

KEY CONSIDERATIONS ON ESG DISCLOSURE POLICY DESIGN FOR CHINA

INTRODUCTION

The United Nations-backed Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2500 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$85 trillion in assets under management.

Responsible investment explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of financial markets.

ABOUT THIS BRIEFING

This briefing provides technical guidance as part of the PRI's work on ESG disclosure in China, with support from the UK China PACT Programme. It is based on the research and recommendations of the report *ESG Data in China: Recommendations on Primary ESG indicators*. This research showed that while there was broad alignment between international and Chinese corporate environmental, social and governance (ESG) data disclosure practices, the disclosures being provided by Chinese companies are not standardised and not readily comparable across markets, industries and portfolios. The report commented that this lack of comparability limits investors' ability to integrate ESG data into their investment decisions, and acts as a barrier to increased investment in green and sustainable assets.

The report therefore recommended that Chinese financial regulators introduce a mandatory environmental, social and governance (ESG) disclosure framework, requiring all major companies to report on a series of standard ESG indicators and to supplement these quantitative metrics with related information on governance, strategy and risk management.

In addition to this report, PRI was asked by the China Securities Regulatory Commission (CSRC) to provide guidance on the specific regulations or regulatory clauses that would be required to implement these recommendations.

This briefing is the PRI's response to that request. It identifies the key questions and considerations that would need to be addressed by any regulator seeking to introduce corporate ESG disclosure requirements. It also recommends draft wording that could be adopted for Chinese legislation on corporate ESG reporting.

While this briefing has been informed by our work on similar legislations in other jurisdictions, there is not yet a single 'best practice' ESG disclosure legislation. Different countries have taken different approaches depending on their specific contexts, e.g. the maturity of ESG or sustainability reporting

in the domestic market, national environmental, social and economic priorities, pre-existing reporting requirements such as industry codes or stock exchange disclosure requirements, the needs and interests of investors. Current efforts of international organisations and industry stakeholders, including PRI and ICGN's project on Meaningful Data, aim to establish global, standardised and comparable corporate ESG reporting. The CSRC should therefore ensure that the disclosure policy they put in place could be re-aligned with any future global standardised ESG disclosure recommendations.

This note focuses on overarching implementing legislation. In jurisdictions where similar regulation has been adopted, it has tended to be supplemented by more detailed guidance over time, covering aspects such as calculation methodologies and reporting formats. Such materials, while important, fall outside the scope of this briefing.

KEY CONSIDERATIONS ON ESG DISCLOSURE POLICY IN CHINA

When designing legislation on mandatory ESG reporting requirements, policymakers need to start by answering a number of important questions. We set these questions out below together with some reflections on the factors that Chinese regulators need to consider when implementing an ESG disclosure requirement for companies.

Key Question 1: Rationale

What is the purpose of the legislation?

These objectives will define the specific data and information to be reported, and will define the companies that are expected to report.

The reasons for introducing mandatory ESG disclosure requirements can include some or all of: providing better information to investors, providing information to other stakeholders, encouraging and enabling better corporate oversight and management of sustainability-related issues, and increasing investment in green and sustainable assets.

Proposed implementation for China

As discussed in the *ESG Data in China: Recommendations for Primary ESG Indicators*, in order to provide usable and comparable ESG data to investors, companies should be required to report on a standardised set of primary ESG disclosure indicators.

More generally, the report suggested that the introduction of mandatory ESG disclosure requirements for all listed companies would:

- Support the building of reliable ESG data series, which could be supplemented by other indicators over time.
- Provide useful information to Chinese and international investors to make investment decisions through the provision of standardised ESG data.
- Enhance management and board oversight of performance on key ESG issues within listed companies.
- Increase investment in green and sustainable assets.
- Support international ESG disclosure standardisation efforts.

Key Question 2: Legal

What is the legal basis for the regulation?

Many countries already have formal disclosure requirements regarding the disclosures that companies need to provide in their annual reports and accounts and similar documents.

