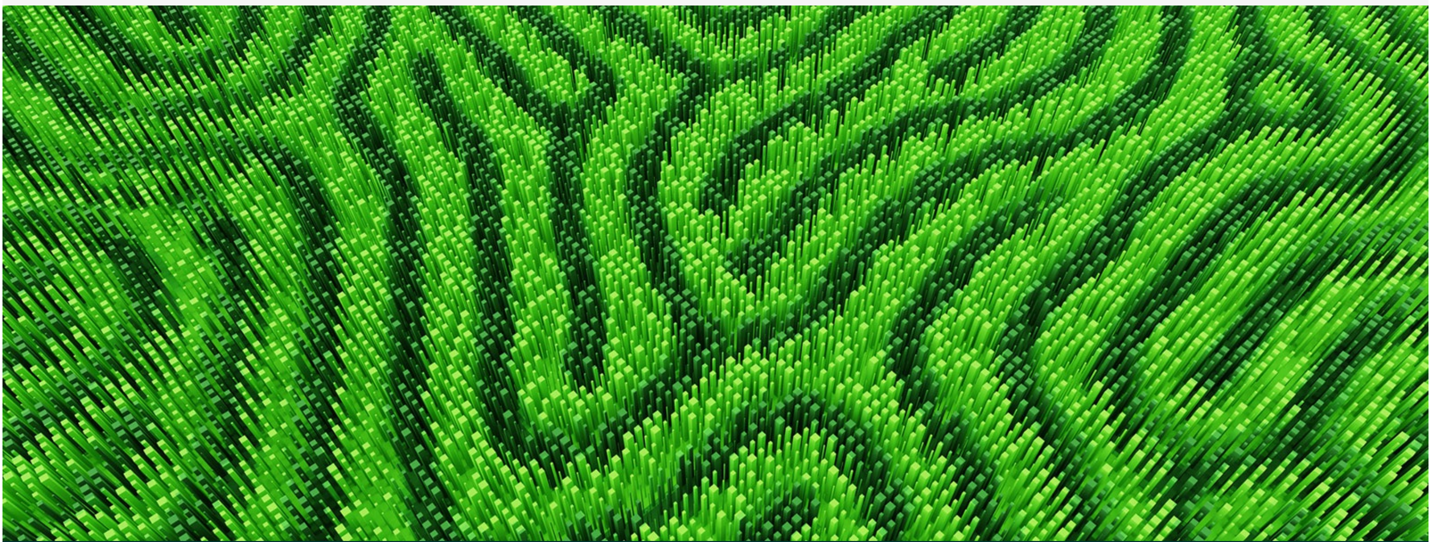
generation

The Global Spread of Sustainability Disclosure

INSIGHTS FIRM-WIDE



IN BRIEF

- Regulators across the world are developing rules that will compel businesses to report on an unprecedented array of sustainability issues.
- It is important that reporting standards be mandatory. So long as disclosure is voluntary, there is no level playing field.
- Some critics object to introducing these rules and regulations as a matter of principle.
- We strongly support a global baseline of mandatory sustainability-disclosure requirements.

INTRODUCTION

We believe a global revolution in sustainability disclosure is under way. Regulators across the world are developing rules that will compel businesses to report on an unprecedented array of sustainability issues, including their greenhouse-gas (GHG) emissions, as well as on climate-related risks and opportunities. Global interest in ’climate

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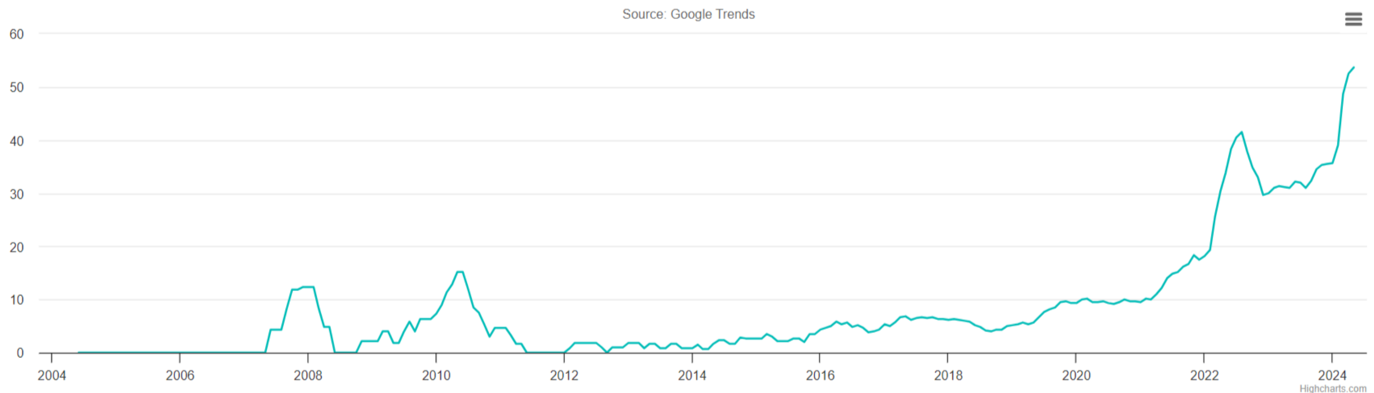
disclosure,' as measured by Google Trends, is at an all-time high.



