

The EU Taxonomy Regulation

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The Taxonomy Regulation (the “Taxonomy”) is the framework for a European Union (“EU”)-wide taxonomy, or classification system, of environmentally sustainable economic activities. As a pillar of the EU’s sustainable finance policy, it requires a limited number of EU companies to report on the alignment of their economic activities to the Taxonomy and requires fund sponsors in scope of the Sustainable Finance Disclosure Regulation (“SFDR”) to report on the extent to which their portfolios are in investments aligned with the Taxonomy. Separate and detailed technical screening criteria accompany the Taxonomy, specifying the activities in scope (Taxonomy-eligible activities) and the criteria for alignment (Taxonomy-aligned activities).

We cover in this update a number of key questions relating to the Taxonomy, including matters that have been addressed by the EU authorities since the adoption of the Taxonomy, and important outstanding matters.

What Is the Status of the Taxonomy Regulation?

The Taxonomy Regulation came into force on 12 July 2020, with staggered application from 1 January 2022. Under the Taxonomy Regulation, the European Commission (the “Commission”) is responsible for defining technical screening criteria for each environmental objective through delegated and implementing acts.

The [Taxonomy Climate Delegated Act](#) applied from 1 January 2022. It specifies the activities, and related technical screening criteria, which contribute to climate change adaptation and climate change mitigation. For climate change mitigation, these activities are either “transitional”, in that they make a contribution based on their own performance, such as renewable energy production or energy efficient manufacturing, or “enabling”, in that they directly enable other activities to make a substantial contribution to climate change mitigations, such as renewable energy technologies and energy storage.

Further technical screening criteria were introduced in June 2022 by the [Complementary Climate Delegated Act](#) that identifies types of nuclear and gas energy activities that contribute to climate change mitigation.

The Commission approved a [Delegated Act](#) in June 2023 that included some new activities, and a few amendments, to the scope of the technical screening criteria.

The Taxonomy specifies six environmental objectives. Whilst the technical screening criteria for the activities which contribute to climate change adaptation and climate change mitigation have been in place since 1 January 2022, the Commission adopted in June 2023 a [Taxonomy Environmental Delegated Act](#) with technical screening criteria for the other environmental objectives, namely: sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and protection and restoration of biodiversity and ecosystems. This includes some further amendments to the Climate Delegated Act. The Environmental Delegated Act is awaiting final adoption by the EU.

What Is the Status of Mandatory Reporting by Portfolio Companies under the Taxonomy Regulation?

The Taxonomy requires companies that are in scope of the existing EU Non-Financial Reporting Directive (the “NFRD”) to disclose the proportion of their turnover derived from the sale of products or the provision of services associated with economic activities that qualify as environmentally sustainable and the proportion of their capital and operating expenditure relating to assets or processes associated with economic activities that qualify as environmentally sustainable. The companies in scope of the NFRD are large “public interest entities”, which comprise companies listed on an EU-regulated market with more than 500 employees, credit institutions, insurance undertakings and other companies designated by member states as public interest entities. Financial undertakings in scope of the NFRD, such as asset managers, will need to disclose the extent to which the economic activities in the companies in which they invest meet the EU Taxonomy criteria.

The manner in which companies disclose this information is governed by the [Disclosures Delegated Act](#), which applied in January 2023. This covers the format of the information disclosed, the scope of reporting for financial services firms and the timing of disclosure for Taxonomy-eligible and Taxonomy-aligned activities. Note that financial undertakings are only required to report on the degree of Taxonomy alignment in their portfolios where the investee company in the portfolio is itself reporting on Taxonomy alignment under the NFRD or where the investee company has issued

environmentally sustainable bonds (“green bonds”) and reports on the Taxonomy alignment of those bonds.

The NFRD has been amended by the EU’s Corporate Sustainability Reporting Directive (the “CSRD”), which came into force at the beginning of this year. The CSRD does not change the substance of the obligation of companies in scope to report under the Taxonomy Regulation but considerably widens the scope of companies in scope of Taxonomy reporting and separately introduces detailed new sustainability reporting standards. For financial years starting on or after 1 January 2025, “large” EU companies (that meet two of the following criteria: balance sheet assets greater than EUR 20 million; net turnover greater than EUR 40 million; or more than 250 employees¹), including EU affiliates of non-EU companies, will be required to report on the alignment of their activities to the Taxonomy, and small- to medium-sized enterprises (“SMEs”) listed on EU-regulated markets will be in scope for financial years starting on or after 1 January 2026. From 1 January 2028, non-EU companies with significant EU operations or subsidiaries listed on an EU-regulated market will also have to report under the CSRD on a world-wide group basis, although it is unclear whether this reporting obligation will include Taxonomy reporting. The CSRD also introduces an external assurance requirement over Taxonomy reporting, to be provided by auditors or separate assurance services providers.

