Forthcoming: European Business Law Review (2024)

Examining the Reasons for Impact Materiality in EU Corporate Sustainability Reporting

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Draft 20 March 2024

The Corporate Sustainability Reporting Directive and the European Sustainability Reporting Standards have adhered to the principle of double materiality. This principle has two dimensions, namely financial and impact materiality, the latter being associated with a company's obligation to report material information on the impacts of corporate activity on people and the environment. Concentrating on the impact materiality principle, this article identifies and discusses key reasons that justified its adoption. The first reason aims to foster the alignment of corporate actions with sustainable development as framed by the European Green Deal and by the Global Reporting Initiative. The second justification is found in the promotion of corporate accountability through sound corporate due diligence processes and effective impact management. Developing markets and products for sustainable investments is the third reason for the disclosure of impact-related information. The article turns to identify constraints to the success of these policy tenets, including (a) distrust in markets due to greenwashing risk, (b) challenges posed by the wide discretionary powers of corporate officers in the evaluation of impact materiality, and (c) poor quality of impact-related data.

Keywords: corporate sustainability reporting, double materiality, information disclosure, sustainable finance, sustainable development goals, impact management, sustainable investments, ESG, investor preferences, CSRD

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I. Introduction

This article examines the double materiality principle adopted in the Corporate Sustainability Reporting Directive (CSRD)[1] and the European Sustainability Reporting Standards (ESRS rules).[2] In order to select the information to be reported, the companies will evaluate the materiality of such information following a double materiality approach. Material information will be included in the sustainability report.[3] A relatively novel and distinct concept, the assessment of double materiality has become critical to sustainability reporting because the ESRS rules have relied on this materiality assessment as the prevalent—albeit not the only—mechanism guiding the reporting process.[4] However, the reasons driving the European Commission to innovate this way have not been totally obvious.[5] The aim of this article is to

[1] Directive 2022/2464/EU of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting, (16.12.2022) OJ L322/15 (hereinafter 'CSRD'). Entered into force on 5 January 2023. Members States will have 18 months to transpose this legislation into their national legal regimes.

[2] Commission Delegated Regulation (EU) 2023/2772 of 31 July 2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards (OJ L, 22.12.2023) ('ESRS DR'). The text of ESRS DR has heavily relied on prior drafts produced by of the European Financial Reporting Advisory Group ('EFRAG').

[3] Josef Baumüller and Michaela-Maria Schaffhauser-Linzatti, *In search of materiality for nonfinancial information—reporting requirements of the Directive 2014/95/EU*, 26 NachhaltigkeitsManagementForum 101-111 (2018) 103; Riccardo Torelli, Federica Balluchi, and Katia Furlotti, *The materiality assessment and stakeholder engagement: A content analysis of sustainability reports*, 27(2) Corporate Social Responsibility and Environmental Management 470-484 (2020) 470 (materiality is the driver through which companies can identify and select issues to be included in their reports); Mathilde Bossut, Ingmar Jürgens, Thomas Pioch, Frank Schiemann, Theresa Spandel, and Raphael Tietmeyer, *What Information is Relevant for Sustainability Reporting? The Concept of Materiality and the EU Corporate Sustainability Reporting Directive*, Sustainable Finance Research Platform Policy Brief, July 2021, 5–6 (accessed 15 January 2023), https://wpsf.de/wp-content/uploads/2021/09/WPSF_PolicyBrief_7-2021_Materiality.pdf.

[4] The double materiality principle was first adopted by the Non-Financial Reporting Directive, 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, OJ L330/1 (hereinafter 'NFRD').

[5] Economics Intelligence Unit, *Sustainability disclosure requirements are tightening* (1 September 2023) https://www.eiu.com/n/sustainability-disclosure-requirements-are-tightening/ ('One of the critical materiality requirements for companies under CSRD is the double materiality assessment, which puts the EU ahead of other regions in terms of sustainability reporting requirements.').

deepen our understanding of double materiality. More particularly, key policy objectives justifying the adoption of double materiality in EU law are identified and discussed.

It is noted that double materiality, on the one hand, and single materiality, on the other hand, are different approaches to corporate sustainability reporting. Single materiality relies on financial criteria to assess information. The reporting standards issued by the International Sustainability Standards Board (ISSB), for example, follow a single materiality approach.[6] Aimed at users of information that are capital providers, such as investors, the ISSB standards require an entity 'to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect the entity's cash flows, its access to finance or cost of capital over the short, medium or long term.'[7] Moreover, they require a company to 'disclose information about its climate-related risks and opportunities that is useful to primary users of general purpose financial reports in making decisions relating to providing resources to the entity.'[8] Financial criteria to evaluate and select information have also been adhered to by the double materiality approach in the CSRD and the ESRS rules, namely the financial materiality approach.[9] However, double materiality, unlike single materiality, contains an additional, separate test guiding reporting, namely the impact materiality assessment, which involves information on how the activity of the company affects the environment or society.[10]

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[6] IFRS Foundation, *ISSB issues inaugural global sustainability disclosure standards* (26 June 2023) https://www.ifrs.org/news-and-events/news/2023/06/issb-issues-ifrs-s1-ifrs-s2/.

[7] Ibid., *IFRS S1 - General Requirements for Disclosure of Sustainability-related Financial Information* (June 2023) Objective, para. 3, https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/ifrs-s1-general-requirements/.

[8] Ibid., *IFRS S2 – Climate-Related Disclosures* (June 2023), Objective, para. 1, https://www.ifrs.org/issued-standards/ifrs-sustainability-standards-navigator/ifrs-s2-climate-related-disclosures/.

[9] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, ss. 3.3-3.5.

[10] Ibid. Also, Hans B Christensen, Luzi Hail and Christian Leuz, *Mandatory CSR and sustainability reporting: economic analysis and literature review*, 26 Review of Accounting Studies 1176-1248 (2021) 1221-23

With impact materiality constituting a highly distinctive feature of double materiality, this article concentrates on this specific materiality dimension. The analysis is valuable to understand the tenets of impact-related sustainability reporting and identify key challenges that may preclude the achievement of such tenets. Section II of this article elaborates more extensively on the two dimensions of double materiality. In section III, three policy objectives are identified and examined: first, fostering the alignment of corporate activity with sustainable development goals; second; promoting corporate accountability; and third, developing markets for sustainable investment products. These policy goals underpinning double materiality, and the challenges ahead afflicting their realisation in the real world, are discussed in Section IV. A brief conclusion is offered at the end of the article.

II. Double Materiality: Financial and Impact Materiality

Entered into force on 5 January 2023, the CSRD has introduced a new regime for the disclosure of sustainability-related information by companies.[11] Replacing in full the NFRD,[12] the CSRD has now prescribed that companies 'shall include in the management report information necessary to understand the undertaking's impacts on sustainability matters, and information necessary to understand how sustainability matters affect the undertaking's development performance and position.'[13] Compliance with this mandatory disclosure obligation will largely rely on evaluating the material status of information. Unlike the NFRD, which had

(examining, among other issues, the distinction between single materiality and double materiality in corporate sustainability reporting).

[11] CSRD n. 1 above.

[12] NFRD n. 4 above.

