

# EU Taxonomy and disclosure regulations



Sustainable Finance  
and Responsible Investment

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# Introduction

This briefing note reflects the content presented in a webinar by Chinyelu Oranefo recorded in March 2021 as part of the Loan Market Associations (“LMA”) Talking Taxonomies series. This is the first note in our sustainable finance April update series.

This webinar follows on from another LMA webinar held in summer 2020 that covered the proposed EU Taxonomy in detail.

This note recaps on what the EU Taxonomy is in the context of EU disclosure regulations and then discusses recent developments on its journey towards implementation.

## EU Action Plan

**The EU Action Plan for Financing Sustainable Growth** complements the EU’s existing 2030 Energy and Climate Framework and Circular Economy Action Plan. It seeks to achieve the following:

- Mainstreaming sustainability into risk management
- Redirecting capital flows towards a more sustainable economy; and
- Fostering transparency and long termism in the financial markets

It proposes to meet these aims by developing a legislative framework extending to matters as broad and diverse as:

- A unified EU classification system (a Taxonomy) to create a common language for sustainable finance and a gold standard against which financial products can be measured
- A green supporting factor
- Incorporating sustainability into prudential requirements
- Strengthening corporate reporting obligations

## EU Taxonomy

In 2019 a group of experts representing a range of European financial services sectors, international organisations and civil society, the “Technical Expert Group” or “TEG” published their recommendations for an EU Taxonomy for sustainable economic activities (the “**Taxonomy**”).

The Action Plan came about broadly as a result of the EU’s pledge, in the context of the Paris Agreement, to reduce greenhouse gas emissions in all sectors by 55% by 2030 and the long-term proposal to achieve carbon neutrality by 2050.

### Creating a Universal Standard

It is important to note that the Taxonomy itself does not impose any positive obligation to invest in “green” assets but rather requires financial products describing themselves as green to be measured against an international standard. Financial institutions and asset managers going to market with green products within the EU will therefore be required to disclose whether those products are “Taxonomy compliant” green products and/or the percentage of the product which meets the criteria. There is currently no requirement to remove the products issued prior to the enactment of the Taxonomy from the market if they do not comply however I think it’s reasonable to expect that they might be required to re-label themselves.

## Taxonomy Framework

*The Taxonomy will apply to:*

- regulators at national and EU level when setting requirements relating to financial products such as corporate bonds that are marketed as environmentally-sustainable; and
- financial market participants offering financial products as environmentally-sustainable. To be clear the Taxonomy will apply to financial products created outside of the EU which are marketed within the EU

In addition it is hoped that the Taxonomy will be used voluntarily by other financial players such as banks where they are marketing products as green e.g. green loans.

## Four Taxonomy Criteria

In order to be an “environmentally sustainable economic activity” the proposed activity must meet the following four criteria:

1. Contribute substantially to one or more of six environmental objectives<sup>1</sup>
2. Do no significant harm to any other environmental objective
3. Comply with the minimum social safeguards
4. Comply with the technical screening data

### 1st criteria: Environmental Objectives

The first criteria consists of six environmental objectives, the first two of which are addressed in this version of the Taxonomy.

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use of protection of water and marine resources
4. Transition to a circular economy, waste prevention and recycling
5. Pollution prevention and control
6. Protection of healthy ecosystems

### Climate Change Mitigation

An economic activity will make a substantial contribution to the mitigation objective where it avoids or reduces “greenhouse gas emissions or enhances greenhouse gas removals” e.g. retrofitting, renewable energy and electric vehicles.

### Climate Change Adaptation

The adaptation objective relates to substantially “reducing the negative effects of the current and expected future climate or preventing an increase or shifting of the negative effects of climate change”.

### 2nd criteria: Do no significant harm to any other environmental objective (“DNSH”)

If the proposed economic activity falls within the climate change mitigation or adaptation environmental objectives, it must also not cause significant harm to any of the other five environmental objectives.

Where evidence is not conclusive on whether the DNSH criteria has been met, a Precautionary Principle applies with the result that the activity is unlikely to be deemed to be sustainable until it can be proved scientifically not to cause harm.

### 3rd criteria: Minimum social safeguards

At this time the Taxonomy sets these out in line with the International Labour Organisation’s core directives which must be observed. Obviously all local laws must be complied with.

### 4th criteria: Technical screening data

Lastly the TEG’s proposed technical screening data for each of the classified economic activities meeting the above three conditions were published in March 2019. i.e. what standard an economic activity needs to meet in order to be considered “green”. The Final TEG Report came out in June 2019.