It is often most efficient, in terms of the speed of adoption and implementation, to add ESG disclosure requirements to these pre-existing corporate disclosure requirements. These may be introduced as amendments to existing legislation or as a separate regulation underneath existing legislation. It also shows that ESG reporting is an integral part of business reporting.

Proposed implementation for China

In December 2017, the CSRC issued *Standards for the Content and Formats of Information Disclosure of Companies Publicly Issuing Securities No.2 - Content and Formats of Annual Reports*.

It is suggested that the ESG disclosure requirements be integrated into these Standards, thereby harnessing, and aligning with, existing implementation and enforcement processes.

Key Question 3: Timing

When do companies need to report?

Companies are usually given a grace period of 1-2 years before they are expected to comply with ESG reporting requirements. The decision will depend on contextual factors such as existing reporting practice and the extent to which such data are already gathered and reported by companies.

Companies should report their ESG-related information at the same time as they report their financial and related information. This allows investors to integrate the two different data sets, e.g. through normalising certain ESG data by revenues or staff numbers.

Proposed implementation for China

The *ESG Data in China: Recommendations for Primary ESG Indicators* report noted that many large Chinese companies already report on similar ESG topics, including on the proposed core indicators. Therefore, for most companies, mandatory reporting requirements could be introduced quite quickly, perhaps even commencing in the first financial year following the introduction of the reporting requirements.

The CSRC may, however, wish to offer some flexibility to companies that have not previously reported. For example, in the first year of reporting, companies could report indicators on a comply or explain basis, where they explain how they intend to address any gaps in their reporting.

Companies should report on their sustainability-related information at the same time as they report their financial and related information.

Key Question 4: Company Universe

Who is required to report?

Different countries have taken different approaches to defining who is required to report. Many have started with a relatively small group of larger companies (usually listed companies) and then progressively extended the scope to cover smaller companies, unlisted companies and other entities (e.g. government agencies).

Policymakers need to consider the following questions:

- Should the universe include some or all of: publicly listed companies, private (unlisted) companies, charities, government departments, state-owned enterprises, other entities?
- Should the disclosure requirements only apply to companies already required to provide other disclosures, or should the universe of companies be extended?
- What size company is expected to report? Different jurisdictions have adopted different approaches but common inclusion thresholds relate to:
 - Turnover (e.g. companies might need to have a turnover of at least US\$50 million), and/or

<ul style="list-style-type: none"> ○ Balance sheet size (e.g. companies might need to have a balance sheet of at least US\$20 million), and/or ○ Number of employees (e.g. companies might need to have at least 250, or even 500, employees).
<p>Proposed implementation for China</p>
<p>It is suggested that the regulation applies to the same universe of companies that is required to disclose under <i>Standards for the Content and Formats of Information Disclosure of Companies Publicly Issuing Securities No.2 - Content and Formats of Annual Reports</i> (Revised in 2017).</p> <p>This universe may be extended over time (see also Key Question 11 below).</p>

<p>Key Question 5: Reporting boundaries</p> <p><i>What is the scope of reporting?</i></p>
<p>In general, ESG data should cover 100% of the issuing entity and ESG reporting should employ the same principles as financial reporting. If a company has partial ownership of certain subsidiaries, the data should be reported on a percentage ownership basis in order to accurately reflect the proportional exposure the company has to these businesses.</p> <p>Companies should also disclose the proportion of company activities that are consistent with sustainability criteria in sustainability taxonomies.</p> <p>There are other options for reporting (e.g. an organisation could report on all activities where it has financial control or where it has operational control). There are cases where these approaches are valuable (e.g. in the extractive industries, companies often provide additional disclosures on facilities where they have operational control); however, such disclosures do not necessarily link to the financial accounts.</p>
<p>Proposed implementation for China</p>
<p>The ESG data reported should cover 100% of the issuing entity and employ the same principles and cover the same scope as financial data. If a company has partial ownership of certain subsidiaries, the data should be reported on a percentage ownership basis in order to accurately reflect the proportional exposure the company has to these businesses.</p>

<p>Key Question 6: Reporting period</p> <p><i>Over what time period should companies report?</i></p>
<p>Most ESG reporting requirements encourage companies to report data over a 12-month period, and encourage companies to align their ESG reporting period with their financial year reporting period. This alignment enables comparison of financial performance with other aspects of the company’s performance.</p>
<p>Proposed implementation for China</p>
<p>Companies should align their ESG reporting period with their financial year reporting period.</p>

Key Question 7: Report content

What data and information are to be reported?

