability Reporting Standards (ESRS), on which ESMA intends to respond. The SMSG deems it important to inform ESMA of its position in this respect, to allow ESMA to take this into account when responding to the consultation and when preparing its subsequent opinion on this matter to the European Commission.

The SMSG welcomes the publication of the ESRS that provide key elements framing the architecture and clarifying key concepts and content of the CSRD proposal. The data is of tremendous importance for investors and the general public in line with the objective of the EU to “shift the trillions” towards a more sustainable economy.

Nevertheless, to foster maximum operability of the framework for preparers and comparability across preparers and sectors for investors, the balance between sector-agnostic and sector-specific disclosure obligations should be reviewed, as well as the appropriate balance between the data needed from stakeholders and the resulting operational burden for preparers.

The SMSG also underlines the importance of a holistic approach, which takes into account the efforts required in transitioning and which is properly calibrated to strike the right balance between different factors that could impact the capital markets.

The SMSG welcomes EFRAG's work because it is an essential prerequisite for the implementation of the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation. The SMSG has in earlier advice pointed at the problems that arise because the disclosure requirements for financial investment products preceded the disclosure requirements for investee companies ¹.

¹ See for example «SMSG advice to the ESMA Consultation Paper on Guidelines on certain aspects of the MiFID II suitability requirements” (ESMA 22-106-2858). https://www.esma.europa.eu/sites/default/files/library/esma22-106-4032_-_smsg_advice_on_mifid_suitability_guidelines.pdf: “The legislation will be implemented in a context where several pieces of the puzzle are still missing. In particular, lack of data on investee companies will make the alignment of sustainability preferences and investment products difficult (...). The approval of the Corporate Sustainability Reporting Directive, its implementation, the proceedings of EFRAG are all crucial for reliable quantitative indicators”.
https://www.esma.europa.eu/sites/default/files/library/esma22-106-2858_smsg_advice_on_esg_disclosure.pdf

The SMSG repeats its concern about the sequence of implementation.

The SMSG is also concerned about the deadline for the adoption of the Delegated Acts and the entry into force of the legislation and recommends extending the deadlines so that EFRAG can have sufficient time to submit its technical advice to the EC. In addition, there is a need to cross this work with the KPIs required by regulation (Tables 1 and 2 of SFDR) and delays should also be considered in these regulations.

Moreover, the SMSG supports the objective of effective coordination with other standard setters, including the International Sustainability Standards Board (ISSB) and the FASB which will apply to 60% of the worldwide equity market capitalisation, to avoid unnecessary regulatory fragmentation, ensure that the global baseline standards are sufficiently clear and ambitious, and encourage full compatibility with the EU framework avoiding “duplicative reporting” for EU preparers.

The SMSG suggests clarifying the definitions across the cross-cutting and topical standards and the scope of the reporting perimeter in the value chain as well as circumstances under which stakeholders’ interests have to be considered. It stresses that the complexity of obtaining appropriate EU compliant data from non-EU undertakings within the value chain and the political, strategic and economic implications for European consumers should be thoroughly analysed. Also, to ensure conciseness of the important information presented in the Management Report, the SMSG is of the opinion that it would be better to allow cross-reference to relevant information in other documents as these reports must be readable and clear for individual retail investors.

The SMSG also suggests following a phasing-in option starting with a restricted value chain scope and further clarifying the concept of materiality and of the rebuttable presumption. It should be investigated whether the „rebuttable presumption” mechanism provides for comparable reports without overburdening preparers and users.

Finally, the SMSG is of the opinion that it is important to prepare and plan for a well calibrated standard for SMEs in the standard-setting exercise.