Are Funds Subject to SFDR Required to Report under the Taxonomy Regulation?

The Taxonomy Regulation sets out the principle that funds under Article 8 of SFDR (that promote environmental characteristics) and under Article 9 of SFDR (that have environmentally sustainable investment as their objective) must disclose to what extent their investments qualify as environmentally sustainable under the Taxonomy Regulation and report on the proportion of their activities that are environmentally sustainable.

Funds under Article 8 of the SFDR may or may not commit to make sustainable investments. It was previously unclear as to whether a fund that does not commit to make sustainable investments is required to report under the Taxonomy. The Commission in its Q&A published in May 2022 provided the following guidance: Firstly, that any fund that promotes environmental characteristics must include in the pre-contractual disclosures a statement on its commitment on the Taxonomy alignment of the portfolio. This may be a statement that the fund does not commit to any Taxonomy alignment. Secondly, that periodic disclosures for funds that promote environmental

¹ Note that the EU recently published a [proposal](#) to increase the thresholds to balance sheet assets greater than EUR 20 million and net turnover greater than EUR 40 million.

characteristics must also include information on Taxonomy alignment, “irrespective of commitments made in the pre-contractual disclosure” and that, to the extent a fund’s investments change over time to include investments in environmentally sustainable investments, that change should be reflected in the fund’s pre-contractual disclosures—although in practice that requirement would not apply to closed-end funds. In support of the Commission’s statements, the European Supervisory Authorities published a decision tree covering Taxonomy reporting in pre-contractual and periodic disclosures in their [Q&A](#) of November 2022.

The Commission’s response that all “Article 8” funds that promote environmental characteristics, regardless of any prior commitment to make Taxonomy-aligned investments, must report on the Taxonomy alignment of their portfolio underlines the importance of data on Taxonomy alignment to investors and the EU economy. Note that the Commission gave this guidance on the condition that the sponsor could assess Taxonomy alignment by reference to “reliable data” but did not provide a definition of reliable data. We discuss this further below—see “What Are the Sources of Data for Reporting under the Taxonomy Regulation?”.

Does a Taxonomy Aligned Investment Also Qualify as a Sustainable Investment?

The SFDR definition of sustainable investment requires that an investment: (i) contributes to an environmental or social objective; (ii) does not significantly harm any environmental or social objective; and (iii) follows good governance practices. There was an open question as to whether a Taxonomy-aligned investment also qualifies as a sustainable investment under SFDR and in particular whether the checks required to align an investment against the Taxonomy also meet the checks for “do no significant harm” (“DNSH”) to any social objective and that the investment followed good governance practices. The Commission confirmed in a [notice on interpretation and implementation](#) in June 2023 that Taxonomy-aligned investments automatically qualify as sustainable investments under the SFDR, pointing to the checks required under the “Minimum Safeguards” test as incorporating the SFDR checks for DNSH to any social objective and good governance practices—see question below “What Is the ‘Minimum Safeguards’ Test in the Taxonomy Regulation?”.

What Are the Sources of Data for Reporting under the Taxonomy Regulation?

Investors have a number of information sources for data for Taxonomy alignment:

- Information on Taxonomy alignment published by a company under the NFRD or CSRD. Under the CSRD, this will be subject to a form of external assurance.
- Information on Taxonomy alignment published by a company under the forthcoming EU [green bonds](#) framework, and also subject to assurance.
- Information on Taxonomy alignment published by the company other than under the NFRD or CSRD. The Commission refers to this as “voluntary” Taxonomy reporting.
- Information obtained by investors from companies, or third-party providers, and used to calculate Taxonomy alignment. This is referred to as “equivalent information” in the [SFDR Delegated Regulation](#). In its [SFDR Q&As](#), the Commission states that such information “should be considered information that provides the same content and level of granularity as that published by the company under [the Disclosures Delegated Act], [with...] the assessment of the substantial contribution of an economic activity relying on actual information”. This requires the company (or a third party) to provide information to an investor to allow the investor to provide the same standard of Taxonomy reporting as if the company were itself in scope of Taxonomy reporting.
- In exceptional cases, estimated data. The [SFDR Q&As](#) state that, “in exceptional cases and only for those economic activities for which complete, reliable and timely information could not be obtained, financial market participants are allowed to make complementary assessments and estimates on the basis of information from other sources” and that “estimates should only compensate for limited and specific parts of the desired data elements and product a prudent outcome”.