[13] CSRD n. 1 above, art. 1(4) (replacing art. 19(a)(1) Accounting Directive). This reporting obligation can also be met following a consolidated sustainability reporting basis, Ibid. art. 1(7) (replacing art. 29(a) Accounting Directive). For the sake of simplicity, this article very often utilises the term 'company' instead of the term 'undertakings' used in the CSRD and other EU legislation. The scope of the term 'undertakings' is however wider than the scope of the term 'company'. Yet this distinction makes no difference to the analysis hereby presented.

utilised a 'comply or explain' approach, the CSRD has imposed a mandatory reporting obligation that, in most situations, is subject to the materiality assessment.[14] This means that under the new reporting framework companies are unlikely to report on all ESRS rules.[15] Information need not be reported if, following a materiality evaluation, such information is deemed to be nonmaterial.[16] It is noted, however, that some reporting standards shall be reported in all cases regardless of the outcome of the materiality evaluation such as the disclosures required by the ESRS 2 General Disclosure rules.[17]

With the evaluation of materiality playing a central role in EU corporate sustainability reporting, it is important to shed light on the meaning and purpose of the 'double materiality' principle guiding reporting under the CSRD. As explained in the ESRS rules, double materiality contains two materiality dimensions, namely impact and financial materiality.[18] Identifying financial effects and impacts that are material is essential for the reporting company to detect those sustainability matters that are relevant to its business. Relying on those 'material sustainability matters', the company identifies material disclosure requirements (DRs), application requirements (ARs) and datapoints applicable to such matters and prepares the information to be disclosed in the sustainability report.[19] The CSRD has defined sustainability matters to mean 'environmental, social and human rights, and governance factors, including

[14] ESRS n. 2 above, Annex I, objectives, para. 2 and para. 21 ('The undertaking shall report on sustainability matters based on the double materiality principle as defined and explained in this chapter.').

[15] Ibid.

[16] Ibid.

[17] Ibid., Annex I, s. 3.2, para. 29 (identifying mandatory information disclosures that must be complied with regardless of the materiality evaluation).

[18] Ibid.

[19] Ibid., s. 1.3 and s. 3.

sustainability factors defined in point (24) of Article 2 of Regulation (EU) 2019/2088'.[20] The ESRS rules have added more detailed content to this definition by identifying specific topics recognised as sustainability matters.[21] Such topics include climate change, pollution, water and marine resources, biodiversity and ecosystems, circular economy, a company's own workforce, workers in the value chain, affected communities, consumers and end-users, and business conduct.[22] This enumeration of sustainability matters is non-exhaustive and it is not a substitute for the process of determining material matters based on each company's specific circumstances.[23]

The conceptualisation of financial materiality is based on the fact that sustainability matters—such as climate change, biodiversity, or employee's working conditions—impact or could impact the reporting company financially:

> A sustainability matter is material from a financial perspective if it triggers or could reasonably be expected to trigger material financial effects on the undertaking. This is the case when a sustainability matter generates risks or opportunities that have a material influence, or could reasonably be expected to have a material influence, on the

[20] CSRD n. 1 above, art. 2(2)(b) (adding art. 2(17) to the Accounting Directive). Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability related disclosures in the financial services sector (OJ L317, 9.12.2019) (hereinafter 'SFDR'), art. 2(24) defining sustainability factors in terms of environment, society, employee matters, respect for human rights, anti-corruption and anti-bribery matters.

[21] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, Appendix A – Application Requirements (ARs), AR 16.

[22] Ibid.

[23] Ibid.

> undertaking's development, financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium- or long-term (…).[24]

These are sustainability matters that produce financial effects (risks and opportunities) on the company and are assessed on criteria that rely on 'a combination of a likelihood of occurrence and potential size of financial effects.'[25] Once sustainability matters are found to be financially material to the reporting company, each one of those matters will trigger information disclosures based on disclosure requirements and datapoints. The materiality of this latter information will be evaluated by reference to criteria based on 'relevance'. Relevance refers to '(a) the significance of the information in relation to the matter it depicts or (b) its decision-usefulness.'[26] In financial materiality, decision-usefulness entails that the information is useful to the decision-making needs of those actors who provide capital to the reporting company including, among others, investors and lenders.

As an illustration, financially material sustainability matters and information captures the impact of climate-related phenomena, such as the flooding, droughts of otherwise fertile land, bushfires and hurricanes, among other events, on the financial position of the reporting company. From the vantage point of financial materiality, these climate-related events are important not because they affect life or ecosystems but because these events have the potential to impact a company's financial performance (i.e., physical and transition risk as components of climate risk).[27] The same reasoning applies to the analysis of financial effects arising from

[24] Ibid., s. 3.5, para. 49 (black and indented letters removed).

[25] Ibid., s. 3.5 para. 51.

[26] Ibid, s. 3.2 para. 31. EFRAG, *Implementation Guidance - Draft EFRAG IG 1 – Materiality Assessment*' December 2023, sections 2-3.

[27] For physical and transition risk see Financial Stability Board, *The implications of climate change for Financial Stability*, 23 November 2020, 5-16 (hereinafter 'FSB').

a company's activity. This is a company carrying on its business and, in so doing, affecting positively or negatively the state of the world. A company's production site can improve the quality of life of nearby communities (e.g., by bringing new jobs and increasing economic activity). It can also pollute waterways near the company's production site (e.g., by dumping industrial waste on rivers and water streams). From the perspective of financial materiality, however, those impacts caused by the company's activity on society or the environment (e.g., the well-being of the community or the biodiversity loss from pollution) are relevant solely to the extent that they influence the financial value (risks and opportunities) of the reporting company.[28]

In contrast to financial materiality, the impact materiality approach grants to the impacts of corporate activity on people or the environment their own entity. Such impacts become distinct, independent effects. These effects must be accounted for and disclosed irrespective of any sustainability-related financial effects that might be generated by such impacts. According to the ESRS rules, 'impacts' refers to positive and negative sustainability-related impacts that are connected with the undertaking's business, as identified through an impact materiality assessment process'[29] The materiality of impacts, and of sustainability matters from a perspective of impacts, is assessed based on criteria of likelihood of occurrence and of severity of the impacts. As in the case of financial materiality, the materiality of impact-related disclosure requirements and datapoints is based on the relevance of that information.[30] Impacts on people or the environment can be actual or potential, positive or negative, or take place over the short-, medium- or long-term. Importantly, impacts may derive not only from the activity

[28] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 1.3 para. 14(b).

[29] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 1.3 para. 14(a).

[30] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 3.2 para 31; EFRAG n. 26 above, ss. 2.2-2.3 and s. 3.

of the reporting company but also from activity arising from the company's value chain. More specifically, these are impacts 'connected with the undertaking's own operations and upstream and downstream value chain, including through its products and services, as well as through its business relationships. *Business relationships* include those in the undertaking's upstream and downstream *value chain* and are not limited to direct contractual relationships.'[31]

Consider, for example, a company carrying on business in the agriculture sector that gains new land for agriculture at the expense of forest land.[32] This corporate action brings about deforestation, which represents a negative impact on climate and biodiversity. Under the impact materiality dimension, such impacts on the forest land are given their own entity, separate from any financial effects that these impacts may also generate. Forest loss or damage is the cause of around ten percent of global warming (as trees capture carbon dioxide) and the cause of ecosystem harm through loss of habitat, as seventy percent of land animals and species live in forests.[33] Deforestation 'affects ecosystems, climate, and even increases the risk for zoonotic diseases spreading to humans.'[34] Such impacts are of relevance not only to investors and creditors but also to other stakeholders including NGOs, consumers, government and civil society, among other actors monitoring the (positive or negative) influence of corporate activity on society and the environment.[35]

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[31] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 3.4, para. 43.

