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ESG: U.S. and European rules reveal differing perspectives on the topic of "materiality" in business

Azish Filabi
Associate Professor and Charles Lamont Post Chair of Business Ethics The American College of Financial Services

Interest in the impact of business activities on social and environmental sustainability are on the rise. The recent focus is around the topic of "ESG", an acronym for "environmental, social, and governance" matters in business and investing.

Regulators and policymakers in the U.S. and E.U. are seeking frameworks that can help companies, investors, and civil society better analyze and disclose sustainability-related factors of business activities. Their aim is that the proposed rules can guide companies to provide investors and other stakeholders information that is meaningful and comparable across companies. The purpose of the disclosure, however, varies across jurisdictions.

In the U.S., disclosure regimes and recently proposed rules on climate disclosure focus on business activities that are *material to corporate financial performance*. The European Commission (E.C.) disclosure rules, however, require disclosure of *double materiality*, which considers how sustainability factors impact corporate financial performance, but also how the corporation impacts society. The differing perspectives on disclosure reveal differing philosophies about the purpose of business.

I. The European concept of double materiality

The EU Corporate Sustainability Reporting Directive was announced on April 21, 2021[1], proposing amendments to the Non-Financial Reporting Directive ("NFRD") from 2014[2]. The concept of double materiality is a priority conceptual guideline of the European sustainability reporting architecture. Embedded within the NFRD is the requirement that companies disclose business activities where there is, at a minimum, impact relating to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters, among others[3].

To facilitate ESG disclosures, the EU approach focuses in on frameworks relating to accounting for double materiality. The concept is a threshold consideration for whether an item must be reported. It is *double* materiality because it considers two perspectives – that is, whether a matter is material to a company's financial condition, and/or if it's material to how the business activities impact society.

Accounting for double materiality can be obscure because it addresses concepts that don't fit squarely within traditional financial standards. Recognizing the need for further guidance on accounting for non-financial risk, the EU has published draft conceptual guidelines for standard setting, in the form of the European Sustainability Reporting Guidelines 1 Working Paper[4].

The draft Working Paper describes how to account for intangibles in business that create enterprise value and exist at the union of financial materiality and societal impact. In this way, there's thus a recognition that financial value has historically not captured all the activities that make an enterprise valuable, such as human capital, relationship capital, organizational capital, natural capital, and so on. The draft Working Paper further states that these various forms of capital "often represent the major part of the enterprise value, well over and above the net assets of the reporting entity as established through financial reporting."[5]

1 - EU Sustainable Reporting Directive (April 21, 2021), retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0189.

2 - Non-financial Reporting Directive, (October 22, 2014), retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095.

3 - *Id.*, at Article 1 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095.

4 - European Sustainability Reporting Guidelines, Working Group 1, Double materiality conceptual guidelines for standard-setting, draft Working paper, (January 2022), retrieved from https://www.efrag.org/Assets/Download?assetUrl=/sites/webpublishing/SiteAssets/Appendix%202.6%20-%20WP%20on%20draft%20ESRG%201.pdf&AspxAutoDetectCookieSupport=1.

5 -*Id.*

This recognition that what matters for business success is not easily quantified or measured is a key concept in corporate sustainability. Research has shown, for instance, that much of the financial value of the stock market is derived from intangibles[6]. That business sustainability concepts are now being integrated into the EU legal reporting frameworks is a major advancement in the field.

The EU Working Paper also offers some innovations. For example, there is the "inside-out" aspects of materiality, which describes the business's activities that are "more likely than not" to impact the environment or society. In such cases, the authors describe the "boomerang" effect, in which the societal or environmental factors will impact the financial prospects of the company, and thus need to be reported. For instance, the boomerang effect occurs if a coffee company depletes its supply of coffee beans through unsustainable consumption or farming techniques, which then rebounds to impact the financial margins of the company because the cost of goods has increased.

The European double materiality approach is addressing head-on the questions of business sustainability through the lens of how disclosures can best help corporates keep focused on risks that are material to their business, and thereby material to society as well. The rules, when finalized, can help guide the national standards. Quantifying these non-financial risks will, however, remain a challenge for industry.

II. Materiality under U.S. securities laws

U.S. securities law mandates that companies disclose information that is or would be material to a reasonable investor. The focus is on the investor as the primary audience for information, and therefore the relevant information is financial impact on the business.