In view of the Commission’s guidance, above, that all funds that promote environmental characteristics must report on the Taxonomy alignment of their portfolios based on an assessment of “reliable data”, the question arises as to what amounts to “reliable data”. The only guidance by the Commission in this respect is that information on Taxonomy alignment published by companies in scope of the NFRD or CSRD is not a “pre-requisite information source” for reporting by funds on Taxonomy alignment. Fund sponsors can rely on other data for Taxonomy alignment if they consider it reliable. In that regard, fund sponsors will need to form their own view on whether they can access “reliable data” on Taxonomy alignment from investee companies and, for investee companies outside the scope of the NFRD or CSRD, the proportionate amount of effort to access “reliable data”.

What Is the “Minimum Safeguards” Test in the Taxonomy Regulation?

The Taxonomy Regulation states that, for an economic activity to be aligned to the Taxonomy, the activity must be carried out in alignment with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the eight fundamental International Labour Organisation conventions and the International Bill of Human Rights. These standards are referred to as the “Minimum Safeguards”, defined in the Taxonomy as “procedures implemented by an undertaking to ensure the alignment” with the OECD Guidelines and the UN Guiding Principles.

The Commission’s Platform on Sustainable Finance published in 2022 its Final Report on Minimum Safeguards under the Taxonomy. This sets out the checks for firms to determine, in line with the Taxonomy, whether their investee companies have in place Minimum Safeguards in relation to human rights, as well as other business practices. Under the headings of human rights, corruption, taxation and fair competition, the Report recommends criteria for checking compliance with the Minimum Safeguards, with different scales of checks required depending on whether the company is in scope of the CSRD or a SME. The checks proposed are essentially:

- Whether the company has established adequate human rights due diligence processes, anti-corruption processes, tax risk management processes and promotion of employee awareness of the importance of competition law compliance. Investors may find some external data available for these checks but will largely need to do their own assessments. As mentioned above, the report proposes checking human rights processes and measures by reference to the Reporting Standards being developed under the CSRD.
- Whether there is evidence that the company did not adequately implement human rights due diligence through the company or senior management finally being found to be in breach of labour law or human rights or through processes initiated by OECD “National Contact Points” or the Business and Human Rights Resource Centre. If a company has been found to have committed a human rights breach, it will need to show that it has provided remedies and made definite improvements in its processes.

Smaller companies are not considered compliant if the company has not established human rights due diligence proportionate to its size and risks or if the company has been found in breach of human rights, labour rights or consumer rights.

The Commission gave guidance on Minimum Safeguards in a [notice](#) dated June 2023. This described Minimum Safeguards as due diligence and remedy procedures implemented by a company to ensure alignment with the OECD Guidelines and UN Guiding Principles and described the checks as to whether a company has implemented appropriate procedures, including procedures to continuously identify, prevent, mitigate or remediate the relevant actual and potential adverse impacts connected with their own operations, value chains and business relationships. The guidance also noted that, where a company cannot address certain risks or eliminate certain negative impacts, this does not necessarily mean that the undertaking does not comply with the Minimum Safeguards, provided that the undertaking has clearly disclosed these potential impacts and explained what it did to identify, prevent, mitigate or remediate them and why it could not eliminate certain impacts.

What Are the Key Challenges to Qualifying an Investment under the Taxonomy?

It is clear that the most challenging aspect of qualifying an investment under the Taxonomy is the “do no significant harm” test. The criteria for the DNSH test are specified against each environmental objective, to the extent that the relevant economic activity poses a risk of harm to that environmental objective. There are specific and generic criteria, with up to twenty DNSH criteria in some cases. Generic criteria include matters such as EU-compliant environmental impact assessments and restrictions on polluting substances. Many DNSH criteria are not typically covered by existing ESG reporting by companies,² and some criteria are quite broadly described.³

Can Investors Qualify the Activities of Non-EU Companies under the Taxonomy?

In its [Taxonomy FAQs](#), the Commission has confirmed that companies in scope of the NFRD must cover the Taxonomy alignment of their economic activities, regardless of whether these take place outside the EU. It follows that funds may take steps to qualify their non-EU investments under the Taxonomy.

² Such as the requirement that climate adaptation solutions “do not adversely affect the adaptation efforts or the level of resilience to physical climate risks of other people, of nature, of cultural heritage, of assets and of other economic activities; and are consistent with local, sectoral, regional or national adaptation strategies and plans”.

³ Such as the requirement under the Circular Economy environmental objective which mandates an economic activity to “design for high durability, recyclability, easy disassembly and adaptability of products manufactured”. More generally, the technical screening criteria do not define several key terms, such as “low-carbon emissions”, “essential” and “materiality”.

The DNSH criteria frequently specify EU standards, and in some cases they specify equivalent standards for activities outside the EU. For instance, in the climate change mitigation criteria, in respect of the requirement to produce an EU environmental impact assessment to ensure no significant harm to biodiversity, the technical screening criteria for activities outside the EU refer to equivalent applicable national law or international standards. There is a similar reference to equivalent national or international standards for non-EU activities under the generic criteria for ensuring DNSH to water and marine resources. However, many of the specific DNSH criteria which include reference to EU environmental protection standards include no reference to non-EU equivalents.

