EU Taxonomy Regulation

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Introduction

The Taxonomy Regulation[1] (the "Taxonomy") defines a European Union ("EU")-wide taxonomy, or classification system, of environmentally-sustainable economic activities, covering six environmental objectives. It contains technical screening criteria that draw on existing EU standards, labeling and certification regimes. It also introduces disclosure requirements for *(i)* financial services firms in relation to activities of their investments that they term as environmentally sustainable and *(ii)* large EU "public interest" companies in relation to their own economic activities.

Reflecting the European Union's commitment under the Paris Agreement to achieve carbon neutrality by 2050, the Taxonomy Regulation (and associated technical screening criteria) initially focuses on climate change issues, with the Taxonomy Regulation applying on 1 January 2022 in respect of the two climate change objectives and 1 January 2023 for the other environmental objectives.

The future importance of the Taxonomy Regulation to EU capital markets cannot be overstated. EU policy makers will use it as the basis for directing capital flows towards environmentally sustainable activities, including, in the fund management sphere, to encourage investment in financial products that meet EU-wide standards to invest in environmentally sustainable projects and companies. EU authorities are also expected to use it as a means to determine the environmentally linked risk of a particular asset, and it will form the basis of bank capital requirements that are linked to environmentally beneficial assets.

The Taxonomy Regulation helps define certain obligations under the Sustainable Finance Disclosures Regulation (the "SFDR") and will help to define those under the Non-Financial Reporting Directive (the "NFRD"). The European Commission (the

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[1] Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088.

"Commission") also expects EU investors and companies to use the Taxonomy on a voluntary basis. For investors, this could be as a tool for due diligence for screening, identifying, and ongoing monitoring of sustainable investment opportunities with a positive environmental impact. For companies, the Taxonomy and particularly the technical criteria could inform their environmental and sustainability transition strategies and targets, as well as providing a basis for ongoing due diligence of environmental impacts caused by their activities, or the activities of other entities within their value chain. The Taxonomy is also likely to influence the definition of "adverse impact" on the environment for the purposes of the EU's forthcoming mandatory human rights due diligence law.

The Taxonomy Regulation is the first worldwide attempt to set out an exhaustive economy-wide definition of what it means for an activity to be environmentally sustainable. Whilst other countries (such as Canada and Japan) are following suit, the EU is the "first mover" in forming the basis of a new global language in the environmental sphere. Whether there will be mutual recognition of taxonomies between the European Union, the United Kingdom (which is planning to adopt its own taxonomy) and other states is an open question.

For further commentary on EU ESG related legislation, see our ESG Resources Centre.

Conditions for an Investment to Be Environmentally Sustainable

The six environmental objectives specified in the Taxonomy Regulation are:

- climate change mitigation;
- climate change adaptation;
- sustainable use and protection of water and marine resources;
- transition to a circular economy including waste prevention and recycling;
- pollution prevention and control; and
- protection of healthy ecosystems.

The Taxonomy Regulation sets out the following conditions for an investment to be considered as "environmentally sustainable":

- It makes a substantial contribution to one or more of the six environmental objectives specified in the Taxonomy Regulation—the technical screening criteria defined what it means to "substantially contribute" to an objective.

- It does no significant harm to any of the other environmental objectives, again, as defined by the technical screening criteria.

- It is carried out in compliance with minimum social safeguards. These social safeguards are aligned with the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights, including the eight fundamental International Labour Organisation conventions and the International Bill of Human Rights.

When Is Compliance with the Taxonomy Regulation Required?

The SFDR applies to "financial market participants" (incorporating a range of regulated EU firms, including alternative investment fund managers) that are responsible for promoting financial products with varying ESG characteristics. The SFDR and the Taxonomy Regulation will ensure that investors investing in financial products in the scope of the Taxonomy will obtain information about the Taxonomy alignment of their portfolios.