The specific information to be reported will depend on the objectives of the reporting regulation. In some cases, the interest will be in the relevance of ESG or sustainability issues to a company’s strategy, with the emphasis on financial materiality and on the management of the business and financial risks and opportunities associated with these issues. In other cases, the interest will be in a company’s overall social and environmental performance and impacts (and how these are managed), or in specific aspects of a company’s social and environmental performance (e.g. greenhouse gas emissions, diversity).

While the specific information to be reported will differ, regulators and other actors will be interested in understanding a company’s exposure to or impact on the ESG issue(s) in question, their strategy for managing the issue(s) in question, the actions they have taken and their performance on the issue(s) in question. They will also want to be able to put these exposures and impacts into context and may want to complement these ESG data with relevant business information such as turnover, the countries and markets of operation, the number of staff and contractors and the quantity, weight or volume of product outputs.

Proposed implementation for China

The *ESG Data in China: Recommendations for Primary ESG Indicators* report recommended that companies report a set of primary standardised indicators that allow for comparability across industry sectors, portfolios and time-series, alongside financial indicators, based on the same reporting scope. Such data should be linked to companies’ business models, their corporate strategy (including financial and sustainability objectives and thresholds) and risk factors. Finally, ESG data should be analysed and explained in comparison to sectoral averages and historical performance;

The *ESG Data in China: Recommendations for Primary ESG Indicators* report proposed the following specific indicators:

- Greenhouse gas (GHG) emissions
 - Total GHG emissions (scope 1,2,3) in tonnes
- Air pollutants
 - Air emissions of NO_x, SO_x, POP, VOC, HAP, PM in kg
- Water
 - Total water withdrawal (m³)
 - % of water recycled
- Energy
 - Total energy consumed (GWh)
 - % of renewable energy
- Waste (water, solid, hazardous)
 - Total waste from operations (tonnes)
 - % of hazardous waste
 - % of waste recycled
 - Water discharges of Nitrogen, Phosphorus and Persistent Organic Pollutants (kg) and Biochemical Oxygen Demand (mg/L)
- Workforce
 - Workforce composition by gender
 - Training hours per employee
 - Wages paid
- Health and safety

- Injury rate (TRIR)
- Fatality rate (for direct and contract employees)
- Governance quantitative indicators
 - % of women on the Board
 - Decentralization of authority President/CEO
 - CEO pay ratio

In addition, companies should describe:

- The scope of reporting.
- The calculation methodology used (including details of data sources and assumptions).
- Any changes to scope or methodology that might affect investors' ability to assess trends in performance over time.
- Where changes to scope or methodology have a material effect on the date reported, companies should update at least the last three years' worth of data.

While the *ESG Data in China: Recommendations for Primary ESG Indicators* report did not specify the contextual or supporting disclosures that might be provided, similar requirements in other jurisdictions have encouraged companies to provide information on:

- The company's business model.
- The relevance of ESG issues to the company's strategy and risk profile.
- The policies the company has adopted in related to the issues in question.
- The commitments, objectives and targets the company has set in relation to these issues, and the key performance measures (KPIs) it uses to tracks its performance against these.
- The actions taken by the company to manage these issues.
- The company's performance on each of these issues.

Key Question 8: Report location/format

Where do companies need to report?