[32] WWF, *The Effects of Deforestation*, ('Most deforestation is carried out to clear land for food production') (accessed 18 September 2023), https://www.wwf.org.uk/learn/effects-of/deforestation; National Geographic, *Why deforestation matters and what we can do to stop it*, (7 December 2022 written by Cristina Nunez), https://www.nationalgeographic.com/environment/article/deforestation ('Farming, grazing of livestock, mining, and drilling combined account for more than half of all deforestation') (accessed 18 September 2023).

[33] Ibid., WWF.

[34] National Geographic n. 32 above.

[35] CSRD n. 1 above, recital 9. Also, European Commission, *Guidelines on Reporting Climate-Related Information*, 4409 final (July 17, 2019), 6–7 (hereinafter '2019 Guidelines').

The ESRS rules have recognized that the same corporate activity may generate both impacts on people or the environment, on the one hand, and financial effects on the reporting company, on the other hand: 'A sustainability impact may be financially material from inception or become financially material, when it could reasonably be expected to affect the undertaking's financial position, financial performance, cash flows, its access to finance or cost of capital over the short-, medium- or long-term. Impacts are captured by the impact materiality perspective irrespective of whether or not they are financially material.'[36] Back to the prior example involving deforestation, such action generates not only negative impacts on the forest size and biodiversity but also financial effects. The reporting company gains more land suitable for agricultural production. Moreover, deforestation involves costs to the reporting company and may generate litigation and/or reputational risks.[37]

As another illustration, also consider the corporate actions towards decarbonization. While the reduction of carbon emissions has a positive effect on climate change and global warming, it also yields financial effects on the reporting company. Lower carbon emissions entail lower transition risks, which is a component of climate risk. The transition from a high- to low-carbon business model also involves financial costs.[38] Litigation on grounds of harm to the environment or violations of human rights provides another example of how corporate value can be affected negatively by the impacts of the company's activity on people or the environment. As Engler put it, '[e]nvironmental impacts could translate into financial risks, for

[36] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 3.3 para. 38.

[37] FSB n. 27 above, 16; Stephenson Harwood LLP, *ESG and Litigation Risks*, July 2021, 1 (describing the costs arising from ESG litigation to companies).

[38] FSB n. 27 above, 12-16.

example, through legal liabilities or harms to a company's reputation.'[39] Besides the direct and indirect financial losses that sustainability-related litigation may cause an organization (such as fines, damages, and expenses), sustainability issues often concern very high-profile events that can significantly impact a company's goodwill, reputation, and its relationships with employees, customers, business partners, and other stakeholders.[40]

The ESRS rules have explicitly accounted for these two different effects that may arise from the impacts of corporate activity and determined that the financial effects can be reported separately from the social or environmental impacts, although the company is allowed to decide how to best organise its own reporting.[41] In a way, impact materiality is rooted in the notion that the company ought to report information that shows the impacts of its activity on the environment and society irrespective of any corporate value effects of such impacts. As Engler pointed out, '[t]he idea of double materiality comes from a recognition that a company's impact on the world beyond finance can be material, and therefore worth disclosing, for reasons other than the effect on a firm's bottom line.'[42] This dissonance between financial materiality and impact materiality is identified by Bradford et al. identifying a 'potentially significant disconnect between the business view of sustainability as an instrument to achieve economic goals [e.g., the view of creditors] and the stakeholder view of sustainability as an end in itself [e.g., the view of a civil society prioritising the protection of air quality].'[43] Whereas the former

[39] Henry Engler, *"Double materiality": New legal concept likely to play in debate over SEC's climate plan*, Thomson Reuters Regulatory Intelligence, 12 April 2022.

[40] Harwood LLP n. 37 above, 1 (Introduction section).

[41] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 3.3, para. 38. EFRAG n. 26 above, para. 5 and para. 15.

[42] Engler n. 39 above.

[43] Marianne Bradford, Julia B. Earp, D. Scott Showalter, and Paul F. Williams, *Corporate sustainability reporting and stakeholder concerns: is there a disconnect?*, 31(1) Accounting Horizons 83-102 (2017) 93 (straight brackets

concentrates on the financial effects and value derived from the company's activity, the latter focuses on, strictly speaking, the social and environmental outcomes of corporate actions.

As mentioned earlier in this section, the ESRS rules utilise the terms 'risks and opportunities' to designate those sustainability-related financial effects that are identified through the evaluation of financial materiality,[44] whereas the term 'impacts' refers to impacts on sustainability matters connected to the undertaking's business and identified through the impact materiality assessment.[45] As put by EFRAG, collectively 'these are referred to as "impacts, risks and opportunities"' and '[t]hey reflect the double materiality perspective of ESRS (…).[46] Conceived and conceptualised in EU policy, the double materiality approach has become central to corporate sustainability reporting. In this context, it is relevant to identify and examine those key drivers that motivated the European Commission to adopt this approach. These justifications are developed and examined in the following sections of this article.

III. Justifications for Impact-Related Information Disclosure Following the Impact Materiality Approach

A. Aligning Corporate Activity with Sustainable Development Outcomes

In creating sustainability-related disclosure requirements, the ESRS rules drew from existing reporting frameworks with an emphasis on the standards produced by the International Sustainability Standard Board (ISSB) and the Global Reporting Initiative (GRI). In relation to

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added) (The authors found a good basis for sustainability-related reporting in the GRI standards, yet the authors also acknowledged that GRI standards do not reflect the expectations of all stakeholders).

44 ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements, s. 1.3 para. 14(b).

45 Ibid., para. 14(a).

46 Ibid., para. 14.

sustainability impacts, the drafters of the ESRS rules aimed to incorporate 'to the greatest extent possible the content of GRI standards, including key concepts in the GRI Universal Standards.'[47] Adopted voluntarily by companies around the world, the GRI standards have revolved around the disclosure of material topics in terms of 'topics that represent the organization's most significant impacts on the economy, environment, and people, including impacts on their human rights.'[48] Impact is defined in terms of 'the effect an organization has on the economy, the environment, and/or society, which in turn can indicate its contribution (positive or negative) to sustainable development'.[49] Therefore, in the realm of GRI reporting, the material status of information is closely connected to information that shows the impact effects of a company's activity on sustainable development goals as defined in the United Nations 2030 Agenda through the seventeen UN Sustainable Development Goals (SDGs).[50]

Another policy that lies at the heart of the CSRD and the ESRS rules is the European Green Deal.[51] The European Green Deal has aimed to promote the decarbonization of the EU economy and to mitigate loss in, and restore, biodiversity. Through the European Green Deal, among other policies, the EU has implemented the United Nations 2030 Agenda and the

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[47] EFRAG, *Draft European Sustainable Reporting Standards*, Cover Letter, 22 November 2022, 2.

[48] General Reporting Initiative (GRI) 1: Foundations 2021, Glossary, term: material topics, (GRI) website accessed 8 May 2023), https://www.globalreporting.org/how-to-use-the-gri-standards/gri-standards-english-language/.

[49] Ibid., term: impact.