Where a "financial market participant", such as an alternative investment fund manager ("AIFM"), makes available a product that promotes environmental characteristics and intends to make "sustainable investments" (as an "Article 8" fund under the SFDR), it must include the information specified in the Taxonomy Regulation. Likewise, where a financial market participant makes available a product with sustainable investment as its objective (as an "Article 9" fund under the SFDR), it must include the information specified in the Taxonomy Regulation. The Taxonomy Regulation requires the financial market participant to disclose information on:

- the environmental objectives to which the investments underlying the financial product contribute

- how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the Taxonomy.

This requires assessment of the alignment of the economic activities of the underlying portfolio with the Taxonomy's technical screening criteria (see below— "What Steps Are Required to Assess Alignment?")

Over time, we expect that Taxonomy-compliant investments (or those that achieve a certain level of Taxonomy compliance) will be sought by investors with specific allocations for that purpose. It is also likely that EU authorities will incentivise, from a tax or regulatory perspective, investment in such products. At present, there is no minimum percentage for an "Article 9" fund, with sustainable investment as its objective, to be Taxonomy aligned. However, the Commission has proposed an "EU Ecolabel" for funds, which would require a certain proportion of a fund's investments to be in Taxonomy-aligned activities.

What Steps Are Required to Assess Alignment?

Financial market participants are required to check alignment of their portfolios at the initial investment stage and on an ongoing basis. The process is as follows.

- Identify the economic activities conducted by the company (e.g., power generation, energy intensive manufacturing or energy storage) that are capable of being aligned, as identified in the Taxonomy's technical screening criteria;

- Break down those activities by turnover and, if relevant, capital expenditure and operating expenditure.

- For each potentially aligned activity, verify whether the company meets the relevant technical screening criteria—e.g., carbon emissions for electricity generation are less than 100 g CO_2e/kWh.

- Verify that the "do no significant harm" criteria are met by the company.

The basis of these checks will either be the investee company's own disclosures of alignment of its activities against the Taxonomy (if it is subject to sustainability reporting requirements, for example under the NFRD (see below) or if it voluntarily discloses such information) or the fund's due diligence information obtained from the company or external data providers.

- Conduct due diligence to avoid any breach of the minimum social safeguards specified in the Taxonomy Regulation.

- Calculate the proportion of alignment of investments with the Taxonomy and prepare disclosures at the investment-fund level. For this purpose, firms will assess alignment in relation to their equity and debt investments in broadly the same way, with the Taxonomy separately recognized the future "EU Green Bond" standard, which are debt instruments that are used to finance Taxonomy compliant projects or economic activities.

Technical Screening Criteria

The Commission has finalised the Taxonomy's technical screening criteria as an exhaustive definition of those economic activities that contribute to climate change mitigation or adaptation. The technical screening criteria cover 70 activities in eight sectors of the economy that contribute to climate change mitigation and 68 activities that contribute to climate change adaptation. The criteria prioritise economic activities that make the most relevant contribution to the climate change objectives because they are either most relevant to reducing greenhouse gas emissions or to improving resilience against a changing climate. These include sectors with the highest contribution to CO2 emissions (energy, manufacturing, transport and buildings) as well as activities that enable their transformation, such as renewable energy-related technology and energy storage. Low-environmental-footprint activities that do not make a substantial contribution to climate change mitigation or adaptation are not covered.

Firms that assess the alignment of their investments as against the Taxonomy must map the activities carried on by their investments onto the relevant EU NACE code and then map the NACE code onto the relevant Taxonomy screening criteria.

Climate Change Adaptation

Climate change adaptation involves steps to reduce substantially the adverse impact on climate change, such as wildfires, storms or droughts, of a particular activity. This includes making facilities more resilient to flooding and installing cooling measures in buildings.

Climate Change Mitigation

The Taxonomy Regulation describes climate change mitigation as an activity that addresses the source of climate change by reducing greenhouse gas emissions or increasing greenhouse gas removals, including through activities such as generating, transmitting, storing, distributing or using renewable energy; improving energy efficiency; and strengthening land "carbon sinks", including through forestation. Climate change mitigation can either be a "transitional" or an "enabling" activity.