In broad terms, companies can report ESG-related information in one or more of:

- Their annual report (or equivalent publication): It is increasingly common for larger listed companies to include explicit references to ESG themes within their annual reports. The inclusion of ESG-related information issues into annual reports allows the process of gathering and verifying this data to be integrated into the processes and information controls that are already in place. It also means that ESG data is readily available to investors at the same time as wider information about the company. In practice, due to concerns about length and complexity, companies tend to discuss relatively few ESG issues in their annual reports, and so may not cover all aspects that are of interest to investors or to other stakeholders.
- Their standalone sustainability report (or a dedicated section of the company website): A standalone sustainability or CSR report provides a clear 'home' for ESG content, enabling this information to be consolidated in a single location. However, the limitation of such reports is that they can imply that sustainability-related information and performance is seen as separate from the core business of the company.
- Their integrated report: The concept of an integrated report is that ESG information and data are presented in an integrated manner within the annual report. Such a report can offer investors a more rounded, concise and holistic insight into business performance and impact over the short, medium and

<p>long term. However, a focus on what management sees as the most business critical ESG areas may mean that investors do not get the breadth of information they need.</p> <p>Companies can make this information available in a variety of ways – through their own websites, in hard copy, through social media and through third-party registers (e.g. government registers, other databases).</p>
<p>Proposed implementation for China</p>
<p>The <i>ESG Data in China: Recommendations for Primary ESG Indicators</i> report recommended that the core ESG indicators and related information should be reported in corporate annual reports, using the same reporting scope as the annual report. This information should be distributed and made available in the same way as corporate annual reports.</p>

<p>Key Question 9: Specific technical issues</p> <p><i>What sort of exemptions might be considered?</i></p>
<p>Regulators may decide that certain companies are exempt from the reporting requirements or that not all of the reporting requirements apply to all firms. This may be for example on the basis of the size or other requirements discussed above.</p> <p>Regulators may also decide that companies do not need to report on all elements of the legislation. This can take different forms:</p> <ul style="list-style-type: none"> • Comply or explain exemptions, where companies can either report the required information or provide a statement explaining what information has been omitted and why. Comply or explain legislation often requires companies to describe the steps they will take to fill any such gaps. • <i>De minimis</i> exemptions where companies do not need to report if they can demonstrate that their impact on the issue in question is minor or that the costs of gathering and reporting the information exceed any benefits that accrue. • Commercial in confidence exemptions where companies do not have to report if the disclosure of information might be commercially or otherwise prejudicial to their interests. <p>While there is a general recognition that having data independently assured leads to higher quality data, regulators may decide not to impose such requirements (e.g. if assurance is seen as too expensive) or may delay the imposition of such requirements (e.g. they start by encouraging reporting and then, based on the quality and quantity of the reported information, decide whether there is a need to introduce assurance or other additional data quality requirements).</p>
<p>Proposed implementation for China</p>
<p>This issue was not considered in the <i>ESG Data in China: Recommendations for Primary ESG Indicators</i> report. However, given the universe of companies and current reporting practice in China, it is suggested that:</p> <ul style="list-style-type: none"> • All companies covered by <i>Standards for the Content and Formats of Information Disclosure of Companies Publicly Issuing Securities No.2 - Content and Formats of Annual Reports</i> be required to report. • All companies are expected to report all indicators. As this is a widely (domestically and internationally) accepted set of core indicators, it is reasonable to expect all companies to report this information.

However, for companies with a small footprint, reporting may be facilitated through the development of some straightforward guidance and tools such as default emission factors.

- Companies are allowed a one year exemption if they have not previously reported an indicator. They are, however, expected to explicitly acknowledge that they are not reporting and explain the actions they will be taking to ensure that they can report in the forthcoming year.
- Companies may claim an exemption for information that is considered commercial in confidence. However, such exemptions should be seen as exceptional and the presumption should be that all affected companies will report against all of the indicators.

It may be premature to introduce mandatory data assurance requirements but it is suggested that this be considered as part of the Review (see Key Question 11 below), with a presumption that such requirements will be introduced following the review unless there are compelling reasons why this should not be the case.

Key Question 10: Enforcement

Who is responsible for enforcement?

What enforcement processes are envisaged?

What sanctions may be applied in the event of non-compliance?

Generally, ESG reporting requirements are additional to other, pre-existing reporting requirements. It often makes sense to integrate these requirements into existing regulatory requirements and to use the existing institutional structures and processes for enforcement. This integration can help to ensure that new ESG reporting requirements are treated with the same degree of seriousness and attention as other reporting requirements.