[50] Resolution A/RES/70/1 adopted by the UN General Assembly on 25 September 2015, Declaration para. 2; GRI (48) (linking material topics for reporting with the UN Sustainable Development Goals).

[51] ESRS DR n. 2 above, 5 ('These consultations confirmed that the draft standards submitted by EFRAG broadly meet the mandate of the CSRD and would achieve the intended policy goals in the context of the European Green Deal.'). The EU has classified the 17 SDGs into 6 broad policy actions. The European Green Deal concentrates on those SDGs connected to climate change and environmental problems: European Commission, Communication from the Commission to the European Parliament, The European Council, The Council and the European Economic and Social Committee and the Committee of the Regions (European Green Deal), Brussels, 11.12.2019 COM(2019) 640 final.

SDGs.[52] The CSRD is basically a product of the European Green Deal and of the EU Sustainable Finance Action Plan implemented by the European Commission.[53] Among other goals, the aim of sustainable finance is to reorient capital allocation decisions so that such decisions are driven not only by corporate financial performance but also by corporate sustainability performance.[54] Disclosure of sustainability-related information assists this objective, while promoting transparency and long-termism in financial markets.[55]

In short, corporate sustainability reporting under the CSRD and the ESRS rules, in particular impact-related reporting, has been conceived within a wider policy frame that aims to align corporate activity with the promotion of sustainable development. Such an objective is consistent with the GRI standards and the European Green Deal, both influencing the CSRD and the ESRS rules.[56] It is important to note, however, that although the CSRD and the ESRS rules support the United Nations (UN) model of sustainable development goals, these two regimes are distinct. In terms of Iris Chiu, '[t]he sustainable goals developed in the EU's sustainable finance policy overlap to an extent but do not map fully on the United Nations' Sustainable Development Goals…'[57] In this sense, the legal definition of sustainability under

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[52] Resolution A/RES/70/1 (n 50) Declaration para. 2.

[53] CSRD n. 1 above, recital 1 ('In its communication of 11 December 2019 entitled "The European Green Deal" (…), the European Commission made a commitment to review the provisions concerning non-financial reporting of Directive 2013/34/EU of the European Parliament and of the Council.'); EU Commission, 'Action Plan: Financing Sustainable Growth' Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions (Brussels, 08 March 2018 COM(2018) 97) 2 (hereinafter 'EU Action Plan').

[54] Ibid., EU Action Plan, s. 1.1.

[55] Ibid., s. 1.3.

[56] Veerle Colaert, *The changing nature of financial regulation sustainable finance as a new policy goal*, Working Paper No. 2022/04 (April 2022) 8-10 (explaining that sustainable development objectives in Europe can be traced back to the European treaties and that sustainability is a 'constitutionally enshrined objective of the European Union').

[57] Iris H-Y Chiu, *The EU sustainable finance agenda: developing governance for double materiality in sustainability metrics*, 23(1) European Business Organization Law Review 87-123 (2022) 97. Also, Iris H-Y Chiu, *Regulating Sustainable Finance in Capital Markets: A Perspective From Socially Embedded Decentered*

the CSRD and the ESRS rules (e.g., sustainable investment or impact) does not flow from the UN SDGs. It instead draws from the CSRD's definition of 'sustainability matters',[58] and from other related sources of EU law, such as the SFDR's definition of sustainability factors, sustainable investments, and principal adverse impacts,[59] the definition of sustainability preferences in MiFID II,[60] and the definition of environmentally sustainable economic activities under the EU Taxonomy.[61]

B. Promoting Corporate Accountability

A corporate accountability explanation to the impact materiality approach thinks of the company as bearing responsibility for its own actions towards society and, more particularly, stakeholders. It also views the impact materiality approach not as a narrowly defined reporting concept but, instead, as a central feature fostering a wider corporate policy aimed at developing sound impact management systems and strategies.

Regulation, 84(1) Law and Contemporary Problems 2021 75 ('Sustainable Finance is an umbrella term that generally refers to private-sector financing for causes related to achieving environmentally or socially sustainable outcomes, such as those articulated in the United Nation's Sustainable Development Goals (SDGs). These include economic development and financial inclusion.').

[58] CSRD n. 1 above, art. 2(2)(b) (adding art. 2(17) to the Accounting Directive). See section II of this article.

[59] SFDR n. 20 above, art. 2(22), art. 2(24) and art. 4. Also, Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 [L196/1 OJ 25.07.2022] supplementing Regulation (EU) 2019/2088 of the European Parliament and of the Council (hereinafter 'SFDR DR 2022/1288').

[60] Commission Delegated Regulation (EU) 2021/1253 of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms, OJ L277/1 2.08.2021 [hereinafter 'MiFID II DR 2021/1253']. More recently, amendments were also made to ESMA's guidelines on suitability requirements, ESMA, *Guidelines on Certain Aspects of the MiFID II Suitability Requirements*, ESMA35-43-3172, 23 September 2022 (hereinafter 'Guidelines on Suitability').

[61] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020) (hereinafter 'EU Taxonomy Regulation').

The aim of steering companies towards responsible business practices is first observed from the strong expectations placed on companies to adequately manage impacts through due diligence processes.[62] This philosophy is also observed in the ESRS rules when defining impact materiality and the due diligence processes needed to support the evaluation of such materiality. The ESRS rules on impact materiality draw from the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, which are guidelines and principles aimed at fostering due diligence and responsible business conduct.[63] The GRI standards have also looked at these OECD guidelines and UN principles to justify underlying expectations for responsible business conduct.[64] In addition to rules and guiding principles, the achievement of accountable business conduct requires effective monitoring. More particularly, corporate reporting enables shareholders and other stakeholders to scrutinise business conduct and its impact on the outside world.[65] In explaining the reasons for corporate sustainability reporting, the Commission has stated that such information assists 'civil society actors, including non-governmental organisations and social partners, which wish to better hold undertakings to account for their impacts on people and the environment.'[66] Within this framework that encourages responsible businesses, the ESRS rules strongly

[62] CSRD n. 1 above, recital 31.

[63] The GRI has explicitly acknowledged the consistency of its objectives with those stated in the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, GRI n. 48 above, GRI 1: Foundations 2021, section 1.1; ESRS DR n. 2 above, ESRS 1 General Requirements, Annex I, s. 3.4, paras. 45-46, s. 4 para. 59 and Appendix A.

[64] GRI n. 48 above, GRI 1: Foundations 2021, s. 1.1.

[65] Chiara Mosca and Chiara Picciau, *Making Non-Financial Information Count: Accountability and Materiality in Sustainability Reporting* (February 10, 2020), Bocconi Legal Studies Research Paper No. 3536460, section II.4, available at https://ssrn.com/abstract=3536460.

[66] CSRD n. 1 above, recital 9.

promote accountable corporate conduct measured by the ability of the reporting company to manage, through corporate processes, the impacts of its business activity.