I. Background

1. On 21 April 2021, The European Commission adopted a legislative proposal for a Corporate Sustainability Reporting Directive (CSRD). One of the key provisions of the CSRD is that undertakings in scope would have to report in compliance with European sustainability reporting standards (ESRS) adopted by the European Commission as Delegated Acts, on the basis of technical advice provided by EFRAG.
2. In a letter dated 12 May 2021, Commissioner McGuinness requested EFRAG to:
 - 2.1. reform its governance following the recommendations made by Jean-Paul Gauzès in his report issued in March 2021; and
 - 2.2. put in place interim working methods to start the technical development of standards immediately, in parallel to legislative negotiations, building on the membership, leadership, expertise and recommendations of the Project Task Force that undertook preparatory work for the elaboration of possible EU non-financial reporting standards (PTF-NFRS), with reference to its report issued in March 2021.
3. The public consultation on the Exposure Drafts of the first set of ESRS was launched end April in order to meet the deadlines for submitting the first set of draft ESRS to the European Commission by November 2022. The Draft ESRS for public consultation deadline is 8 August 2022. These EDs correspond to the first set of standards required under the CSRD proposal and cover crosscutting standards and topical standards on the full range of sustainability matters: environment, social, governance with a sector-agnostic angle. The SMSG deems it important to inform ESMA of its position in this respect, to allow ESMA to take this into account when responding to the EFRAG consultation and when preparing its subsequent opinion on this matter to the European Commission.

II. General remarks

4. The SMSG welcomes the publication of the Exposure Drafts on the European Sustainability Reporting Standards (ESRS) that provide key elements framing the architecture and clarifying key concepts and content of Articles 19a, 19b, 19c and 19d of the CSRD proposal. The resulting data is of tremendous importance for investors and the general public in line with the objective of the EU to “shift the trillions” towards a more sustainable economy. We particularly appreciate that the overall architecture of the Exposure Drafts is designed to ensure that sustainability information is reported in a carefully articulated manner and to facilitate the navigation through the reported information. We note that the contents of the Exposure Drafts are consistent with the EU sustainable finance regulatory framework and seek to meet all stakeholders’ sustainability data needs. Nevertheless, to foster maximum operability of the framework for preparers and comparability for investors across sectors, the SMSG is of the opinion that the balance between sector-agnostic and sector-specific disclosure obligations should be reviewed, as well as the appropriate balance between the data needed from stakeholders and the resulting operational burden for preparers. The development of the standards is still at a very early stage and this allows stakeholders to share what the expectations are. In the opinion of the SMSG, the ambition should be scalable to something that is at the same time, in line with data asked from investors and banks (SFDR, Taxonomy; MiFID sustainability preferences; ESG risks Pillar 3 report and ESG Benchmark Regulation) and feasible, since the cost-benefit analysis is quite difficult and companies need to know how far they should report the data.

5. The SMSG underlines the importance of a holistic approach which takes into account the efforts required in transitioning and which is properly calibrated. Indeed, there is a need to strike the right balance between different factors. On one hand, for preparers some disclosure requirements on business secrets and skills (on production processes used on carbon reduction for example) relate to their internal knowledge and expertise, and generate a competitive advantage that might be hindered by the loss of their hedge cumulated with excessive costs of reporting. Indeed, the information disclosure in relation to the reporting of contractual terms on certain aspects with sub-contractors and revenues with open and closed clients can be a threat to the competitive position a company has gained in a market. The ESRS requirements might, therefore, dissuade undertakings to enter the capital markets to fund their growth and/or finance their transition journey through the capital markets. On the other hand, the SMSG recognises that the pool of more available relevant, comparable, understandable, faithful, and verifiable ESG data creates an asset for ESG investors and lenders in their investment and financing decision process based on all the information at their disposal. Accordingly, the SMSG is supportive of the ability for Member States to exempt companies from disclosing information that is too competitively sensitive. As mentioned by Article 19a3 of the EC proposal: *“Member States may allow information relating to impending developments or matters in the course of negotiation to be omitted in exceptional cases where, in the duly justified opinion of the members of the administrative, management and supervisory bodies, acting within the competences assigned to them by national law and having collective responsibility for that opinion, the disclosure of such information would be seriously prejudicial to the commercial position of the undertaking, provided that such omission does not prevent a fair and balanced understanding of the undertaking's development, performance, position and impact of its activity”*. However, the commercial exemption should be harmonised at the EU level.

