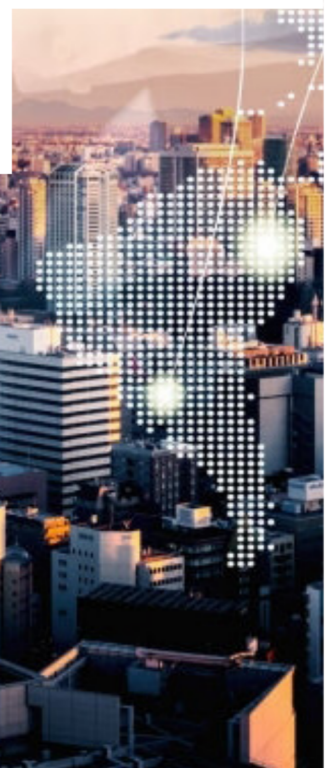




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# ESG – Adding a new perspective

to corporate governance  
and transparency



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## Introduction

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The concept of how a business can create value is changing fast. The increased frequency of catastrophic weather events and the social consequences of the Covid-19 pandemic led more people to question the conventional models of environmental and social responsibility, and how the activities of companies are impacting the environment and society. At the same time, investors are starting to seriously question how vulnerable businesses are to climate change and social change.

Until recently, the ESG conversation was guided by moral and ethical concerns, with no significant financial materiality. Nowadays, investors are looking for a broader set of criteria to integrate ESG issues into their analysis of risks and opportunities. Their clients are demanding more transparency and disclosure and are keen to understand and monitor the broader impact of their financial decisions.

But to advance the sustainability agenda, the global business community and authorities must address key issues such as supply chain oversight, convergence of ESG standards, data collection and dissemination. The evolution of these aspects in the next few years will be crucial to accelerate the world's transition to a more sustainable economy.

## Harmonization of ESG standards globally

Convergence of at least some of the ESG regulations, principles, initiatives and reporting standards is essential in the global fight against climate change and to establish common environmental, social and governance priorities among companies, investors, and other stakeholders.

While no central body is coordinating the effort or trying to reconcile different objectives, entities are coming together to harmonize some standards. More importantly, international sustainability accounting norms are around the corner.

At the moment, companies and investors are faced with a daunting number of ESG regulations, principles, initiatives and reporting standards. A few are mandatory, many are voluntary, and individual industries are constantly evolving their own best practices for environmental, social and governance issues. Making matters more complex for multinationals, regulations, or proposed regulations, are in different stages of development in different regions, and countries have distinct, often conflicting priorities.

The variety fuels inconsistency in how ESG data is measured and reported by companies, investors, rating agencies, and data providers. Studies have found more than 20 different ways organizations report their employee health and safety data. Different approaches to deal with data gaps that span industries and time periods for ESG metrics also cause discrepancies.

“There is a desire among enterprises to engage more in ESG, they understand it is expected of them, they understand that it is good for business, but I think they are hindered by the diversity of standards,” says Claude Brown, a London-based partner of international law firm Reed Smith LLP. “Maybe the way forward is having accounting bodies provide a harmonized framework,” he adds.

### **Too many standards to harmonize**

Most ESG standards and requirements are private initiatives, often inspired by the Sustainable Development Goals set by the United Nations, including the Principles for Responsible Investment, the Global Reporting Initiative, the Carbon Disclosure Project, Climate Disclosure Standards Board, the Impact Measurement Project and the Value Reporting Foundation (created in 2021 following a merger of the Sustainability Standards Accounting Board in the United States and the Integrated Reporting Council).

Europe has taken the global lead in terms of ESG disclosure rules. The European Union has three main statutes on that front: the Sustainable Finance Disclosure Regulation (SFDR, applied to all asset managers, who must assess the sustainability risks that could negatively impact their financial returns and how their investments could adversely impact sustainability factors, thus addressing the so-called double materiality of sustainability), the Non-



Financial Reporting Directive (NFRD, applied to listed and large public-interest companies, which must publish reports on their ESG policies), and the EU Taxonomy (a classification system of economic activities that expands disclosure requirements for companies and asset managers in scope for SFDR and NFRD). The NFRD is due to be replaced by the recently proposed Corporate Sustainability Reporting Directive (CSRD).

