



EU Taxonomy Regulation — A Major Building Block for Comprehensive ESG Measures in Europe

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The EU's Green Deal, adopted in 2019, calls for achieving net zero greenhouse-gas emissions in the EU by 2050 and other very ambitious goals.^[1] Meeting them will require very significant shifts in the economy worldwide over many years — some voluntary but many, inevitably, by constraint.

A key instrument in this process is the **EU Taxonomy Regulation**,^[2] adopted June 18, 2020, with direct force in all 27 EU member states.^[3] It sets out a conceptual framework and a vocabulary for describing measures that can be considered “**environmentally sustainable**” and, more generally, for evaluating environmental, social and governance (**ESG**) performance of companies. The Taxonomy Regulation also strengthens disclosure requirements under prior legislation (discussed below): the EU Non-Financial Reporting Directive (**NFRD**)^[4] and the EU Sustainable Finance Disclosure Regulation (**SFDR**).^[5]

The Taxonomy Regulation sets out criteria and a vocabulary “for determining whether an economic activity qualifies as environmentally sustainable.” It does not set out recommendations or requirements as to adopting such activities, but these criteria and this vocabulary could be used in other legislation to encourage — or require — modification of behavior or minimum levels of environmentally sustainable investment or activity.

In other words, the Taxonomy Regulation does not contain requirements as to what economic activity to adopt or what investments to make, but it could be used in other legislation establishing such requirements.

A fundamental concept used in the Taxonomy Regulation is whether an economic activity is “**environmentally sustainable**,” which requires that the activity:

- **Contribute “substantially” to one or more of six environmental objectives**, two relating to climate and four others. The relevant activities, in summary, are as follows:
 - **Climate change mitigation (CCM)**. Such an activity avoids or reduces greenhouse gas emissions or increases greenhouse gas removal in areas such as renewable energy, improved energy efficiency, energy-efficient transportation, sustainably sourced renewable materials, carbon capture and utilization (**CCU**), carbon capture and storage (**CCS**), measures relating to

forests, “decarbonisation” of energy systems, or renewable or carbon-neutral fuels.

- **Climate change adaptation (CCA).** This is an activity which either substantially reduces adverse impact (or the risk thereof) of climate on economic activity or substantially contributes to preventing (or reducing the risk of) adverse impact of climate on “people, nature or assets.”
- **Sustainable use and protection of water and marine resources.** The activity must contribute substantially either
 - to achieving good quality, or preventing deterioration, of bodies of water, including surface water, groundwater or marine waters, for example in respect of waste water discharges, drinking water, aquatic ecosystems, water reuse, floods/droughts and sustainable use of marine ecosystem services; or
 - to contributing to the good environmental status of marine waters, including by protecting, preserving or restoring the marine environment and by preventing or reducing inputs in the marine environment.
- **Transition to a circular economy.** Such activities involve sustainable use of natural resources; durability, reparability, upgradability, reusability, recyclability or prolonging use of products; reducing use of hazardous substances or those of “very high concern”; recycling; waste management infrastructure; minimizing incineration and avoiding waste disposal, including via landfill, in accordance with the “waste hierarchy”; and avoiding/reducing litter.
- **Preventing/controlling pollution.** The relevant activities include preventing or reducing pollutant emissions into air, water or land; improving quality of air, water or land; chemical disposal; and clean-up of pollution (including litter).
- **Protecting/restoring biodiversity and ecosystems.** These activities involve conservation of habitats and species; sustainable land use and management; sustainable agricultural practices; and sustainable forest management.
- **Not “significantly harm”** any of those environmental objectives (do no significant harm, or **DNSH**).
- **Comply with minimum “social safeguards,”** including those set out in international guidelines relating to multinational enterprises, human rights and international labor standards.^[6]

The standards defined in the Taxonomy Regulation are supplemented by more detailed “technical screening criteria” promulgated by the EU Commission in the form of Delegated Regulations. The first set of such criteria, providing extensive details on assessing compliance with CCM and CCA standards, was set out in a Delegated Regulation published April 21, 2021, and adopted June 4, 2021.