Transitional Activities

Transitional activities are activities for which low-carbon alternatives are not yet available and that have greenhouse gas emission levels that correspond to the best performance in the sector or industry. Transitional activities comprise activities that are already low carbon (e.g., forestation or renewable energy) or activities that are energy intensive, are critical to the economy and should enhance their carbon reduction (such as cement manufacturing). Transitional activities make a substantial contribution based on their own performance, such as energy-efficient building renovation, energy efficient manufacturing (e.g., best-in-class iron and steel manufacturing) and low-carbon energy production.

The Taxonomy Regulation specifically excludes power generation activities from solid fossil fuels (such as coal or lignite) but does not exclude oil- or gas-related economic activities.

Enabling Activities

Enabling activities directly enable other activities to make a substantial contribution to one or more of the climate change objectives. This includes manufacturing of renewable energy technologies, energy storage, information and communications technology for climate change mitigation and professional, scientific and technical activities for climate change adaptation.

When a fund assesses Taxonomy alignment, the value in the numerator (top part of the equation) will be the value of the fund's securities in those companies, weighted by the share of turnover or (where relevant) capital expenditure or operational expenditure in economic activities carried on by those companies that are aligned to the Taxonomy, including the value of investments in "Green Bonds" (see "EU Green Bond Standard" below). The value in the denominator (bottom part of the equation) will be the total net value of the fund's securities. The fund will count capex and opex when that relates to a project to achieve the climate thresholds for an economic activity contributing to climate change mitigation or adaptation and will count turnover when that is associated with climate change mitigation, but not adaptation, activities. This reflects the Commission's view that climate change "resilience" (adaptation) is "an ongoing process and not a fixed end-state".

External Assurance or Audit

For financial market participants performing the Taxonomy assessment, there is no explicit requirement for external assurance or audit. This is unlike the position for companies within scope of the proposed extension of the NFRD (see below), which envisages companies that report, inter alia, on the taxonomy alignment of their activities to obtain external assurance of the information, likely from existing auditors or newly authorised independent assurance service providers. In practice, where investors cannot rely on an investee company performing its own Taxonomy-related audit of its activities, the investor will need technical assistance to apply the technical screening criteria and may well rely on a form of external assurance in this regard. The Commission has flagged the absence of any requirement for investors to seek external verification or assurance of their disclosures as an area for future review. In the meantime, investors will be mindful of their existing obligations for the accuracy and presentation of pre-contractual and periodic reporting when assessing Taxonomy alignment.

Ongoing Review of Taxonomy Regulation

The Taxonomy Regulation requires the European Commission to review the technical screening criteria for transitional activities at least every three years and for other activities at least every five years. In the course of this review, it is possible that some activities that were previously considered taxonomy-aligned will cease to be eligible, although the Commission is mindful of the risk of creating inconsistent incentives for sustainable investing.

Do No Significant Harm Test

In addition to making a substantial contribution to one of the six specified objectives, a financial product must "do no significant harm" to any of the other environmental objectives in the Taxonomy where there is a risk of such harm taking place. The technical screening criteria include the do no significant harm criteria for each activity, which, depending on the activity, are quantitative (such as a threshold for acceptable greenhouse gas emissions) and/or qualitative (such as a requirement for there to be in place a waste management plan in relation to a particular project or to have consulted with stakeholders on water management).

The small number of European companies which are bound by the NFRD must assess compliance with the do no significant harm criteria (and the minimum social safeguards) when reporting on the percentage of their turnover, capital expenditure and operating expenditure that complies with the Taxonomy (see "Non-financial Reporting Directive—application of Taxonomy Regulation to Non-Financial and Financial Undertakings" below). Otherwise, investors will need to step in and assess compliance when investing or reporting on Taxonomy-aligned activities conducted by those companies, requiring initial and ongoing due diligence. Due diligence will be based on the company's own processes, factual analysis and information on "controversies" from databases and other external sources. The requirement for investors to ensure that a business does no significant harm on a continuing basis raises questions as to the ability of an investor to control, and take a level of responsibility for, the activities of a company in its investment portfolio.

One issue that stakeholders have pointed out in relation to the "do no significant harm" tests is that the "process"-based requirements (such as having done a climate adaption assessment) are suitable for companies raising finance before starting a project, but less easy to put in place for a company applying the rules to existing assets.