As we have previously argued, it is best to think of sustainability-related disclosure very simply: it is an evolution of accounting principles. Regulators around the world are broadening the definition of what it means for an investor to understand a company. The idea is to include *all* material sustainability matters that are reasonably likely to create risks or opportunities for companies, whether in the short, medium or long term. What do these changes mean for investors?

ANALYSIS

As practitioners, we make four observations:

First, the value an entity creates for itself and its investors is inseparable from the value the entity creates for other stakeholders, society and the natural world. In turn, a company's impacts on its stakeholders can create risks and opportunities for that company. For instance, a company that pollutes a local river risks destroying the short-term value it creates for its investors, as angry local citizens mobilise to curtail the company's operations.

A company, therefore, cannot determine its sustainability-related risks and opportunities unless and until it has identified its significant impacts on its stakeholders.

Second, sustainability information only provides insight when it is set in the wider context of planetary boundaries and related social and ecological thresholds. Climate has been a real pathbreaker here. The Paris Agreement of 2015 provides the basis for science-based targets and the idea of transition planning, which means investors can better understand where a company is today and the risks and opportunities related to its transition to net zero. This is the critical story investors need to understand. We need this logic to be extended to other sustainability issues.

Third, globally comparable information matters. Most investors have global portfolios and most companies have global

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value chains. Investors benefit from disclosure because it allows them to compare companies and then allocate capital to those that have the greatest chance of success. If information about the sustainability-related risks and opportunities of different assets in different countries is similar but *not* the same, comparability is threatened. This, in turn, threatens the efficiency of capital allocation.

Fourth, it is important that any standards be mandatory. Many investors (including Generation) have over many years worked together to encourage and develop voluntary standards. The IFRS Foundation, the not-for-profit responsible for developing global accounting and sustainability disclosure standards, has diligently worked on these standards. These voluntary standards have formed the basis of the IFRS's new board, ISSB (International Sustainability Standards Board), which is now proposing mandatory standards.

The development of voluntary standards brought market participants – and other stakeholders – together to agree on topics and metrics that matter. However, so long as disclosure is voluntary, there is no level playing field. At Generation, we look for companies whose business activities are consistent with a sustainable future. The companies we like most are those actively contributing solutions, but regardless we expect all the companies in which we invest to act to avoid harm to their stakeholders. If some companies but not others disclose how they are (or are not) managing their negative impacts, it makes it harder for more sustainable business models to position themselves.

NEW PROPOSALS

Moving on to the new proposals themselves. There are five big developments to be aware of.

1. ISSB – International Sustainability Standards Board

The ISSB standards create a global baseline for sustainability-related disclosure to meet the needs of capital markets. In 2023 the ISSB published two standards: S1 and S2.

The first, S1, covers general sustainability-related risks and opportunities. It requires companies to disclose all material sustainability-related risks and opportunities, which may relate to dependencies on natural resources or impacts on people, and think about how these could affect the performance and prospects of the company.

It is important to recognise that S1 is the very core of the ISSB proposals. S2 is just as important, but is known as a 'thematic standard,' meaning that it builds on S1. It requires companies to disclose risks and opportunities as they relate to climate *specifically*. S2, for instance, requires a company to disclose its scope 1, scope 2 and scope 3 greenhouse-gas emissions.