6. The SMSG is concerned about the deadline for the adoption of the Delegated Acts and the entry into force of the legislation in view of the need to ensure a proper implementation of the Directive. The derogations to the Due Process Procedure for ESRS at the launch of the public consultation on the ESRS Exposure Draft were needed to comply with “the European Commission’s firm request to EFRAG to submit its technical advice for a full set of draft ESRS in November 2022”. To ensure high quality ESRS, the SMSG recommends ESMA to urge the Commission to extend the deadlines so that EFRAG can have sufficient time to submit its technical advice to the EC. Moreover, an extended deadline would give EFRAG TEG and SRB the possibility to effectively play their role in the revision of the draft standards and the assessment of the cost-benefit analysis. Alternatively, the scope of the Delegated Acts to

be adopted under the current timeframe should be reduced. Delays that impact financial market participants' access to information should also be considered, as they might not be able to comply with their own regulatory constraints and supervisors should be lenient in those circumstances.

7. The SMSG supports the objective of effective coordination with other standard setters, including the International Sustainability Standards Board (ISSB), who should ideally follow the in-depth quality work of EFRAG. The Exposure Drafts, in their basis for conclusion, clarify where their recommended disclosures are built on, or compatible with, existing standards² or the draft international baseline standards of the ISSB. This is key to avoid unnecessary regulatory fragmentation that may have negative consequences for companies operating globally. The SMSG advises ESMA to encourage the European Commission's contribution to the process of convergence of sustainability reporting standards at the global level. While being conscious that the standards should first permit financial market participants to comply with their own regulatory obligations stemming from the EC sustainable agenda (SFDR, Taxonomy, ESG risks Pillar 3 disclosures, ESG benchmark Regulation, MiFID sustainability preferences...), coordination and as much convergence as possible between the CSRD and the ISSB standards are much needed for entities subject to the CSRD and acting in multiple jurisdictions, from the following angles:
 - Compliance with all local rules without duplicating reporting efforts
 - Competitiveness/level playing-field with local actors
 - Access to sustainability data for local entities in the value chain
8. The Commission should also encourage the ISSB to work closely together with EFRAG on their building block approach to ensure that the global baseline standards are sufficiently clear and ambitious to ensure appropriate convergence and full compatibility with the EU framework. This is key to avoid "duplicative reporting" for EU undertakings with a global footprint, with ESRS inside the EU and non-EU local regimes inspired from the ISSB's global baseline standards outside the EU. Once compatibility is ensured, as much convergence as possible between the ESRS and the ISSB's standards is also needed to ensure a level playing field amongst jurisdictions and to achieve ambitious sustainability objectives at the global level.

III. Advice on the relevance of (i) the proposed architecture, (ii) the implementation of the CSRD principles and (iii) the overall content of each ED

9. The scope of the public consultation appears to be very detailed and therefore it will be difficult for most stakeholders to reply to the whole set of questions. This could affect the conclusions. In that context, the SMSG is of the opinion that the methodology of the analysis of the answers to the public consultation should be explained, in particular about the way third party contractors will handle the answers and attribute weight to the different contributions.
10. Although we are aware that it is not part of the EFRAG Consultation, the SMSG deems ESG ratings a relevant topic in the area of the information relevant to investors. Therefore, the SMSG is of the opinion that the European Commission should adopt measures to ensure that ESG rating agencies align with the ESRS in the choice of their methodologies, in order to avoid divergence or dispersion on ESG ratings and different solutions on the assessment of ESG performance (using estimates or raw data for example), and to ensure convergence and comparability of non-financial ratings. The data and quality of ratings is important for all market participants.
11. In the same vein, the very detailed requirements in the ESRS may lead to an information overload for investors and important information may be missed by investors. Some SMSG members express an overall concern over the quality of reporting due to the complexity, of the amount of information, the