Minimum Social Safeguards

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 UN Guiding Principles on Business and Human Rights, including the eight fundamental International Labour Organisation conventions and the International Bill of Human Rights. The OECD guidelines for multinational enterprises bring together various areas of business responsibility, including human rights and labour rights, as well as information disclosure, environment, bribery, consumer interests, science and technology, competition and taxation. The OECD Guidelines also recommend that enterprises apply good corporate governance practices drawn from the OECD Principles of Corporate Governance. In practical terms, investors seeking alignment with these Guidelines and Principles will focus on human rights, labour rights and anti-bribery matters at the due diligence stage and, to the degree possible, during the ongoing monitoring of the investment.

Non-Financial Reporting Directive—Application of Taxonomy Regulation to Non-Financial and Financial Undertakings

The scope and application of the NFRD will widen considerably over the next few years (as envisaged by the Corporate Sustainability Reporting Directive, see below). Companies that fall within the scope of the NFRD will be required to disclose information about their Taxonomy-aligned economic activities—regardless of the company's business sector.

The Taxonomy Regulation requires those non-financial undertakings that are in scope of 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", public interest entities comprising companies listed on an EU-regulated market, 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 that their funds invest in meet the EU Taxonomy criteria.

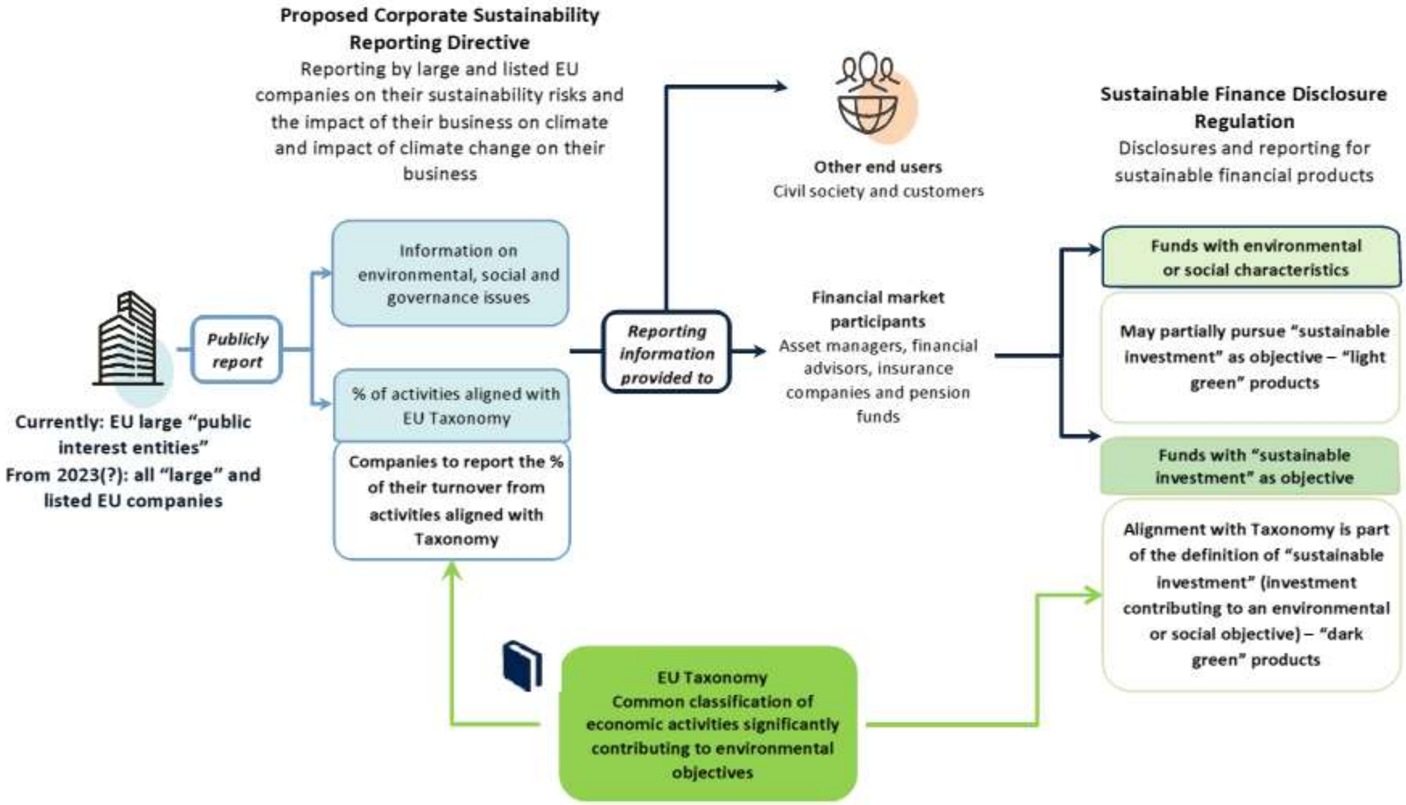
The Commission has commented that turnover gives a clear picture of "where a company currently is relative to the Taxonomy" and includes, for instance, the turnover associated with an activity that meets an emissions threshold, whilst capex gives investors a sense of "the company's direction of travel and strategy", pointing out that revenue and capex information linked to the EU Taxonomy allows the translation of environmental performance (such as reduction in greenhouse gas emissions) into financial variables.