Additionally, there are specific standards for climate change, chiefly the recommendations by the Task Force on Climate-related Financial Disclosures (TCFD), created by the Financial Stability Board.

Around the world, countries have distinct strategic priorities that hinder the harmonization of ESG standards. While some are focused on slowing down climate change or addressing its consequences, others primarily seek to grow their economies in a sustainable manner. China, for instance, only has reporting requirements for certain high-polluting firms. Even after the Joe Biden administration took over the White House, the United States and the EU have significant differences on ESG standards, which are all evolving at their own speed and aim at different moving targets.

**Accounting boards come to the rescue**

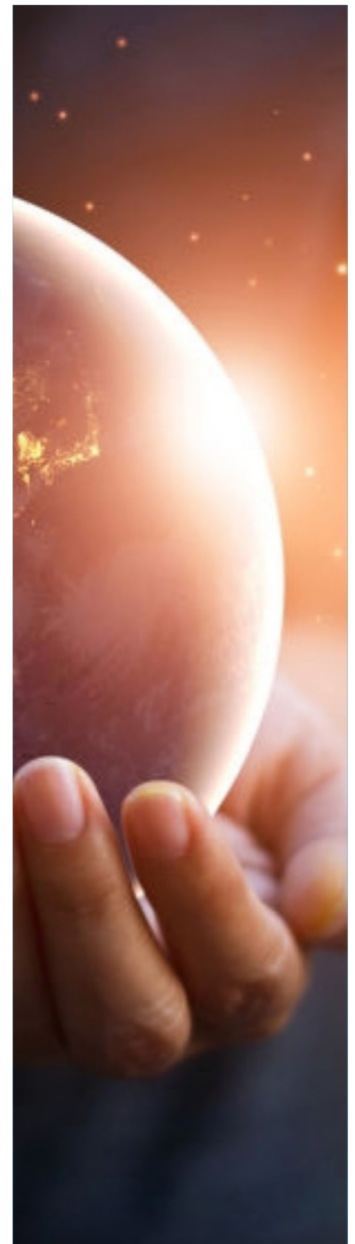
Meanwhile, major international bodies are joining forces to harmonize some standards. In 2020, the Sustainability Accounting Standards Board, the International Integrated Reporting Council, the Global Reporting Initiative, the Carbon Disclosure Project, and the Climate Disclosure Standards Board announced plans to align their climate standards more closely.

At the global level, the IFRS Foundation, which oversees the International Financial Reporting Standards applied in the vast majority of countries, proposed the creation of an International Sustainability Standards Board. This ISSB will work together with the International Accounting Standards Board to ensure interconnectedness between accounting and sustainability-related requirements. The sustainability standards will aim to capture financially material information about sustainability-related risks and opportunities, and their impact on enterprise value.

In another promising effort, the International Organization of Securities Commissions sees an urgent need to improve the consistency, comparability, and reliability of sustainability reporting for investors. IOSCO is engaging with the IFRS Foundation to develop a common set of global sustainability standards to help meet investor needs and set a baseline for jurisdictions to consider when establishing their own sustainability disclosure requirements.

The adoption of international sustainability standards would allow uniform sustainability information based on a common standard, particularly if they become mandatory in national jurisdictions. The ISSB is set to be launched at the 26th UN Climate Change Conference of the Parties (COP26) in Glasgow, beginning on 31 October 2021.

“We are at a real pivotal point because we have global and regional developments happening very quickly that will put infrastructure into place,” says Ida Levine, a board member at the Impact Investing Institute. “At least with the ISSB, everybody will be starting on the same page.”





## Balancing supply chain issues with ESG goals and obligations

Supply chains can be highly complex and interdependent, spanning multiple tiers and jurisdictions. As they fall outside a company's core operations, direct and indirect suppliers may expose the organization to grave environmental, social and governance risks — such as pollution, deforestation, corruption, and human rights violations — if they lack oversight. In a few years, insufficient knowledge of supply chains should also make products more expensive when they cross into Europe, forcing companies and their suppliers around the world to accelerate their efforts to make products more sustainable.