The information disclosures required by the ESRS rules include a description of the process that the company is expected to follow in order to determine relevant impacts and evaluate the materiality of such impacts.[67] Yet, these ESRS disclosures do not stop at this point. The company is also required to report on the policy and actions it has adopted to manage impacts (as well as to manage risks and opportunities).[68] More particularly, the ESRS rules set out minimum disclosure requirements regarding the company's 'policies and actions to prevent, mitigate and remediate actual and potential material impacts, to address material risks and/or to pursue material opportunities (…)',[69] as well as actions to achieve the objectives and targets of such policies.[70] Moreover, the company is required to disclose information on the metrics it uses to evaluate material impacts, risks or opportunities, as well as to track the effectiveness of its actions and policy targets to manage impacts, risks and opportunities.[71] All these policies, actions, metrics and targets are basically administered by the company through due diligence.[72] Importantly, these disclosure requirements are mandatory-in-all-cases rules (they are set out in the ESRS 2 'General Disclosure'), a fact that shows the high priority status granted to these requirements by the ESRS drafters.

[67] ESRS DR n. 2 above, Annex I, ESRS 2 General Disclosures, s. 4.1, and Annex I, ESRS 1 'General Requirements' s. 4 para. 59.

[68] ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements' s. 4 para. 59, and Annex I, ESRS 2 General Disclosures, s. 4.2.

[69] ESRS DR n. 2 above, Annex I, ESRS 2 General Disclosures, s. 4.2 para. 60 (black and indented letters removed).

[70] Ibid., para. 67.

[71] Ibid., s. 5 paras. 74-75 and paras. 78-81.

[72] ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements' s. 4, para. 59.

Although, these are disclosure requirements that do not impose any 'conduct requirements' on companies in relation to due diligence (e.g., to what extent and how a company decides to establish due diligence processes),[73] such disclosures could induce the reporting companies to actually alter their business policy and behaviour. Enjoying greater transparency from disclosure, investors and other stakeholders may react and induce the company to engage in activities with positive impacts or abandon activities with negative impacts on society or the environment. Users of sustainability reports will be placed in a better position to monitor corporate performance and decision-making, and this way exercise tighter scrutiny.[74] In addition to corporate governance conduits, benchmarking by industry rivals has been cited as another channel through which information disclosure can provoke real change in corporate actions: 'firms want to avoid the public backlash associated with looking worse than their peers.'[75] With impact materiality rules being a central driver of disclosure on impact-related information and, potentially, of impact management processes, the role of impact materiality in influencing corporate accountability becomes evident. Moreover, since the impact management process is not a purely internal process of the reporting company, this process is expected to involve the actual interaction of the company with its stakeholders. To this extent, impact management can also foster accountability in the company-stakeholder relationships. In terms of Adams et al., '[t]he enhanced stakeholder engagement required by the double-materiality analysis contributes to diverse and reciprocal accountability relationships between

[73] Ibid., para. 58.

[74] Christensen et al. n. 10 above, s. 5 1210-1218.

[75] Ibid., 1215.

the organisations, their stakeholders, and the wider society and enables discussions and evaluations on sustainable development'.[76]

It is noted that the company-stakeholder interaction is a salient feature in the ESRS rules. The determination of impacts enables collaboration between the reporting company and 'affected stakeholders.'[77] In this sense, the term affected stakeholder is critical to the identification, management, and disclosure of impacts. Affected stakeholders are 'individuals or groups whose interests are affected or could be affected–positively or negatively—by the undertaking's activities and its direct and indirect business relationships across its value chain'[78] Although prior research has shown that stakeholder engagement has not achieved the expected levels,[79] the ESRS rules provide a way forward towards increased accountability in the area of stakeholder engagement. Again, although the ESRS rules mandate the disclosure of information showing the extent to which and how the reporting company has engaged its stakeholders, such rules do not impose conduct requirements and, therefore, the type and scope of actual stakeholder engagement remains still a discretion of the reporting company.[80]

[76] Carol A. Adams, Abdullah Alhamood, Xinwu He, Jie Tian, Le Wang, and Yi Wang, *The Double Materiality Concept: Application and Issues*, published by the Global Reporting Initiative (2021) 6 (citing several sources).

[77] ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements' s. 3.3 para. 38 and Annex A, ARs 6-7.

[78] Ibid., s. 3.1 para. 22(a).

[79] Silva Samanthi, Anne-Katrin Nuzum, and Stefan Schaltegger, *Stakeholder expectations on sustainability performance measurement and assessment. A systematic literature review*, 217 Journal of Cleaner production 204-215 (2019) 212 (finding that 'stakeholders in practice are dissatisfied with existing approaches' due to 'a lack of explicit consideration of stakeholder expectations in the sustainability performance measurement and assessment').

[80] ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements' s. 4 para. 59 and Annex II, ESRS 2 General Disclosures, s. 4 (impact, risk, and opportunity management).

C. Developing Markets for Sustainable Investment Products

A clear understanding of the impacts of corporate activity on people and the environment is critical for the development of consumer and financial markets that care about sustainable development. Evidently, consumer markets are essential for companies as these markets generate vital revenues. In turn, consumers in such markets are increasingly sensitive to the green credentials of companies and their products.[81] Financial markets are also essential as they provide the capital to finance corporate activity and expansion. This section focusses on the role of impact-related information in the development of financial markets and, more particularly, the development of sustainable investment products. Markets for sustainable investment products have grown steadily in Europe and internationally, with global Environmental Social and Governance (ESG) assets estimated to surpass US$50trillion by 2025.[82] European markets are leading this trend. They have become increasingly eager to evaluate the sustainability performance of investments in term of sustainability risk (e.g., climate risk and other financial effects) and in terms of the impacts of corporate activity.[83] In this context, corporate sustainability reporting is a primary source of data that spills over all the other actors operating across the financial markets such as data service providers, rating

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[81] McKinsey & Company Consumers care about sustainability—and back it up with their wallets, (6 February 2023 written by J Bar Am, V Doshi, A Malik, S Noble and S Frey), https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/consumers-care-about-sustainability-and-back-it-up-with-their-wallets (Evaluating the US markets and recommending companies to bring 'environmentally and socially responsible products to market as part of overall ESG strategies and commitments. Creating such products turns out to be not just a moral imperative but also a solid business decision.') (accessed 15 November 2023).

[82] Bloomberg Intelligence Report (2022) (accessed 14 September 2023), https://www.bloomberg.com/company/press/esg-may-surpass-41-trillion-assets-in-2022-but-not-without-challenges-finds-bloomberg-intelligence/.

[83] Natalie Brandau and Jo Freeman-Young, *How ESG data markets have evolved for financial services*, EY (21 March 2023), https://www.ey.com/en_gl/financial-services-emeia/how-esg-data-markets-have-evolved-for-financial-services ('Investor demand is a key driver of growth in the ESG data market.'). In the 2019 Guidelines (n. 35 above) the Commission had already anticipated this phenomenon. It highlighted the interest of investors, including asset managers, in the 'impact' pillar of double materiality, namely the social and environmental materiality.

agencies, index administrators, asset managers, creditor institutions, investors, and securities exchanges. All these actors depend largely on quality corporate data to service the needs of their clients and develop new products and markets.[84]

As an illustration, consider the client-provider relationship in investment services. Here, the conventional rationale is to deem investors (clients is the terminology used in MiFID II) as profit-maximiser actors, yet evidence has shown that investors are increasingly driven by preferences based on sustainable investments in the form of mixed strategies that combine financial returns and social or environmental goals.[85] Profit-driven mainstream investors have often pursued social or environmental investment objectives, yet they have done so for utilitarian purposes. That is, those investors prefer sustainable investments only when such investments contribute to maximising their targets for short-term financial returns.[86] Other investors showing sustainability preferences may forego returns to advance social or environmental goals. These latter investors are motivated by both financial returns and gains for the environment and society.[87] Although corporate sustainability reporting is essential to both groups of investors, impact-related data caters especially to the latter group of investors showing sustainability preferences.[88] In the client-provider relationship, such sustainability

[84] Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings, Data and Research*, November 2020 (study prepared for the European Commission).

