EU SUSTAINABILITY TAXONOMY: CREATING THE GOLD STANDARD IS EASIER SAID THAN DONE

The European Union continues to move forward in its efforts to reduce greenwashing and promote sustainable finance through a series of inter-related, and complex, legislative initiatives. Over the past year, the European Commission has been focused on taxonomy – in essence, a common reference system for classifying which products and activities are to be deemed sustainable, with the most recent pronouncement issued on the last day of 2021. The ultimate goal of the taxonomy is to pave the way for reaching net zero by 2050.

This year-end consultation – on a complementary delegated act – underscores both the difficulty of phasing out fossil fuels and the tensions between policy and politics, as pro-nuclear member states and pro-natural gas member states seem to have succeeded in convincing the Commission that their energy sources should not lose the coveted "green" or "transitional" taxonomy labels, although conditions were attached and the concessions are time-limited. While there is a mechanism to force through efforts backed by a weighted majority, the Commission must seek compromise where it can, and therein lies a broader warning.

EU Taxonomy

The EU Taxonomy regime establishes a common classification of economic activities ("sustainable activities") deemed to contribute to environmental objectives. Article 8 of the Taxonomy Regulation (2020/852), which entered into force July 12, 2020, is designed to increase transparency in the financial markets and reduce greenwashing by calling for disclosure of information about the environmental performance of assets and economic activities of financial and non-financial enterprises. The mandated transparency in respect of corporate environmental performance also facilitates green finance. (See generally FAQ and Q&A.)

The classification system is to be used, for example, in the proposed Corporate Sustainability Reporting Directive ("CSRD"), which is intended to extend reporting requirements of the Non-Financial Reporting Directive ("NFRD"), and the Sustainable Finance Disclosure Regulation ("SFDR"), the principal building blocks of the EU sustainable finance regime. The CSRD will drive reporting by large companies and listed companies on their sustainability risks and sustainability impacts (in effect, the impact of their operations on the climate, and the impact of climate change on their operations). Reporting companies will need to disclose, together with other ESG information, the percentage of current revenue aligned with sustainable activities (per the Taxonomy) and the percentage of capital expenditures associated with those activities. (For an overview of corporate reporting obligations published by the European Commission, see generally, EU Corporate sustainability reporting.)

Corporate disclosures will be available to end users directly, but will also feed into reporting by financial market participants (*e.g.,* asset managers, insurance companies, pension funds and the like) and financial advisers, who under the SFDR, will need to categorise products that have environmental or social characteristics and products with a "sustainable investment" objective (*i.e.,* contributing to an environmental or social objective).

A Delegated Act (the "Taxonomy Disclosure Delegated Act") is to specify the content, methodology and presentation of information for both financial and non-financial companies on the share of their respective business, investments or lending activities that are aligned with the EU Taxonomy.

Delegated Acts – June and July 2021

The Taxonomy Disclosure Delegated Act (2021/2178) was adopted by the European Commission July 6, 2021 and came into force January 1, 2022. Non-financial companies are to disclose the share of their revenue, capital expenditure and operational expenditure ("Performance KPIs") associated with environmentally sustainable economic activities as defined in the Taxonomy Regulation and the first Taxonomy Delegated Act (2021/2139) adopted June 4, 2021 (that set out technical screening criteria for economic activities having the potential to contribute to climate change mitigation and adaptation), as well as any future delegated acts on other environmental objectives. Financial institutions, mainly large banks, asset managers, investment firms and insurance/reinsurance companies, are to disclose the share of environmentally sustainable economic activities in the total assets they finance or invest in. The European Commission recognized that not all relevant sectors and activities, in particular nuclear energy and natural gas, were covered in the first Taxonomy Delegated Act.

In sum, the Taxonomy Disclosure Delegated Act allows companies to translate the technical screening criteria into the quantitative economic Performance KPIs. These Performance KPIs are intended to assist investors and the market understand the trajectory of reporting companies towards sustainability. In addition to making it more difficult for companies to greenwash, these corporate disclosures are intended to be used by market participants to design credible green financial products and, thereby, help channel capital to more sustainable projects. Companies covered by the NFRD are subject to mandatory reporting; companies not so covered (*e.g.*, small and medium-sized enterprises) can report some or all of the Performance KPIs on a voluntary basis.

By providing the common reference points for financial market participants covered by the SFRD and reporting companies covered by the NFRD – all of which are now required to disclose, among other things, the extent to which their respective products or activities are environmentally sustainable, the Taxonomy Disclosure Delegated Act, read with the Taxonomy Regulation, the NFRD (as extended by the CSRD) and the SFRD, thus underpins the reporting regime on which the EU sustainable finance strategy is based. The Taxonomy Disclosure Delegated Act will also serve as the basis for future sustainable finance initiatives, including the development of EU-wide standards for environmentally sustainable financial products and the creation of labels that recognize compliance with these standards. The anticipated European Commission proposals on the EU green bond standard and EU ecolabel for financial products are to use the same taxonomy.