In July 2021, the European Commission adopted a proposal for a new Carbon Border Adjustment Mechanism which will put a carbon price on imports of a targeted selection of products. The mechanism seeks to ensure that Europe's emission reductions contribute to a decline in global emissions instead of pushing carbon-intensive production overseas, while also encouraging the rest of the planet to take steps in that direction. In doing so, the mechanism will give renewed vigor to the EU's Emissions Trading Scheme and help establish the cost of carbon within the EU.

The CBAM, working in conjunction with the EU ETS, will equalize the price of carbon between domestic products and imports, thus preventing relocation of factories to

countries with looser environmental protections and demanding more sustainable production processes in other parts of the globe.

"The European Union is very keen to decarbonate its economy and make sure that its companies can compete," says Yves Melin, a partner of international law firm Reed Smith based in Brussels. "It will level the playing field and it is all crystalizing at the border."

In addition to the emissions-focused CBAM, the Commission is also working on supply chain due diligence initiatives, which require European importers to monitor respect for human rights and the environment in their supply chain. The EU is already preceded in this by some ambitious member states, such as Germany.

### **Companies need to ask more questions in their supply chains**

The CBAM mechanism will be phased in gradually and will initially apply to iron, steel, cement, fertilizer, aluminum, and electricity generation — the very inputs of most processed goods. A simplified system will be in effect in 2023, requiring importers to report emissions embedded in their goods without paying a financial adjustment. The definitive system will become fully operational in 2026, and businesses should deepen their understanding of how their input is produced in order to protect their

competitiveness. This also applies to other supply chain due diligence initiatives. “Be concerned now, be ready before the end of the decade,” recommends Melin.

A few industries have long had an advanced understanding of their supply chains, namely those that claim preferential origin to access reduced duty rates. The automotive, textile and chemical sectors stand out among them and have been doing supply chain due diligence for a long time, as they need to show the conditions in which products were manufactured to get preferential tariff treatment.

Even for those businesses that traditionally have more comprehensive supplier oversight, the magnitude of supervision policies and efforts will only increase to accommodate ESG considerations, according to Melin.

That means asking more questions across the entire supply chain. These questions fall under three big categories: how much carbon is emitted to manufacture a certain good; how labor practices compare to the major conventions of the International Labour Organization; and what is the impact that suppliers’ activities have on the environment and biodiversity.

**‘Investors should be very concerned’**

Effective management of ESG risk in the supply chain is clearly positive for companies and their investors. Loosely supervised supply chains may harm a company’s reputation, raise costs and operational risks. Poor practices may lead to harmful products,

supply bottlenecks due to workers’ strikes or loss of operational licenses due to violations, among other problems. These issues affect the operations and financial results of businesses, as well as the performance and reputation of their investors.

Ensuring compliance with local regulations is often not enough to meet stakeholders’ expectations. Guidelines for Multinational Enterprises set by the Organisation for Economic Co-operation and Development (OECD) assume that investors can influence the responsible business conduct of the investee company. Thus, investors are expected to include ESG risks in their due diligence and consider ESG risks in their analysis and investment processes. That means investors should engage with companies to ensure that they can identify and assess ESG risks in their supply chains and verify that they can do that throughout the many supply chain tiers.

The Carbon Border Adjustment Mechanism adds urgency to this effort and should accelerate investments and technology in sustainable production processes all over the world.

“We will have a virtuous cycle that is not going to happen overnight, it is not going to be painless, but we will move in a steady direction because it makes sense”, says Melin. In a context of greater scrutiny of ESG issues embedded into every good sold, supply chain oversight “will decide which companies will succeed and which ones will fail, so investors should be very concerned,” he adds.



## Managing the challenges of data collection and dissemination

The lack of common definitions combined with the wide variety of ESG standards and disclosure requirements place a burden on companies and investors. They are forced to mobilize financial and human resources to produce countless reports and questionnaires, but still the data presented is often inconsistent, ambiguous, and incomparable.

Though ESG information is highly contextual and conventional metrics sometimes do not measure the same thing, access to high-quality, reliable ESG and climate data is considered indispensable to accelerate the transition to a sustainable economy and to provide greater transparency to all stakeholders.

“The absolute key point is data and how you collect data and adjust the data for reporting standards,” says Reed Smith partner Claude Brown. “The way forward is disclosure and reporting, and it is necessary to acquire as much data and detail as possible.”

Right now, however, collecting environmental and social data is expensive and time-consuming, particularly for smaller enterprises, which would welcome access to cheaper, streamlined services that could be linked to their own systems and used more broadly.