² And upcoming standards (EU Green Bond Standard)

number of topics and the significant details to be reported. An overload reporting with unnecessary information generates more bureaucracy for companies and makes the annual report less easy to assess, whilst the objective is to make them more readable. Therefore, the data will need to be at least compatible with regulatory requirements with respect to CSRD, SFDR, Taxonomy Regulation, MiFID sustainability preferences, ESG risk disclosures under Pillar 3 and ESG Benchmark Regulation reporting obligations for banks. SFDR asks investors/asset managers to assess principle adverse indicators as well as to incorporate ESG factors into risk management and investment decision processes and to disclose to which extent the products they market as sustainable include ESG characteristics or meet ESG objectives (according to article 8 and 9 under SFDR). The ESRS should therefore include at least the relevant indicators (Tables 1 to 3 of Annex 1)³ in the data to be disclosed by companies. In addition, ESG risks Pillar 3 reporting obligations require certain banks to disclose quantitative metrics on their exposures to all carbon-related sectors and associated financed GHG emissions with a strong sectoral granularity, to companies operating in fossil fuel and electricity generation, to top 20 polluters in the world and to companies vulnerable to physical risks. It also requires those banks to disclose how, by exposed sector, they steer their corporate credit portfolio towards the net-zero objective. It is thus key that the ESRS also include the necessary information, which is expected to be relevant at the sector-specific ESRS level.

12. Nevertheless, the reporting obligations should be well feasible for companies. There is a gap of data that is not available yet and there is a need for sufficient time and resources to allow companies to gather that information and implement the system. Something feasible and well-calibrated is needed, again taking into account the requirements of CSRD, SFDR, “the Taxonomy”, ESG risks Pillar 3 for banks, ESG Benchmark Regulation and MiFID.
13. There are many abbreviations and the terminology is not always clear. In particular, there is a lack of proper understanding of the concepts of rebuttable presumption and of materiality at all levels of the undertakings.
14. On the rebuttable presumption mechanism, the SMSG is of the opinion that the European Commission should assess the approach and the underlying architecture of the ESRS. In particular, the European Commission should review whether this approach should be constructed under the current system or another one. The current system combines a large sector-agnostic level of disclosure requirements that applies obligatory to all companies, that can decide which of the requirements may be rebutted, with a small set of sector-specific standards disclosure requirements. Another approach, for the sake of clarity and transparency of the information on the market and comparability on capital markets, is to combine a narrow set of sector agnostic-disclosure requirements for companies, which is mandatory (basic disclosures requirements especially for the environmental objectives other than climate-related which are required from all companies) with comprehensive and elaborated sector-specific standards set with tailored information. A further alternative approach is to shift the sector-agnostic ESRS on environmental objectives other than climate mitigation and adaption to the sector-specific ESRS, so that the materiality presumption for those topics would be made at the sector-specific level. This would free companies in sectors for which such topics are not material from the obligation to justify their materiality assessment. It should, moreover be clarified whether companies have to justify each time they use the presumption to waive a disclosure requirement. ESMA should provide a clear indication on the direction to EFRAG, the Board and the TEG on how the standards shall be shaped.
15. The SMSG suggests that the double materiality concept, which derives from CSRD could be more explicit and detailed in its application. The process to assess double materiality should be made clearer and simplified. The cost/benefits of doing an overly detailed materiality assessment should be taken into consideration, also considering the fact that for most companies the KPIs included in the draft standards

³ Link to the RTS:

https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf

will be for sure material. Moreover, having the sector standard with the list of material KPIs for the industry the materiality analysis should be a simple assessment and not an overly burdensome process to just confirm the list of KPIs already included in the sector standard.