Proposed implementation for China

It is suggested that CSRC uses the enforcement powers and processes that underpin *Standards for the Content and Formats of Information Disclosure of Companies Publicly Issuing Securities No.2 - Content and Formats of Annual Reports*.

Key Question 11: Review and monitoring

What sort of review and monitoring processes should be adopted?

It is good practice to build structured, formal review processes into regulatory processes. It both allows for regulation to be adapted and changed in response to experience, and it also means that regulators are held to account for ensuring the effective implementation of the legislation.

The questions that could be considered in reviews include:

- Have companies complied with the legislation (e.g. have they reported)?
- What actions have been taken to encourage non-reporters?
- Have companies provided the quality of disclosures that are required by investors and other stakeholders?
- What are the barriers to better reporting (in terms of quantity and quality)?

- Have the wider objectives of the regulation been delivered (e.g. are stakeholders such as investors actually using the information provided, is capital flowing to companies with better ESG performance)?
- How could the operation of the regulation be made more effective?
- Is the regulation still relevant or does it need to evolve (e.g. the addition of additional reporting requirements, the introduction of assurance requirements)?

Proposed implementation for China

It is suggested that the legislation include a formal review which is to be conducted one to three years from the adoption of the legislation. The review should consider:

- The level of compliance with the legislation (e.g. have they reported).
- Whether companies have provided the quality of disclosures that are required by investors and other stakeholders.
- The barriers to better reporting (in terms of quantity and quality) and how these might be overcome.
- Whether the wider objectives of the regulation have been delivered.
- How the operation of the regulation could be made more effective.
- Whether additional reporting requirements should be introduced.
- Whether there is a need to introduce of assurance requirements.

DRAFT CLAUSES

The following Table proposes draft wording for the implementation of the recommendations of the *ESG Data in China: Recommendations for Primary ESG Indicators*. As discussed above, it is assumed that these clauses will be integrated into an updated version of the *Standards for the Content and Formats of Information Disclosure of Companies Publicly Issuing Securities No.2 - Content and Formats of Annual Reports* and the style and form of the draft clauses has been written so that these clauses can be incorporated directly.

Key Questions	Draft Clauses
Purpose/Objectives	
What is the purpose of the legislation?	[Chapter 1: General Provisions] New Article to follow Article 3: “The information to be reported includes information on the social and environmental policies, performance and impacts of the company as set out in these Standards, including discussion of those aspects that have or may have a significant impact on investor decisions.”
Legal	
What is the legal basis for the regulation?	No specific text proposed but, as noted above, it is expected that these clauses will be integrated into the <i>Standards for the Content and Formats of Information Disclosure of Companies Publicly Issuing Securities No.2 - Content and Formats of Annual Reports</i> .
Timing	
When do companies need to report?	Modification to Article 9 (the modification is in italics and underlined): “ A company shall, within 4 months as of the end of the each accounting year, publish the full text of the annual report, <u>including the items on the environmental and social performance of the company referred to in Clause XX</u> , on the website designated by CSRS; and at... <u>The reporting requirements on the environmental and social performance of the company shall commence on [date to be specified by CSRC]</u> ’.
Company universe	
Who is required to report?	No new text required. The universe of companies required to report is as defined in Article 2.
Reporting boundaries	