“Companies should be able to get all the data they need and be able to use it for regulatory reporting across the board and for different voluntary standards – if they could do that quickly, investors would get easily digestible data and there would be no need to translate it,” adds Brown.

### Technology comes to the rescue

At the company level, teams responsible for dealing with ESG information usually extract data from different systems and data is rarely current, with limited – if any – tools for scenario analysis and planning ahead as a business. Moreover, traditional Enterprise Resource Planning (ERP) systems, as well

as other systems running across an organization, do not integrate with each other, making data collection for ESG purposes especially challenging.

As stakeholders become more demanding of ESG information and technology evolves, it will be possible to have “multiple systems of an organization feeding into a secure platform, set up in a way that different teams can work together,” says Amos Wittenberg, deployment strategist for New Energy & Decarbonization at Palantir Technologies in New York. Ideally, such platforms would also offer auditing and reporting capabilities (alongside critical simulation engines), while protecting commercially sensitive information and ensuring compliance with any applicable data protection and privacy laws and regulations.

To deliver that, however, tech companies need authorities and private sector initiatives to intensify their efforts to harmonize ESG standards and reporting practices. Investors are also waiting for these developments because asset managers need to be able to ignore the noise and have actionable data to come up with the insights that set them apart.

One important step in that direction is the European Union’s Taxonomy Regulation, a classification system to help investors/organizations understand whether an economic activity is considered environmentally sustainable, setting a common language between companies, investors, and authorities. These types of regulations must be passed to ignite ESG efforts within companies, says Scott Zuercher, Wittenberg’s colleague at Palantir Technologies who leads the firm’s Climate Finance/Net-Zero solutions from Munich.

“The situation now is that you do your best with the data you have”, says Zuercher. “Companies will likely have some information, not all information, but as the wheels start turning, ESG data processes and the need for granularity in data will grow.”

# Disclosing your ESG reporting and credentials accurately and intelligibly to your universe of stakeholders

While consumers and investors are keen to achieve clarity about the environmental and social impacts that their decisions have, companies all over the world are producing a deluge of ESG data without materiality, information that is often subjective and caters to very different audiences.

Corporate ESG data for a single company may come from many sources. Law firms and consultants are thrown in the mix to ensure compliance with disclosure requirements and voluntary reporting standards. On the recipient side, rating agencies, asset managers and business partners force companies to fill out countless questionnaires, often asking just slightly different questions. “It is not optimal or efficient,” says Ida Levine, member of the board of the Impact Investing Institute in London.

At the same time, policymakers are relying on increased disclosure to influence behavior and set the right incentives to accelerate the transition to a more sustainable economy. In doing so, they also aim to help companies address the growing demand for ESG reporting in an efficient manner.

The proposed CSRD is a step in this direction. On April 2021, The European Commission published a draft of the CSRD, which will amend the existing Non-Financial Reporting Directive (NFRD). Under the proposed CSRD, companies will be required to disclose adequate information about sustainability risks and opportunities using a so-called double materiality standard: including both the impacts of environmental and social factors on their enterprise value and the impact that their activities have on people and the environment. The reported information must be consistent with European Union regulations, comparable, reliable, and easily accessible.



Businesses will be required to gather internal information across divisions to understand their activities, drive change across their organizations and communicate these efforts to the outside world. Data will become more accurate and granular.

The new directive is expected to be transposed into law by the end of 2022. Hence, companies that fall within the scope of the directive will need to comply with the amended rules in 2023. These rules cover accounting, transparency, and auditing aspects.

In the future, the European Commission plans to subject ESG information to the same level of scrutiny as financial information, in another move to advance sustainable behaviors in the corporate governance frameworks.

Reporting will become easier for companies and investors when regulators offer more structure and other standard setters come together to harmonize their definitions and guidelines. Accounting and technology initiatives will also support the effort to streamline ESG information across the corporate world. “We should have more clarity within the next couple of years,” says Levine.

While that time does not come, companies communicate more successfully when their ESG disclosures are material to their area of activity, show real commitment to solving environmental and social problems, and create value to stakeholders in the long run. Whether reporting is mandatory or voluntary, information is considered more robust and reliable when it is measurable and comparable.