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<sup>1</sup> Contribute substantially to the EU’s six environmental policy objectives. To be eligible for the Taxonomy framework the proposed economic activity must fall within one of the six environmental policy objectives of the proposal, known as the Six Principles (the first two of which are addressed in this version of the Taxonomy[4]):

# Disclosure Regulations

## *Sustainable Finance Disclosure Regulation*

The Sustainable Finance Disclosure Regulation entered into force on 29 December 2019 and begins a phased implementation from 10 March 2021. It applies to Financial Advisors and Financial Market Participants. It applies to any Financial Product offered within the EU regardless of where it is “manufactured”.

Each relevant firm falling within their scope needs to comply with disclosure obligations at both a firm and product level. They need to publish sustainable risk policies and make a “Principal Advisers Impacts statement”. At the product level, there must either be a disclosure on how sustainability risks have been addressed or an explanation as to why they have not been. Where the product has an ESG focus then the disclosures required are more specific and need to meet the detailed objectives and conditions set out in the EU Taxonomy and reference any relevant benchmarks.

## *Non-Financial Reporting Directive*

This regulation covers Public Interest Enterprises, a definition which includes listed companies, banks and insurance companies with more than 500 employees. These entities will need to disclose in their annual accounts what proportion of their turnover, capital or operating expenditure is associated with Taxonomy aligned activities. Amongst other things they will also need to describe their policies, outcomes and risks in management reports and identify, prevent and mitigate existing and potential adverse impacts. NFRD entities are due to start reporting under Article 8 of the Taxonomy Regulation by June 2021.

So in addition to applying to green products the Taxonomy feeds into these disclosure regulations impacting a wide variety of institutions.

# Recent Developments

## *EU Commission consultations*

Following the publication of the TEG recommendations last year the Commission produced a draft delegated Act relating to the first two environmental objectives (climate change adaptation and climate change mitigation). These drafts were due to be adopted by the end of 2020 with the publication of the final technical screening criteria due to occur in January 2021. Delegated Acts for the four remaining objectives (water, pollution control, biodiversity and circular economy) are scheduled to follow.

In reality the Commission published the first two sets of technical screening criteria last November and in response to that consultation the Commission received more than 46,000 responses. The EC website now states that the delegated act will be adopted by the end of April 2021.

## *Deviations*

Whilst the draft Delegated Acts is based on the TEG recommendations the Commission appears to have strengthened some requirements and softened others. This has given rise to much concern and it's fair to say that there has been widespread criticism of some aspects of the draft, particularly with respect to its treatment of fossil fuels. Examples of this concern have been expressed by a coalition of 130 NGOs and sustainability experts which suggest that the original recommendations have been weakened and call for the Taxonomy to be “rooted in climate and environmental science”.

By way of example of the criticisms, I'll touch on two areas of interest for me – real estate and energy.

## *Buildings Criteria*

Properties constructed before 2021 will need to have an EPC class “A” or higher to be eligible under the Taxonomy. The TEG had recommended that buildings falling within the top 15% of the most efficient amongst local stock would be eligible with that threshold tightening over time in order to encourage market change. For those of you involved in real estate it's worth noting that the proposed criteria does not provide for the acquisition and subsequent retrofitting of a property which in practice is how most upgrading of existing stock will be achieved.

The draft Delegated Act would also have the consequence of many existing green property bonds and green property funds falling outside the Taxonomy – this is a market estimated to be worth around EUR80 billion. These products will have been structured either in line with the Climate Bond Standards (the “CBS”) which was aligned to the TEG approach or the green bond principles and a divergence here could result in a split in the market between the Taxonomy and the green frameworks which institutions have already voluntarily put in place. Furthermore according to the CBS, if an EPC A criteria is used it will in practice be very difficult to structure a green bond portfolio because there is very limited supply of building stock at this level – perhaps as small as 1%. The EPC A criteria may also even be an issue for new building stock.

## Energy

The draft Act provides for a threshold of 100 grams of Co2 equivalent per Kwh for electricity generation (thus effectively excluding fossil fuel generation but including gas-fuelled power plants if they meet this limit) but did not include the TEG recommendation that this threshold would decrease every five years in line with the 2050 net zero ambition.

The draft Act also allows for the integration of hydrogen and other low carbon gases i.e. gas, which could result in a permanent embedding of a blending approach which ultimately will not result in achieving net zero targets.