The Taxonomy Disclosure Delegated Act provides for tiered implementation:

- January 1, 2022: for the reporting period 2021, only qualitative information and information on the proportion of taxonomy-eligible activities in relation to total activities set out in the Delegated Act must be disclosed.
- January 1, 2023: for the reporting period 2022, the Delegated Act will apply fully to non-financial companies and, as January 1, 2024, for the reporting period 2023 to financial companies with the understanding that certain exposures and investments of financial institutions, including in sovereign debt and non-NFRD undertakings, may not have been fully reflected in their KPIs.
- By 30 June 2024, the Delegated Act will be reviewed in particular with respect to the treatment in the KPIs of exposures of financial undertakings to sovereigns and non-NFRD undertakings; and

- As of 1 January 2026: for the reporting period 2025, the Delegated Act will apply for the KPIs of credit institutions for the trading book and non-banking services

The Taxonomy Disclosure Delegated Act takes the form of an EU Regulation (rather than a Directive) and, as such, has direct binding effect in all EU member states.

Taxonomy Complementary Delegated Act – December 31, 2021

The European Commission has now begun "expert" consultation on a third Taxonomy Climate Delegated Act – the Taxonomy Complementary Delegated Act (amending the two 2021 delegated acts). (The text is available on the internet but, in a surprise move, was not published by the Commission.)

The consultation is with the Member States Expert Group on Sustainable Finance and the Platform on Sustainable Finance (whose members are drawn from the public sector, industry, academia, civil society and the financial industry, and which is the successor to the Technical Expert Group on Sustainable Finance ("TEG")). The TEG (through reports issued in 2018, 2019 and 2020) was a key contributor to the taxonomy effort, tasked with developing recommendations for technical screening criteria for economic activities that can make a substantial contribution to climate mitigation and adaptation (the first two of the six environmental objectives of the Taxonomy Regulation), while avoiding significant harm to the other four environmental objectives (namely, sustainable use of 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 new Delegated Act has generated significant criticism for including nuclear power and natural gas, with critics warning that the changes would lead to greenwashing, incentivize inefficient use of renewables and increase costs of transition. The draft issued in April 2021 (see Q&A and further EC steps) did not specifically include nuclear power or natural gas, with the understanding, at the time, that a complementary Delegated Act would cover them following further assessment.

According to the Commission press release, the Commission "considers there is a role for natural gas and nuclear as a means to facilitate the transition towards a predominantly renewable-based future. Within the Taxonomy framework, this would mean classifying these energy sources under clear and tight conditions (for example, gas must come from renewable sources or have low emissions by 2035), in particular as they contribute to the transition to climate neutrality. In addition, to ensure transparency, the Commission will amend the Taxonomy Disclosure Delegated Act so that investors can identify if activities include gas or nuclear activities, and to what extent, so they can make an informed choice." While natural gas is deemed transitional, nuclear energy does not appear to be. For nuclear energy, construction permits will have to have been issued by 2045, and projects will need to meet criteria relating to removal of toxic waste and so-called applicable DNSH (do no significant harm) criteria, among others.

The Member States Expert Group on Sustainable Finance and the Platform on Sustainable Finance have until January 12 to provide their "contributions." Under the Taxonomy Regulation, these delegated acts need approval (or the absence of objections) from a qualified majority of EU member states (20 member states representing at least 65% of the EU population, acting through the European Council) and the European Parliament.

Concluding Thoughts

The EU sustainable finance efforts represent the most advanced and ambitious undertaking to tackle climate change from a whole of market perspective. These efforts have the potential to become the gold, and perhaps the global, standard. A range of stakeholders are looking to these efforts to be credible, clear, consistent and coherent. The internal infighting within the European Union (in this case, pitting groups of member states against one another over whether to include nuclear energy and natural gas, as well as the inclusion of forestry and bioenergy) and ultimate compromise highlight the fraught nature of achieving the Paris thresholds, and in particular how to *manage the transition* to net zero.

The taxonomy regime has the advantage of not being a static undertaking, allowing, for example, for conditions around natural gas to be tightened over time, taking into consideration technological advancements and the success of climate change mitigation strategies. Ultimately though, the sad reality is that politics will have to be accommodated and, just as there are different interests among the EU-27 as to who bears the greater burden of transitioning away from fossil fuels (with Germany, Poland, Bulgaria and the Czech Republic viewing natural gas as key to the transition, while France, the Czech Republic and other eastern European member states pushed for the inclusion of nuclear energy, and Nordic countries called for inclusion of their major source of bioenergy, forestry), so too are there additional significant differences when the rest of the world is factored in. Others can be expected to develop their own taxonomies (choosing to follow the EU lead, or not), and there is little sense today as to where other major emitters such as the US and China will come out.

The urgency of the task remains, and the delays to date heighten the risk that the planet runs out of time. Policymakers, regulators and other participants must resist the temptation to undermine the ultimate goal.

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