It is for jurisdictions to decide whether they want to mandate the ISSB standards. We also expect that there will be further 'thematic standards' in the future i.e., S3, S4, etc., requiring more detailed reporting on other issues (biodiversity or human capital, for instance).

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2. CSRD – EU Corporate Sustainability Reporting Directive

The European Union is developing its own standards. These are likely to be fairly interoperable with the ISSB rules. So it is not correct to think of the EU as either 'adopting' or 'not adopting' ISSB. Rather, it is building upon it.

These standards are more comprehensive than those of the ISSB. The regulations will apply to thousands of companies, initially those with securities traded on EU markets, but then extending to private companies and non-EU companies doing significant business in the EU. The regulations impose broad reporting requirements on participating firms – as many as 1,000 data points or more.

Encouragingly, in 2024 there is already evidence that companies are responding to the proposed regulations. We are aware that some US companies are already at work compiling enhanced scope 3 data in readiness for CSRD. Indeed, corporate America in general is gearing up. If 'what is measured is managed,' then we might expect a material impact of the new rules and regulations on actual emissions.

3. CS3D (or CSDDD) – EU Corporate Sustainability Due Diligence Directive

This is the other big regulation coming out of the EU. It passed the European Parliament in April 2024. It obliges large companies to monitor actual and potential adverse impacts on the environment and human rights. For the first time, companies will be required to put into effect a plan ensuring that their business model and strategy are compatible with limiting global warming to 1.5°C. It’s the 'put into effect a plan' part which is the important difference from the CSRD. The directive will also apply to many non-EU companies.

4. California bills

The State of California has passed two climate-related disclosure bills. One requires emissions reporting (on scopes 1 to 3 emissions) and one requires Task Force on Climate-Related Financial Disclosures (TCFD) reporting i.e., related to climate-related financial risks, and thus similar to S2 of the ISSB proposals. It covers all companies doing business in California, subject to revenue thresholds.

5. Securities and Exchange Commission Climate Disclosure Rule

The US is also developing its own set of climate-disclosure guidelines. The SEC will require publicly listed companies to disclose information on two sorts of climate-related risks: physical and transition. Companies would be required to disclose scope 1 and 2 emissions.

As discussed below, the SEC’s proposed standards will be challenged in the courts. But even if they do not survive legal challenge, many American businesses will still have to report sustainability metrics in some way. This is because they will be covered largely by other climate-disclosure regulations, including those of the EU, as well as those of jurisdictions around the world bringing the ISSB’s global baseline into local law.

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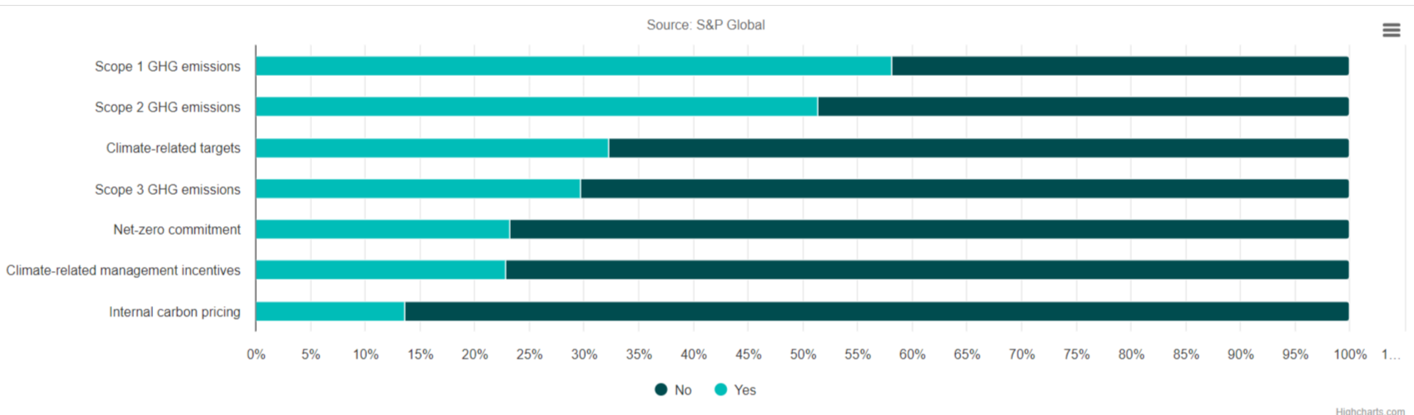
GENERATION'S VIEW

Generation strongly supports a global baseline of mandatory sustainability-disclosure requirements. The current regime of voluntary disclosures fails to meet our needs as investors. Approximately 15% of companies in the S&P 500 fail to disclose scope 1 and 2 emissions, with higher rates of nondisclosure in other parts of the world.[2] At a global level, less than a quarter of companies have a net-zero commitment (see chart below). And even when companies do disclose, they often do not do so in a comprehensive or comparable way. This is inadequate for investors and wider stakeholders.