In its [Taxonomy FAQs](#), the Commission further confirmed that, to assess the Taxonomy alignment of an activity outside the EU, companies should ascertain whether it is performed in compliance with EU requirements where specified in the technical screening criteria, a relevant international standard or equivalent applicable national law in a third country. However, crucially, where the technical screening criteria do not specify the use of equivalent non-EU standards, there is no clear basis for using such equivalent standards.

In its SFDR Q&A, the Commission stated that, while it should be possible to use estimates to assess the DNSH based on equivalent information, “controversy-based approaches” (such as the use of publicly reported environmental incidents) alone are considered insufficient.

The Commission’s [notice](#) on the interpretation and implementation of the EU Taxonomy includes guidance on the technical screening criteria and limited guidance as to how companies can apply standards in the technical screening criteria to activities in non-EU jurisdictions, and the [Taxonomy FAQs](#) provide guidance on classifying non-EU real estate assets as Taxonomy aligned.

Is the Taxonomy Likely to Be Revised in the Future?

The Taxonomy technical screening criteria identify those activities with the highest potential to make a substantial contribution to a given environmental objective. In the case of GHG emissions reduction, the screening criteria prioritise economic activities which make the most emissions and with the potential to reduce emissions, such as transport and heavy manufacturing.

The Taxonomy Regulation provides for the Commission to review regularly the technical screening criteria and specifically to review activities that are considered

“transitional” on contributing to climate change mitigation at least every three years. The Commission has confirmed that it will review the technical screening criteria over time to keep them aligned with overall policy objectives, technological developments and the existence of “scientifically robust evidence” to justify the introduction of new or updated criteria. Commentators have pointed out that many enabling activities are still missing from the Climate Delegated Act and Environmental Delegated Act, such as energy-efficient industrial solutions and digital solutions, and that there is no clear communication channel to allow sectors whose activities are not covered to request the inclusion of new activities or revisions to Technical Screening Criteria.⁴

The Taxonomy also flags the possibility of establishing a brown taxonomy (a taxonomy of environmentally harmful activities), a taxonomy of “low impact” environmentally sustainable activities and a social taxonomy but does not commit itself to this project. To date, the Commission’s Platform on Sustainable Finance has published a final report on the Social Taxonomy, outlining its scope and material for the contribution (including a set of specific social objectives) and do-no-significant-harm tests, but the progress of this project is unknown.

Is External Assurance of Taxonomy Reporting Required?

When publishing their reports on Taxonomy alignment in line with the [Disclosures Delegated Act](#), companies are not required to obtain external assurance of the information published.⁵ Reports on Taxonomy alignment will be subject to external assurance under the framework provided for in the CSRD. However, the technical screening criteria contain specific verification requirements for certain activities.⁶ The Commission’s [notice on the interpretation and implementation of the EU Taxonomy](#) states that external verifiers are either the relevant national competent authorities or an independent third-party verifier.

⁴ See, for example, the [European Round Table for Industry’s Expert Paper: Practical Implementation of the EU Taxonomy](#).

⁵ Note that national rules transposing the NFRD may require that Taxonomy reporting is verified by an independent assurance services provider.

⁶ For instance, the activities of “Manufacture of other low carbon technologies”, “Manufacture of plastics in primary form” and “Electricity generation from geothermal energy” require independent verification of GHG emission savings.

Will the Taxonomy Be Subject to International Alignment and Equivalence?

The UK is working on producing its own environmental taxonomy, which is likely to be well aligned to the EU version, although the UK has signalled a more flexible approach to the DNSH test compared to the EU Taxonomy. The UK has committed to make the UK Taxonomy's technical screening criteria as operable internationally as possible. It is interesting to note that, whilst there is a mechanism in the CSRD for the EU to determine other sets of sustainability reporting standards as equivalent to the EU's, there is no mechanism for the EU to view any other taxonomy as "equivalent" to its own regime.

Note that the following resources are available on the EU Taxonomy Navigator Website:

- The [EU Taxonomy Compass](#) is an online tool that allows users to search for economic activities covered by the technical screening criteria. It provides information on which activities are eligible, their contributions to the six environmental objectives and the criteria for Taxonomy alignment. The tool includes filtering options and hyperlinks to relevant EU regulations.
- The [EU Taxonomy Calculator](#) is an interactive tool that helps non-financial undertakings to determine their Taxonomy eligibility and alignment ratios based on proportion of turnover, capital expenditure and operational expenditure.
- The [EU Taxonomy User Guide](#) offers a step-by-step approach for companies to assess their eligibility and alignment. It provides users with examples to illustrate this process.

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Please do not hesitate to contact us with any questions.



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