16. Also other concepts worded in the ESRS are subject to interpretation (employee, education or training, water recycling) and need clarification and alignment across standards. It is important for users and preparers, that the definitions – including wording across the cross-cutting and topical standards of key concepts, principles, characteristics of information used in those standards – are harmonized and that the same definitions apply in financial and sustainability reporting requirements (i.e., financial materiality, value creation, value chain or stakeholders). Most corporates might not understand the language being used, even if they are yet involved in the sustainability disclosure area. Also, the wordings vary according to the international definitions, for example the notion of undertaking only exists in the EU regulatory framework
17. The SMSG observes that the definitions of the ESRS are located in different places. For the benefit of users and preparers, it recommends EFRAG as the standard setter to centralize in one appendix an online dictionary defining all the terminology used in the ESRS.
18. The SMSG is of the opinion that the scope of the reporting requirements in the value chain as well as the definition of stakeholders and the scope of their expected level of implication in the different steps of the governance processes should be clarified and better delimited. On the value chain issue, there is uncertainty of what is being asked to be reported, particularly as most information to be reported will be new data, raising the issue of legal liability of European companies in regard of the information that will be shared in the Annual Reports. Specifically, if the extent of the ESG reporting should coincide with the financial perimeter for the Annual Report, it should be better specified what should be included in this perimeter (i.e. we take into consideration the equity or operated boundary, Joint Ventures, etc.) in order to avoid misunderstandings. More in particular, the reporting boundary needs to be more clearly defined, better specifying the levels in companies of the Value Chain for which it is deemed useful to obtain disclosure. It may be premature to claim to obtain this large amount of information for the entire value chain. The broad definition of the value chain would create clear difficulties in reporting data outside the control of an undertaking (problems of verifiability, quality and control of the data). It would be also difficult to ask and perform an assurance activity for data that is not directly controlled by the undertaking and this would also lead to potential duplication of information.
19. Moreover, value chains for many EU reporting undertakings extend both inside and outside the EU, while the complexity of obtaining appropriate EU compliant data from non-EU undertakings within the value chain should not be underestimated. Accordingly, we welcome that the final text on the CSRD specifies that *“For the first three years of the application of this Directive, in the event that not all the necessary information regarding the value chain is available, the undertaking shall explain the efforts made to obtain the information about its value chain, the reasons why this information could not be obtained, and the plans of the undertaking to obtain such information in the future.”* Nevertheless, we are concerned that this could result over time in a relocation of the entire value chain to entities within the EU. The political, strategic and economic implications of such a shift, also for European consumers, should be thoroughly analysed. Certain cases of relocation might imply higher costs for EU consumers especially where the EU based alternative suppliers may not be so cost-effective as those currently used outside the EU. At the same time, this might be seen positively by the investors and policymakers as a growth driver for the EU economy and could encourage strategic autonomy. Furthermore, with regard to the upstream and downstream approach, whilst the standards prescribe that the value chain be considered from the start to the end consumer, the Commission should evaluate whether data might not be more easily accessible upstream rather than downstream and reassess disclosure requirements accordingly.
20. Mandatory information required by the standards can be included in the sustainability report by cross-references only to other parts of the management report. Cross-references to documents other than the

management report are not permitted. It would be better to allow cross-reference to relevant information contained also in other documents (as required for example by Italian regulations in relation to certain documents like the Report on Corporate Governance), on conditions that these documents are standardised across the EU. The risk would be otherwise to increase costs in terms of collection and duplication of information. On this point, it should be noted that the IFRS instead allows that, the information required by the standards can be included in the sustainability report by cross-reference also to other documents made available with the same timing as general purpose financial reporting.

21. Moreover, the conciseness of the information is important. All this information must be presented in the Management Report and we strongly support this decision. In order to be included in the Management Report the information should be concise and limited to the relevant one to understand how the companies destroy or create value and contribute to ESG objectives. As such, there is still some room for improvement to better identify which KPIs should be sector-agnostic and which other KPIs should be moved to the sector-specific disclosure requirements to be released (as an example some air pollutants in the ESRS E2 are not relevant for all the industries - NH3 ammonia, for example, for the Oil and Gas Industry is probably an air pollutant which is present but not so material if compared to other industries such as agriculture).