<p>What is the scope of reporting?</p>	<p>No new text required.</p> <p>The existing Clause 22(3) (“The Company that formulates consolidated financial statements shall fill in or calculate the aforesaid data and indicators with the data in the consolidated financial statements.”) applies to all disclosures required by the legislation.</p>
<p>Reporting Period</p>	
<p>Over what time period should companies report?</p>	<p>See suggested modifications to article 9 above, and note reference to timeframes in proposed new Section YY below.</p>
<p>Report content</p>	
<p>What data and information are to be reported?</p>	<p>It is suggested that a new Section YY be added to follow Chapter II, Section 3.</p> <p>Clause AA: The Company shall report in quantitative terms on each of the following specific indicators, for the same scope as applies to the remained of the Annual Report:</p> <ul style="list-style-type: none"> • Greenhouse gas (GHG) emissions <ul style="list-style-type: none"> ○ Total GHG emissions (scope 1,2,3) in tonnes • Air pollutants <ul style="list-style-type: none"> ○ Air emissions of NO_x, SO_x, POP, VOC, HAP, PM in kg • Water <ul style="list-style-type: none"> ○ Total water withdrawal (m³) ○ % of water recycled • Energy <ul style="list-style-type: none"> ○ Total energy consumed (GWh) ○ % of renewable energy • Waste (water, solid, hazardous) <ul style="list-style-type: none"> ○ Total waste from operations (tonnes) ○ % of hazardous waste ○ % of waste recycled ○ Water discharges of Nitrogen, Phosphorus and Persistent Organic Pollutants (kg), and of Biochemical Oxygen Demand (mg/L) • Workforce <ul style="list-style-type: none"> ○ Workforce composition by gender ○ Training hours per employee ○ Wages paid • Health and safety <ul style="list-style-type: none"> ○ Injury rate (TRIR) ○ Fatality rate (for direct and contract employees) • Governance quantitative indicators <ul style="list-style-type: none"> ○ % of women on the Board ○ Decentralization of authority President/CEO ○ CEO pay ratio

	<p>Clause BB For each of these indicators, the Company shall describe:</p> <ul style="list-style-type: none"> • The scope of reporting. If the scope of reporting is not the same as for the entity covered by the Annual Report, the Company shall explain the reasons for the difference and discuss the implications for the users of the information. • The calculation methodology used (including details of data sources and assumptions). • Any changes to scope or methodology that might affect investors’ ability to assess trends in performance over time. • Where changes to scope or methodology have a material effect on the date reported, the Company should provide at least three years’ of updated data. <p>Clause CC: The Company shall describe:</p> <ul style="list-style-type: none"> • The relevance of ESG issues to the company’s strategy and risk profile. • The policies the company has adopted in related to the issues in question. • The commitments, objectives and targets the company has set in relation to these issues, and the key performance measures (KPIs) it uses to tracks its performance against these. • The actions taken by the company to manage these issues. • The company’s performance on each of these issues. <p>Clause DD: For [insert first year], companies may choose not to report on certain indicators if they have not previously done so. However, these companies will explicitly acknowledge that they are not reporting and will explain the actions they will be taking to ensure that they can report in the forthcoming year. In the second year, all of the companies covered by these Standards will be required to report against all of the requirements in Clauses AA, BB and CC.</p> <p>Clause EE: On or before [date – within 3 years of the adoption of these Clauses] CSRC will conduct a formal review, including consideration of feedback from relevant stakeholders, on Clauses AA to DD. The review will, amongst other relevant matters, consider:</p> <ul style="list-style-type: none"> • The level of compliance with the legislation. • Whether companies have provided the quality of disclosures that are required by investors and other stakeholders. • The barriers to better reporting (in terms of quantity and quality) and how these might be overcome. • Whether the wider objectives of the regulation have been delivered. • How the operation of the regulation could be made more effective. • Whether additional reporting requirements should be introduced. • Whether there is a need to introduce assurance or other audit requirements.
Report location/format	

Where do companies need to report?	No new text required, although note the modification to Clause 9 above. The ESG-related information should be reported in the same locations and at the same time as the annual report
Specific technical and design issues	
What sort of exemptions might be considered?	Proposed modification to Clause 7 (on auditing): "These requirements do not apply to the information reported under Clauses AA-DD."
Enforcement	
Who is responsible for enforcement?	No new text required.
What enforcement processes are envisaged?	
What sanctions may be applied in the event of non-compliance?	
Review processes	
What sort of review processes should be adopted?	See Clause EE above.

The PRI has experience of public policy on ESG disclosure and responsible investment across multiple markets and is available to further support the work of the CSRC on promoting investment and ESG disclosure.

Any question or comments can be sent to policy@unpri.org.