[85] 2 Investing Initiative, *A Large Majority of Retail Clients Want to Invest Sustainably: Survey of French and German Retail Investors*, Sustainability Objectives, March 2020, 5-9.

[86] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 University of Colorado Law Review 733 (2019), 750-754 (looking at evidence indicating that ESG portfolios have performed equal or better than traditional portfolios); Friede, Gunnar, Timo Busch, and Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. Sustainable Fin & Inv. 4 (2015), 210-33 (linking superior ESG performance with superior equity performance).

[87] University of Cambridge Institute for Sustainability Leadership, *Walking the talk: Understanding consumer demand for sustainable investing* (Cambridge UK; 2019); Department of International Development, *Investing in a Better World. Survey Results* (UK; September 2019).

[88] Drawing from the CSRD and ESRS rules, multiple actors are interested in impact-related disclosures. In addition to investors, other stakeholders are expected to use the reported information including NGOs, consumers,

preferences have recently been recognised and protected by the law through modifications introduced to the MiFID II rules.

Those reforms of the MiFID II rules have explicitly stated that investors as clients have a wide distribution of investment objectives including the preference to invest sustainably.[89] More particularly, the MiFID II suitability requirements have been modified to accommodate this fact.[90] As a result of this reform, the providers of investment services shall satisfy the client's investment objectives even when such objectives contain sustainability preferences. When the client-provider relationship is governed by a mandate, MiFID II suitability requirements aim to ensure that service providers recommend investment products, or manage investment portfolios on behalf of their clients, that are suitable for those clients. In this process, the suitability assessment identifies and accounts for the clients' characteristics, investment knowledge and experience, financial capacity and investment objectives.[91] Such investment objectives include the choice by investors of investments that, to a greater or lesser extent, contain sustainability properties.[92]

government, and civil society, among other actors monitoring the influence of corporate activity on people and the environment, CSRD n. 1 above, recital 9. Also, 2019 Guidelines n. 35 above, 6–7.

[89] Félix E. Mezzanotte, *Accountability in EU Sustainable Finance: Linking the Client's Sustainability Preferences and the MiFID II Suitability Obligation*, 16 CAP. MARKETS L.J. 482 (2021).

[90] Suitability requirements are set forth in art. 25(2) of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L173/349 (hereinafter 'MiFID II'). The regime governing suitability requirements is also governed by the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive [2017] OJ L87/1 (hereinafter 'MiFID II DR 2017/565'). The key instrument driving the reform was the Commission Delegated Regulation 2021/1253 (n. 60), which modified the MiFID II DR 2017/565.

[91] Ibid., MiFID II art. 25(2).

[92] The legal definition of sustainability preferences is set forth in art 1(1) of MiFID II DR 2021/1253 (n. 60 above) (adding art. 2(7) to MiFID II DR 2017/565).

In this context, it is evident that investment service providers cannot discharge such MIFID II duties in the client-provider relationship without adequate corporate sustainability information, including impact-related data, needed for product selection and monitoring.[93] In addition to suitability requirements, another related process that requires this information is the manufacturing and distribution of investment products. MiFID II product governance rules have also been modified to require that the manufacturing and distribution of investment products meet the characteristics of potential clients falling in the identified target market, including the clients' sustainability preferences.[94] In addition, due compliance with disclosures sought by both the MiFID II information-to-client rules and the SFDR cannot be achieved without quality corporate sustainability data.[95] This fact places those financial intermediaries selling and marketing sustainable investment products in a position of functional dependence to the extent that the provision of adequate corporate sustainability data is, at the source, undertaken by the very reporting companies.[96] Due to this systemic element, were corporate sustainability data to prove insufficient or inaccurate, this problem would necessarily distort the functioning and development of financial markets. All in all, corporate sustainability

[93] Anastasia Petraki, *Sustainability Preferences and How to Assess Them*, Schroders Report (July 2022) (identifying challenges that investment advisers will face when implementing suitability requirements that include sustainability preferences, especially data challenges).

[94] Product governance requirements are laid down in MiFID II (n. 90) art. 16(3) and art. 24(2). This is supplemented by the Commission Delegated Directive (EU) 2017/593 of 7 April 2016 (OJ L87, 31.3.2017, 500-517). The integration of sustainability into the product governance process was made through Commission Delegated Directive 2021/1269 of 21 April 2021 amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations, OJ L 277/137 2.8.2021. Subsequently, the Guidelines applicable to product governance were also updated, ESMA, *Guidelines on MiFID II product governance requirements*, 03/08/2023 ESMA35-43-3448.

[95] SFDR n. 20 above.

[96] Félix E. Mezzanotte, *EU Sustainable Finance: Complex Rules and Compliance Problems*, 42(2) Review of Banking and Financial Law 845-96 (2023), s. II and s. V.

disclosure is essential for the development of investment products and markets in a way that ensures transparency and due compliance with existing laws and regulations.

IV. Discussion

It was argued in section III.A of this article that the choice of a double materiality approach for corporate sustainability reporting under the CSRD and ESRS rules has been justified by a policy trajectory that promotes the alignment of corporate behaviour with sustainable development objectives. In this context, it is evident that the success of the European Commission in adopting double materiality could not have been achieved without first gathering a wide political consensus. Double materiality, and more particularly impact materiality, is an innovative approach to corporate sustainability reporting that poses deep, divisive questions such as questions on the purpose that companies should pursue, or questions on the role that investors, and even the financial sector, should play in light of environmental and social policy.[97] An obstacle in exporting the use of double materiality to non-EU jurisdictions may precisely reside in the difficulty of achieving the necessary political consensus in support of such reforms. Consider the case of the United States, for example, where disagreement around the purpose and scope of corporate sustainability reporting has been substantial,[98] a fact that has constrained the reform process to operate largely within the

[97] For example, Arnim Wiek and Olaf Weber, *Sustainability challenges and the ambivalent role of the financial sector*, 4:1 Journal of Sustainable Finance & Investment 9-20 (2014); Olaf Weber, *The financial sector's impact on sustainable development*, 4:1 Journal of Sustainable Finance & Investment 1-8 (2014); Guido Ferrarini, *Redefining Corporate Purpose: Sustainability as a Game Changer* in *Sustainable Finance in Europe: Corporate Governance, Financial Stability and Financial Markets*, 85-150 (Danny Busch, Guido Ferrarini and Seraina Grünewald eds., Springer International Publishing 2021).

[98] See for example the article authored by the US Former Vice President Mike Pence arguing against ESG in the financial sector and corporate business, Wall Street Journal, *Republicans Can Stop ESG Political Bias* (26 May 2022 written by Mark Pence) and the article authored by US Former Vice President Al Gore arguing for ESG investments, Wall Street Journal, *ESG Investing is Consistent with Fiduciary Duty* (8 November 2022 written by Al Gore and David Blood). Also, Wall Street Journal, *The ESG Investing Backlash Arrives*, Opinion, Editorial Board, 16 August 2022; Wall Street Journal PRO, *ESG Regulatory Divide Poses Challenges for Asset Managers* (28 November 2022 written by Luis Garcia).

boundaries of the single materiality paradigm focusing on climate-related risks.[99] It is therefore vital that the EU institutions continue nourishing consensus and trust regarding corporate sustainability reporting and double materiality during the rule implementation process.