IV. Advice on the possible options for prioritizing / phasing-in the implementation of the ESRS

22. The SMSG suggests following a phasing-in option: the value chain could first be restricted to a small scope before being extended within reasonable boundaries; in each pillar (E, S, G) focus first on disclosure requirements that are essential (e.g., for financial institutions' regulatory requirements with respect to SFDR, Taxonomy Regulation, MiFID sustainability preferences, ESG risks Pillar 3 and ESG Benchmark Regulation).
23. Moreover, the SMSG suggests also that EFRAG develops some structure explaining the topics and sub-topics and sub-sub-topics as today there exist only three main topics, Environment, Social and Governance, and the level 1 sub-topics. In fact, when a company does a materiality assessment in order to rebut or not some elements of the ESRS, there is no further architecture below level 1. It would further enhance the calibration on how to determine what is relevant and the data point or breaking point of when a disclosure requirement is considered material or not. A knowledge-based list which consists of the key concepts defined in a common language will enhance the quality of reporting, allow to train talents and skills of competent experts in the field and enable a comprehensive approach.

V. Advice on the Adequacy of Disclosure Requirements (Cross cutting, Environmental, Social, Governance standards)

24. There are comments on the Social ESRS, in particular the concept of work-life-balance. This is a new concept and companies have no idea how they should be dealing with this and what policies should be in place. Moreover, there is a lack of "standards" on certain topics, e.g. biodiversity and social, and the KPIs are not properly balanced for sector-agnostic and sector-specific standards. We would welcome a clarification of the minimum principles to be applied on these issues.
25. Also, on the casual workers of the value chain the definition and scope are unclear. It seems as if the full set of disclosures are required unless the undertaking proves that it is not material which is very difficult to do. The burden of proof should be the other way around.
26. Moreover, companies will not be able to disclose all this unless there is a phase-in approach. There is not even a social taxonomy at the moment and moving in such details may be too ambitious. In addition, there should be a recognition of the link between the timing and calibration of the supply of these data and requirements imposed on investors and banks through the SFDR, MiFID, ESG Benchmark Regulation, Taxonomy regulation and ESG risks Pillar 3 disclosures. If not, there is a risk of misunderstanding for the final investors, who are not necessarily knowledgeable of the current temporary misalignment between regulations.

27. At this stage, the reporting requirements are quite ambitious, even if in the long term we will get there. At this moment, the SMSG does not see how companies would provide information in the short-term, whilst in the long term the information would be expected to be available. Also, the scope 3 emissions and the equivalent on the social side are social issues on the value chain on which companies have no control whatsoever. Moreover, they may have very little knowledge on it. Therefore, companies might report that something is not material and then something unknown occurs leading to reputational and legal damage as a result out of that same issue. This could result over time in a relocation of the entire value chain of entities within the EU. This may prove particularly complex for companies operating in sectors highly dependent on resources or technologies for which there is no alternative within the EU. Again, the political, strategic and economic implications of such a shift for European citizens should be thoroughly analysed.
28. Moreover, there is a fundamental issue in respect of the value chain. Numerous companies have activities across and outside the EU. While companies might follow some of the reporting requirements if the value chain is in the EU, when their activities are outside the EU they might find it extremely difficult to gather information. It may then be difficult to report even if they intend to do “the right thing”. This might cause unintended consequences on the EU boundaries.
29. The scope of the reporting requirements is a related issue: data and information will also be required from SMEs, while only a small number of them are listed on the regulated market. We will see a trickle-down effect from large companies to all SME’s. It is therefore important to prepare and plan for a well-calibrated standard for SMEs. Those will be mandatory for listed SMEs and voluntary for non-listed SMEs that are required to provide information. Since that information will be used by their partners in the value chain, it should be aligned. The SMSG is of the opinion that this work should be done as part of the first set of standards, as it will, otherwise, not only be difficult to obtain information from the value chain from outside of Europe, but also create problems inside the European Union for listed SMEs.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA’s website.

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[signed]

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[signed]

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