The Commission has pointed out that companies that are not in scope of NFRD may decide voluntarily to disclose their activities' alignment with the Taxonomy, in part because it will help those companies obtain access to "green financing" opportunities.

As stated above, under the Commission's proposal for a new Corporate Sustainability Reporting Directive, "large" EU companies (that meet two of the following criteria: balance sheet greater than EUR 20 million, net turnover greater than EUR 40 million or more than 250 employees), including EU affiliates of non-EU companies, will be required to report on the alignment of their activities to the Taxonomy. This may apply as early as 2023, although that will depend on the passage of the proposal through the EU legislative process.

The diagram below shows the relation between Corporate Sustainability reporting, the Taxonomy Regulation and the disclosures required by financial market participants under the SFDR.[2]

[2] This diagram is derived from the Commission's factsheet "How does the EU Taxonomy fit within the sustainable finance framework?" — https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-factsheet_en.pdf.



EU Green Bond Standard

As part of the Commission's work on standards and labels for green financial products, the Commission's Technical Expert Group on Sustainable Finance is working on a "Green Bond" standard. This is a voluntary standard for issuers of privately issued and publicly listed securities, which will confirm that the proceeds from the bond issue will go to finance (or re-finance) projects and activities that are aligned with the Taxonomy. As well as upfront disclosure by the issuer on the use of the proceeds, there will be mandatory ongoing reporting and verification by an external reviewer, with the Technical Expert Group recommending the setting up of an accreditation scheme for external verifiers for green bonds.

Brown and Social Taxonomy

At present, the Taxonomy Regulation only covers environmental sustainability goals, whilst the sustainability indicators in the SFDR (and the definition of "sustainable investment" in the SFDR) cover both environmental and social goals. The Taxonomy Regulation flags the possibility of establishing both a brown taxonomy (a taxonomy of environmentally harmful activities) and a social taxonomy, but does not commit itself to this project. It is unknown whether the Commission will devote resources in this field, particularly in relation to a taxonomy for economic activities that contribute to social objectives, such as those that assist economically disadvantaged communities.

UK Taxonomy

The UK is not, of course, bound by the EU Taxonomy Regulation. However, the UK government has signalled its own intention to implement a UK "green taxonomy", with the establishment in June 2021 of the UK Green Technical Advisory Group.

There is little indication to date on the form of the UK Taxonomy, with a range of policy decisions open to the government in this area. The EU Taxonomy will certainly be the government's starting point, given that the vast majority of the existing EU regulations which refer to the technical screening criteria now form part of EU retained law in the United Kingdom. However, the United Kingdom could also pursue a taxonomy with an eye on what might more acceptable internationally, and so easily transferable, with more guidance for companies to use non-UK/EU "proxies" to the UK/EU standards.

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Please do not hesitate to contact us with any questions.

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