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As mentioned above, the Taxonomy Regulation has immediate impact on EU disclosure requirements set out in the NFRD and the SFDR, as follows:

- The NFRD establishes EU-wide rules, to be transposed into EU member state legislation, requiring non-financial disclosure on matters relating to ESG matters. These reporting obligations apply to listed companies, banks, insurers and other designated financial-sector companies, if they have at least 500 employees and either turnover exceeding €40 million or a balance sheet totaling €20 million, with the possibility for member states to lower these criteria to include a broader population of companies, so that currently the disclosure requirements apply to about 11,700 entities. The Taxonomy Regulation expands disclosure requirements to include the proportion of turnover, capital expenditures and operating expenditures related to environmentally sustainable activities. The disclosures must report on such environmentally sustainable activities meeting the objectives of CCM and CCA beginning on Jan. 1, 2022, and on those meeting the other four environmental objectives beginning Jan. 2, 2023. On July 6, 2021, the EU Commission adopted a Delegated Regulation detailing the content, methodology and presentation of disclosures.^[8] The EU Commission has proposed a new framework for such disclosures in the form of a proposed Corporate Sustainability Reporting Directive (**CSRD**), now under review by the European Parliament and Council.
- The SFDR sets out requirements for financial services firms distributing financial products in the EU to disclose the environmental objectives to which the investments are supposed to contribute and the environmentally sustainable activities subject of the investment. The EU Commission, on April 21, 2021, adopted several measures reinforcing these disclosure requirements.^[9]

The legislation described in this note are expected to have far-reaching effects in the EU, not only on the reporting and disclosure requirements mentioned above but also in respect of how EU policymakers will direct capital toward ESG-friendly assets and encourage — or mandate — environmentally sustainable practices.^[10] Similar measures are being considered in other countries. Every major player in Europe — and many elsewhere — should take heed.

^[11] These goals are stated to include transforming the EU into “a fair and prosperous society, with a modern, resource-efficient and competitive economy” while protecting “the environment and the health of European citizens,” featuring “the most efficient and sustainable use of natural resources” consistent with other EU goals, including “building an economy that works for the people, strengthening the EU’s social market economy, helping to ensure that it is future-ready and that it delivers stability, jobs, growth and investment.” EU Commission Explanatory Memorandum of June 4, 2021, on the draft Delegated Regulation on technical screening criteria, described below.

- ^[2] Regulation (EU) 2020/852 of June 21, 2020, on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.
- ^[3] Adoption is pending in the European Economic Area (EEA), encompassing EU member states plus Iceland, Liechtenstein and Norway.
- ^[4] Directive (EU) 2014/95 Oct. 22, 2014, amending EU Accounting Directive 2013/34 as regards disclosure of non-financial and diversity information by certain large undertakings and groups.
- ^[5] Regulation (EU) 2019/2088 of Nov. 27, 2019 (as amended), on sustainability-related disclosures in the financial services sector.
- ^[6] The relevant guidelines include the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights, and those referred to in the Declaration of the International Labour Organization on Fundamental Principles and Rights at Work.
- ^[7] Adoption is subject to potential objection by the European Parliament and the EU Council for a period of four months, with possible extension by two months.
- ^[8] This Delegated Regulation is subject to potential objection by the European Parliament and the EU Council for a period of four months, with possible extension by two months. Also on July 6, 2021, the EU Commission published a proposed regulation on a voluntary European Green Bond Standard (EUGBS), which calls for funds raised by the bond to be allocated fully to projects aligned with the EU Taxonomy Regulation; full transparency, including reporting requirements, on allocation of bond proceeds; verification by an external reviewer; and registration of external reviewers. External reviewers providing services to issuers of EU green bonds must be registered with and supervised by the European Securities Markets Authority (ESMA).
- ^[9] The measures adopted April 21, 2021, published in the EU official journal Aug. 2, 2021, include:
- Commission Delegated Regulation (EU) 2021/1253, amending Delegated Regulation (EU) 2017/565 (supplementing the MiFID II Directive) as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms.
 - Commission Delegated Regulation (EU) 2021/1254, correcting Delegated Regulation (EU) 2017/565 supplementing the MiFID II Directive as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of the MiFID II Directive.
 - Commission Delegated Regulation (EU) 2021/1255, amending Delegated Regulation (EU) 231/2013 (supplementing the AIFM Directive) as regards the sustainability risks and sustainability factors to be taken into account by alternative investment fund managers.
 - Commission Delegated Regulation (EU) 2021/1256, amending Delegated Regulation (EU) 2015/35 (supplementing the Solvency II Directive) as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings.
 - Commission Delegated Regulation (EU) 2021/1257, amending Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 (supplementing the Insurance Distribution Directive) as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products.
 - Commission Delegated Directive (EU) 2021/1270, amending Directive 2010/43/EU (supplementing the UCITS Directive 2009/65/EC) as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS).
 - Commission Delegated Directive (EU) 2021/1269, of April 21, 2021, amending Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations.
- ^[10] Examples include the measures proposed by the European Commission on July 14, 2021, under the "Fit for 55" program.

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