Lastly the difficult question of whether nuclear power will fall within the scope of the Taxonomy has been deferred pending further assessment by the Commission. The TEG had clearly taken the view that nuclear was not consistent with the “do no significant harm” principle.

## Mounting Pressure

On the other side of the argument interested parties have raised concerns that the Taxonomy has gone too far. The concerns include that:

- companies that can not show they already operate sustainably will not be able to attract finance in the future. Obviously this is not how the Taxonomy is supposed to work although it is true that in essence the Taxonomy is at heart an attempt to redirect financial flows but I suspect that there will always be financiers ready to fund all types of operations as new players will enter the market.
- existing EU policies may also have been a source of deviation from the TEG recommendations where a choice was made as to whether the Taxonomy would be aligned with existing laws or the more recent environmental objectives.
- whilst the EU policy indications have been encouraging to investment into gas by the fossil fuel industry as a transition fuel, other institutions have declared that its use is not consistent with net-zero emission levels by 2050. They believe that the Taxonomy should recognise that the industry will “decarbonise over time” and thus form part of the transition.

Lastly and looking forward, we must also not forget that the final Delegated Acts will need to be adopted by the Commission and then reviewed and unanimously approved by the European Parliament member states. It’s well known that some member states have already cautioned that they will find it difficult to support the exclusion of certain activities from the criteria.

## The Platform on Sustainable Finance

Perhaps to help with this challenging task of striking a balance between the two camps, the Commission referred back to the Platform on Sustainable Finance (“PSF”) which is the new expert group replacing the TEG. Last year the Commission asked it to respond to the draft Act and it did so with a detailed paper, reminding the Commission, amongst other things, (a) not to lose sight of the fact that the Taxonomy needs to result in the 2030 emissions reductions target of 55% on 1990 levels and (b) the importance of using the Taxonomy as a tool to support transition to a sustainable economy, for example by, allowing the financing of improvement measures if they are part of a project which will meet the relevant activity threshold over a specific period – no more than five years.

Earlier this year, the PSF was asked to advise the Commission further on transition matters. The PSF is also tasked with considering, amongst other things:

- a brown Taxonomy – it has been suggested that a brown Taxonomy would be useful to effectively differentiate between the most and least risky activities falling outside the green Taxonomy; and
- Social objectives

## Conclusions

A key question to be resolved by the Commission is whether it is indeed helpful to take a binary – is it green or not? - approach without incorporating some form of dynamic transition mechanic. Some authors are talking about this being an “olive” curve which brings us towards a green economy. There is a risk that if the Taxonomy is framed too narrowly it will fail in its primary purpose to direct money towards sustainable activity.

Another reason for taking a gradual approach is that much of the data required to make comparable assessments is not available yet so it seems there is a bit of a “best guess” element to the thresholds in certain respects until these data sets become available. This approach seems to be even more important when one takes into account that climate change scientific understanding is also developing at a pace and often requiring new assessments of what is required to achieve Paris Agreement or net zero goals.

Notwithstanding that, as a finance lawyer, I think that a five year gradual tightening approach could raise an interesting dilemma for any finance product which straddles two technical specification criteria.

But perhaps one should consider what message a transition approach sends to investment committees and what effect does it have on the overall reduction in carbon? Perhaps a quick sharp shock to the system is what’s needed?

We also must not forget the social agenda here. As a result of the re-direction of financial flows, many people across the EU may lose their jobs and the EC has acknowledged this in their proposals to support a “Just Transition” through its Green Deal package.

We should also mention the International Platform on Sustainable Finance, which should not be confused with The Platform on Sustainable Finance (“IPSF”) discussed above. The IPSF working group is formed of 17 different countries, key financial institutions and led by the EU and China with a view to formulating a “common ground Taxonomy” which will identify commonalities between the various taxonomies which are being developed globally. They plan to deliver a report on a Taxonomy and sustainability disclosures by Q3 2021.

## Contact



**Chinyelu Oranefo**

Senior Associate

**T** +44 20 7524 6932

**E** [chinyelu.oranefo@cms-cmno.com](mailto:chinyelu.oranefo@cms-cmno.com)



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CMS Cameron McKenna Nabarro Olswang LLP  
Cannon Place  
78 Cannon Street  
London EC4N 6AF

T +44 (0)20 7367 3000  
F +44 (0)20 7367 2000

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