Where there are gaps in disclosure and action, we have to engage on a company-by-company basis to request that the gaps be closed. This is both time-consuming and costly – even for a sustainability-focused investment manager like Generation that follows a relatively small number of listed companies.

We also believe that inadequate disclosure has wider social costs. To put it bluntly: it is a market failure. Investors cannot make informed decisions without full information – just as they would struggle to make informed decisions if companies did not disclose reliable information on their assets.

Requirements around the world, we believe, should be consistent and comparable. This is why it is so critical for the ISSB standards to become the global baseline.

Making disclosures mandatory and assured would have positive effects, we believe. It would ensure that credible, consistent, useful information of important sustainability-related risks was available across the market. This would, we believe, reduce issuer as well as investor costs, increasing efficiency to the benefit of all market participants. We note that our belief on this point is consistent with the historical evidence on the adoption of mandatory *financial* reporting guidelines, such as International Financial Reporting Standards (IFRS). More information tends to be good for both investors and companies.

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THE CONTROVERSY

Some critics object to introducing these rules and regulations as a matter of principle. We take these objections seriously but ultimately do not believe they hold water. The debate largely takes place in the US, where some have argued that such rules violate the First Amendment of the Constitution. Both the SEC and California's climate-disclosure standards are being challenged on these grounds.

Essentially this argument boils down to the following maxim: the government typically cannot 'tell people that there are things they must say.' A related argument is that agencies are overstepping their authority in making such expansive rules.

Such concerns are not in and of themselves misplaced. We can think of examples of things that it would be unreasonable for the SEC to force companies to say (such as pledging allegiance to a political party). But there are lots of things that public companies must already say, things with which no one seems to have a problem. Public companies must disclose their financial statements, for instance.

As we see it, climate disclosures should rightly be in the same bucket as financial disclosures.

Climate-related risks and opportunities represent economic risks and opportunities for companies. Importantly, they also create economic impacts on the market as a whole from which investors cannot protect themselves by diversification. To us, it therefore seems legitimate and proportionate that companies should be required to disclose this information.

We also note that scholars from the Knight First Amendment Institute at Columbia University have argued that "disclosure requirements that inform and protect investors do not ordinarily raise First Amendment concerns." Indeed the very principle of securities regulation is to keep investors informed about what they are investing in. This is as true for financial information as it is for sustainability information. As Roberta Karmel, a former SEC Commissioner, memorably argued in a 1989 lecture: "Securities regulation is essentially the regulation of speech."

CONCLUSION

Achieving goals set out by successive climate summits will require action by multiple actors. Governments are required to establish clear policy frameworks, while investors price investment capital based on those policies (as well as the risks and opportunities of decarbonisation). The overall effect is to give companies an incentive to embrace

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sustainable business models.

The efficiency of this supply chain, however, requires high-quality, globally comparable information. Investor-focused international standard-setters support the delivery of those objectives.

Sustainability disclosure is by itself not enough to create a sustainable world – one in which the economy operates within the limits of the natural world and supports human wellbeing.

As we see it, corporate sustainability reporting is *necessary* but not *sufficient.* The same is true of capital markets when it comes to sustainable development. Governments must play their part.

How can we more fully reconcile businesses with their externalities? CS3D, which obliges large companies to monitor actual and potential adverse impacts on the environment and human rights, is interesting because it is getting towards requiring businesses to address problems, not just to disclose them. On top of that, there is a suite of policy measures that can create more profound changes in the business world, including more extensive carbon pricing and the elimination of fossil-fuel subsidies.

The point is not to pile more and more rules and regulations on global business. Rather, it is to improve informational symmetry in financial markets. We look forward to the continued adoption of sustainability-disclosure requirements.

Endnotes

1. Numbers represent search interest relative to the highest point on the chart for the given region and time.
2. S&P Global

IMPORTANT INFORMATION

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