With respect to ESG-related disclosures, in March 2022, the U.S. Securities and Exchange Commission (SEC) published a proposed rule on climate-related financial disclosure[7]. The proposal, if finalized, would require that companies disclose information that is "reasonably likely to have a material impact on their business, results of operations, or financial condition."

In contrast to the European approach, the locus of activity here is impact on the business, rather than impact on society. This focus on financial materiality therefore may leave out those elements of the business that are *externalized* from the company's operations.

A business externality describes activities that the company has placed outside of its core business operations, such that it is not financially accountable for them under existing rules. A classic example of an externality is environmental pollution. Absent legal regulation, a company, let's say a manufacturer, can demonstrate a a better financial condition if it releases its industrial waste into a river which then washes it into the ocean, rather than capturing the waste for proper disposal, which can be expensive. When that expense is "externalized" it will impact society but is, arguably under securities laws, not financially material to a reasonable investor in the company because that investor is not paying for it directly.

III. Reconciling these approaches

At first glance, the SEC's March 2022 proposed climate related financial disclosure rules seem to narrowly focus on financial materiality. The proposals do, however, indirectly incorporate the "boomerang" effect embedded in the EU double materiality approach.

They do this by mandating that the company's board and management identify climate-related risks that impact their business, requiring that the company identify how those risks "have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term."[8] Thus, for example, if the aggregate level of greenhouse gas (GHG) emissions in the atmosphere eventually impacts a company's energy consumption through higher prices, it is a risk that will have a material impact on financial statements. Recognizing that climate risk is a financial risk to the company thereby influences how a company confronts its own emissions and contributions to aggregate GHG levels.

While the European concept of double materiality *directly* grapples with the dynamic nature of materiality, the SEC's proposed approach on climate disclosure identifies the interdependence between environmental systems and financial systems, thereby requiring company management to grapple with these existential risks.

Nevertheless, the differing approaches between the EU concept of double materiality, and the U.S. regulatory focus on financial materiality reveal different

6 - See, e.g., Sarah Ponczek, Bloomberg (October 21, 2020). Epic S&P 500 Rally Is Powered by Assets You Can't See or Touch, retrieved from, https://www.bloomberg.com/news/articles/2020-10-21/epic-s-p-500-rally-is-powered-by-assets-you-can-t-see-or-touch#xj4y7vzkg.

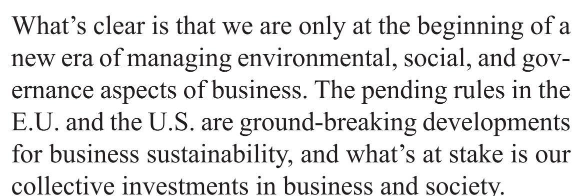
7 - 17 CFR 210. The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities and Exchange Commission. (March 21, 2022), retrieved from https://www.sec.gov/news/press-release/2022-46

8 - *Supra* note 8 at Section I(E).

philosophies about the purpose of business in society. The American concept appears to adhere to the norms of an investor-centric company. Disclosures are intended for investors as the primary audience. By doing so, it fails to recognize that that those investors are also likely to embody other stakeholder roles in the company, such as a customer, employee, supplier, community member, or citizen, among others. Moreover, as long-term investors in public equities markets, the boomerang effect creates long-term financial risk for many investor's portfolios.

The European approach directly addresses materiality as a feedback loop within a system. They describe an "inside out" materiality that refers to the impact of the company on society, in addition to the "outside in" materiality, which is impact on the firm's financial performance. In this way, they've placed society and citizens as the core of the analysis, rather than the investor. This approach identifies that the purpose of business is to facilitate social activities and financial performance is one by-product.

For multi-national companies subject to both U.S. and E.U. regulation, the subtlety across jurisdictions requires that leaders demonstrate a heightened understanding of their business and its material risks – both risks to their own financial performance, as well as long-term risk to the environment and other stakeholders, which can thereby create risks to the business. Companies will need to defend their view of materiality and demonstrate an understanding of interdependence between their business and its stakeholders. Compliance will thus require identification of the company's material stakeholders and a risk assessment of how a company's business affects those stakeholders, and how those stakeholders affect the company.



What's clear is that we are only at the beginning of a new era of managing environmental, social, and governance aspects of business. The pending rules in the E.U. and the U.S. are ground-breaking developments for business sustainability, and what's at stake is our collective investments in business and society.