A serious problem that has the potential to undermine such consensus and trust is greenwashing. Greenwashing is 'a practice where sustainability-related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, financial product, or financial service. This practice may be misleading to consumers, investors, or other market participants.'[100] As explained by the European Securities and Markets Authority (ESMA), greenwashing risk at the issuer level includes, among other claims, misleading claims on, or omissions of, impact-related performance.[101] Since the widespread presence of greenwashing would fatally injure trust on companies' behaviour and disclosures, it is essential that the recent reforms aimed at mitigating greenwashing, including the SFDR, the EU Taxonomy, and the CSRD,[102] be adequately implemented. These new rules have represented crucial legislative steps to fight greenwashing and advance underlying policy goals, yet their effectiveness will be curtailed if rule compliance is not warranted. The role of regulators and supervisors will therefore be paramount to ensure that progress is made towards the achievement of sustainable development objectives,[103] as

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[99] The Securities and Exchange Commission (SEC) has proposed new climate-related risk disclosures. It has stated that the new information disclosures 'would include climate-related risks that are reasonably likely to have a material impact on their businesses, results of operations, or financial conditions as well as certain climate-related financial statement metrics in a note to their audited financial statements.' SEC website (accessed 16 September 2023), https://www.sec.gov/securities-topics/climate-esg.

[100] European Securities and Markets Authority (ESMA), *Progress Report on Greenwashing*, ESMA30-1668416927-2498, 31 May 2023, 11.

[101] Ibid., 20-21 and 30-39.

[102] SFDR n. 20 above; EU Taxonomy n. 61 above; CSRD n. 1 above.

[103] The CSRD has relied on a regime whereby NCAs will supervise and enforce compliance with sustainability reporting rules, CSRD n. 1 above, recital 59 and recital 79.

will the role of auditors because the CSRD has prescribed for sustainability reports to be externally audited.[104]

This article has also identified corporate accountability as another critical policy objective underlying the disclosure of impact-related information as guided by the impact materiality approach. It has been argued in section III.B that under the ESRS rules, corporate accountability and impact management are closely related objectives. This is because ESRS rules require companies to disclose information on their processes for impacts management and the consequent outcomes. Although such disclosure requirements need not lead to behavioral changes—as they are not conduct requirements, they nevertheless signal clear expectations on corporate behavior.[105] According to such expectations, having in place sound due diligence processes that adequately manage sustainability risks and impacts is a critical factor towards responsible businesses.[106] The ultimate rationale is that companies will show accountability by acquiring, through impact management policy and processes, the ability to minimise and remedy negative impacts on people and the environment, and the ability to maximise positive impacts. Adequate impact management can also prove a key strategy to minimise ex-post litigation against the reporting companies (financial risk), which is a relevant issue due to the substantial increment in litigation activity observed.[107]

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[104] Ibid., art. 1(12) and art. 1(13) (amending art 34 Accounting Directive), and arts. 2-4.

[105] This point has been noted in section III.B of this article.

[106] The CSRD conveys a clear message in this direction as well, CSRD n. 1 above, recital 31.

[107] Jones Day, *ESG—Climate Change and Related Litigation Take Center Stage in Europe*, White Paper (December 2022). Litigation is growing particularly in the United States where sustainability-related lawsuits have been entered relying on a wide range of statutory provisions, Kate Gee and Alex Cheah, *With greenwashing lawsuits proliferating, boards need to step up scrutiny of ESG claims*, Reuters, Comment, 21 August 2023; David Hackett, Reagan Demas, Douglas Sanders, Jessica Wicha, and Aleesha Fowler, *Growing ESG Risks: The Rise of Litigation*, 50 Envtl. L. Rep. 10849 (2020); Stephenson Harwood LLP n. 37 above.

With disclosure and transparency acting as incentives for companies to take action and build up sound impact management policy and processes, the power of those ESRS rules to compel compliance is a relevant factor to account for. It therefore matters whether these disclosure rules work on a mandatory, comply-or-explain, or voluntary basis. Although the CSRD has been presented as giving rise to mandatory rules on corporate sustainability reporting, the reality of the ESRS rules suggests that these mandates are less stringent than initially envisioned. Along the extensive process of public consultation on the design of the ESRS rules, a gradual weakening of the mandates has been observed.[108] Relative to the initial ESRS proposal submitted by EFRAG as drafters, the number of ESRS mandatory rules have been reduced importantly. The draft ESRS rules of November 2022 issued by EFRAG had given mandatory-in-all-cases status to a significant number of topics and disclosure requirements, including the ESRS 2 'General Disclosures', ESRS 2 'General Disclosures' Appendix C (disclosure standards that are required by EU law) and Appendix D, ESRS E1 Climate Change (all disclosure requirements and datapoints) and ESRS S1 Own workforce (for companies with 250 or more employees), among other disclosures. More recently, following the European Commission's scrutiny of these draft ESRS rules, the number of mandatory-in-all-cases rules were reduced significantly—only the ESRS 2 'General Disclosures' rules were kept as mandates regardless of materiality assessment, whereas the other set of rules became mandatory subject to the materiality assessment.[109]

[108] ESRS DR n. 2 above, Explanatory Memorandum, s. 2. The ESRS rules underwent several phases of public consultation, with the last public consultation being called by the European Commission on 9 June 2023 to collect feedback from proposed changes to the November 2022's Draft ESRS rules produced by the European Financial Reporting Advisory Group, (accessed 16 September 2023), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en.

[109] ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements' s. 3.2, para. 29.

In this latter case of materiality-guided reporting, EFRAG had first proposed a materiality assessment process that relied on a (rebuttable) presumption of materiality of all topics and disclosure requirements contained in the ESRS rules.[110] In order to not disclose, the reporting company would have been forced to challenge this presumption. Yet later in the rulemaking process, the Commission changed this stance and instead approved a different system whereby almost all mandatory disclosure requirements must be met depending on the results of a materiality evaluation of the information. This evaluation, undertaken by the reporting company, includes both the financial and the impact materiality assessments.[111] This means that a company will report on the critical ESRS rules, such as ESRS E1 Climate Change and ESRS S1 Own workforce, only if, following a materiality evaluation, the company concludes that the information is material and, therefore, must be reported.[112] Although the effects of these last-ditch changes made by the Commission to the ESRS rules—changes that curtailed the coerciveness power of such rules—cannot be totally anticipated, respondents to the latest public consultation launched by the Commission stated their opposition to these changes because, among other reasons, the crucial role given to the materiality assessment would lower the quality and comparability of reporting, frustrating this way the ambitions of the CSRD.[113]

The concern with the materiality assessment is that it allows corporate officials to exercise a wide scope of discretion in selecting sustainability matters and in determining the information to be disclosed for each one the selected sustainability matters (e.g., discretion in determining

[110] EFRAG, Draft ESRS 1 'General Principles' Basis for Conclusions, May 2022, BC54-BC63.

[111] Section II of this article. ESRS DR n. 2 above, Explanatory Memorandum, s. 2.

[112] Ibid., ESRS DR, Annex I, ESRS 1 'General Requirements' s. 3.2, para. 29.

[113] Comments to the Public Consultation submitted by Reclaim Finance (in file with the author).

thresholds of severity and likelihood of impacts and in prioritising impacts).[114] In the presence of such discretion, the behavior of corporate officers is influenced by incentives that need not operate to support stakeholders or by incentives that might promote opportunistic behavior.[115] Moreover, the obligation born by the reporting company to explain the rationale supporting their assessment of materiality has recently also been downgraded from a mandatory rule status to a voluntary rule status in all cases except for the materiality evaluation of ESRS E1 Climate Change and ESRS 2 'General Disclosures' Appendix C (disclosure standards that are required by EU law).[116] Disclosures in relation to a company's biodiversity transition plans, and in relation to non-employees in the company's own workforce have also become voluntary rules.[117] Despite this situation, the fact that ESRS 2 'General Disclosures' rules have remained mandatory irrespective of the materiality assessment (mandatory-in-all-cases rule) is an encouraging development from the perspective of impacts-related disclosure (as ESRS 2 'General Disclosure' rules require such disclosures) and of impact management because mandatory rules promote compliance with greater force, strengthening this way the behavioural incentives triggered by public disclosure.[118]

In section III.C of this article, it was noted that a connection exists between the notions of impact materiality (and impact-related information) and that of an investor's preferences for sustainable investments. The investors that prefer to invest with the purpose of achieving a

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[114] ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements', Appendix A, AR 9(c).

[115] For example, Lucian A. Bebchuk and Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 Cornell Law Review 91 (2020); Lucian A. Bebchuk and Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?* 75 Vanderbilt Law Review 1031 (2022); Lucian A. Bebchuk, Kobi Kastiel and Roberto Tallarita, *Stakeholder Capitalism in the Time of COVID*, 40 Yale Journal of Regulation 60 (2023).

[116] ESRS DR n. 2 above, Explanatory Memorandum, s. 2.

[117] Ibid.; ESRS DR n. 2 above, Annex I, ESRS 1 'General Requirements' para. 32.

[118] Christensen et al. n. 10 above, s. 4.6 1208-10.

social or environmental impact require—as information users—impact-related information to evaluate and make their investment decisions. The legal recognition of both impact materiality, under the CSRD and ESRS rules, and sustainability preferences under MiFID II are thus inter-connected developments. Closely related, impact-related information also serves the providers of investment services in their effort to comply with the statutory duties to supply information and suitable products to their clients. Adopting the double materiality approach to corporate sustainability reporting, as opposed to single materiality approach, recognises and facilitates this sustainable investment model that goes beyond the mere integration of sustainability risk.

In aligning investors' preferences and double materiality, the EU has provided statutory backing to a conceptualization of the average investor that accommodates sustainability preferences widely defined. More specifically, this is an investor that makes decisions based not only on financial risks and return but also on the impacts of the investment on people and the environment. This characteristic of the average investor can also be inferred from legal definitions stated in other EU sustainable finance rules, such as the definition of 'sustainable investment'[119] or the definition of 'principal adverse negative impact' on sustainability factors.[120] This EU approach distinguishes the longstanding position upheld by the federal securities laws in the United States, where both the corporate reporting regime and the investor profile definition—the reasonable investor paradigm—have thus far been conceptualised within the scope of single (financial) materiality.[121] By statutorily recognizing sustainability

[119] SFDR n. 20 above, art. 2(22).

[120] SFDR DR 2022/1288 n. 59 above, Annex I, supplementing the SFDR (n. 20 above).

[121] George S. Georgiev, *The SEC's Climate Disclosure Rule: Critiquing the Critics*, 50 Rutgers L. REC. 101 (2022), s. IV (distinguishing the materiality principle in the United States from the double materiality principle in the European Union); Aisha I Saad and Diane Strauss, *A New "Reasonable Investor" and Changing Frontiers of Materiality: Increasing Investor Reliance on ESG Disclosures and Implications for Securities Litigation*, 17 Berkeley Bus. LJ 391-433 (2020), 292-397 (claiming that the modern investors also rely on ESG data to make

preferences, the EU has introduced profound changes aimed at integrating sustainability risks and impacts in the development of products and markets. Nevertheless, these recognitions in the EU legal regime will also pose new challenges.

One of those challenges is connected to the gathering of data and metrics. Data collection and evaluation is necessary to properly identify the sustainability preferences of investors and the consequent satisfaction of these preferences by the service providers through suitable investment products.[122] In this context, the needs of investment service providers for sustainability-related information are substantial. Such information is essential to inform clients, create new products and continuously monitor investment portfolios. However, that impact-related data will achieve the expected quality is not evident. The determination of facts that exist outside the company can be negatively affected by factual uncertainty, observability and/or measurement problems.[123] Observations require resources and they can be costly to perform. Limited capacity and resources curtail a company's ability to observe facts, learn about them, and measure them.[124] Impact metrics can prove inaccurate where measurement relies on estimations based on strong assumptions.[125]

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investment decisions and that, to this extent, materiality under the US federal laws disclosure regime should cover a wider scope of information).

[122] Mezzanotte n. 96 above, s. III.A (describing the problems of interpretation and compliance afflicting the MIFID suitability requirements and the SFDR disclosure rules especially in the context of sustainable investments).

[123] Adam I. Muchmore, *Uncertainty, Complexity, and Regulatory Design*, 53 Hous. L. Rev. 1321 (2016), 1338-39.

[124] Ibid., 1338 and 1346-47.

[125] ESRS DR n. 2 above, Annex I, ESRS 1 General Requirements s. 7.2; Virginia Harper Ho, *Climate Disclosure Line-Drawing & Securities Regulation*, SSRN Working Paper 4339497 (2023), 22-28 (discussing the quality of estimations of climate risk in corporate reporting and litigation risk in the context of the SEC's proposed climate-related reporting rules).

This problem of determining impacts may produce information of poor quality, or information that contains misstatements or omissions that diminish market transparency and expose investors. In this context, investor protection and the development of investment products and markets are heavily dependent on the ability of companies to comply with the CSRD and the ESRS rules to deliver quality sustainability disclosures, including impact-related information.[126] This outcome is essential for transparent and well-functioning financial markets that minimise greenwashing risk and other informational problems in the financial sector.

V. Conclusion

This article has identified and discussed policy justifications for the adoption of double materiality, especially impact materiality, in the CSRD and ESRS rules. Reporting information following an impact materiality approach aims to create incentives that align corporate activity with the achievement of sustainable development objectives, promote accountable business conduct through sound impact management mechanisms and develop markets and products for sustainable investments. This article has also identified challenges to adequately implementing impact materiality and, this way, to achieving the underlying policy tenets. Poor quality of information disclosures, ineffective impact management policies and processes, as well as weak performance in rule compliance and enforcement are crucial factors that can undermine the meaningful yet ambitious policy goals underpinning double materiality in corporate sustainability reporting. Since these factors ultimately determine policy success or demise, it is crucial to learn more about their workings and research following this direction is worth pursuing.

[126] Mezzanotte n. 96 above, s. II and s. V (describing systemic problems affecting compliance by financial market participants with the SFDR disclosures).