UNDERSTANDING MANDATORY EU SUSTAINABILITY REQUIREMENTS - A PRIMER FOR NON-EU COMPANIES

US and other non-EU companies with operations in the European Union should be aware of the ongoing efforts of the European Union to legislate around sustainability. That awareness is important, in part, because the efforts represent the global direction of travel for disclosure standards tied to sustainability, for both companies as well as financial market participants, but more importantly because, as I have highlighted in previous briefing notes (*see, e.g.,* the update on the Corporate Sustainability Reporting Directive, available here), many of these efforts have extra-territorial reach.

At the heart of the growing web of EU mandated regulatory requirements (some applicable to companies, others to financial market participants) is the green taxonomy, the most ambitious roadmap in the world to meet climate and energy targets for 2030, by directing investment towards sustainable projects and activities. The taxonomy, based at its core on a set of four overarching conditions and six environmental objectives, sets out a complex definition of sustainability and what products can be marketed as sustainable. It does so through the common classification of sustainable economic activities deemed to contribute to environmental objectives via the EU Taxonomy Regulation and related Delegated Acts.

Taxonomy 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 resulting taxonomy-compliant transparency in respect of corporate environmental performance also facilitates green finance.

I set out below a lexicon of relevant concepts (terminology, legislation and delegated acts) as well as an update on recent developments.

Lexicon of EU Sustainability Concepts

General

- Delegated Acts are secondary legislation from the European Commission, and in the sustainability area will set out technical screening criteria that define thresholds and specific requirements for activities to be considered to be contributing significantly to an environmental objective.
- DNSH: the acronym for "does not significantly harm" any of the environmental objectives.
- **Environmental objectives** (set out in Article 9 of the Taxonomy Regulation):
  - climate change mitigation (in accordance with Article 10);
  - climate change adaptation (in accordance with Article 11);
  - the sustainable use and protection of water and marine resources (in accordance with Article 12);
  - the transition to a circular economy (in accordance with Article 13);
  - pollution prevention and control (in accordance with Article 14); and
  - the protection and restoration of biodiversity and ecosystems (in accordance with Article 15).

- European Financial Reporting Advisory Group ("EFRAG"): draws up the European Sustainability Reporting Standards ("ESRS").
- European Green Deal: sets out a series of actions to transform the EU into a modern, resource-efficient and competitive economy by achieving net-zero by 2050, economic growth decoupled from resource use, and no person or place left behind.
- European Sustainable Finance Agenda: part of the broader effort to connect finance with the specific needs of the European and global economy for the benefit of the planet and society. Specifically, the agenda aims to reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth; manage financial risk flowing from climate change; and foster transparency and long-termism.
- **Extra-territorial impact** CSRD disclosure requirements will apply (*see* my previous briefing note for the phase-in dates) to:
    - all "large undertakings" or "large groups" (whether or not listed on an EU regulated market), which encompasses EU companies (either an EU company or an EU subsidiary of a non-EU parent company) or EU groups on a consolidated basis, in all cases meeting *any two of the following three* criteria: as of the most recent balance sheet date: (i) more than €40 million of annual net revenue, (ii) more than €20 million of total assets, and (iii) average numbers of employees in excess of 250. Note: this could include a large EU subsidiary of a non-EU parent company and an EU parent undertaking of a large group that on a consolidated basis satisfies at least two of the three EU nexus criteria is also covered. All undertakings that are parent undertakings of large groups should report at the group level;
    - companies (wherever organized) listed on an EU regulated market[1], including SMEs that are not micro-enterprises;
    - EU credit institutions;
    - EU insurance undertakings; and
    - other companies designated as public-interest entities by national authorities.

    Finally, groups with non-EU parent companies will be required to comply with certain requirements (with reporting based on the entire group, from the perspective of the parent) if:
    - the group, on a consolidated basis, generated EU net revenue of more than €150 million in each of the last two consecutive financial years; *and*
    - the group has at least one EU subsidiary that meets the requirements for an EU public-interest entity (*i.e.*, a "large undertaking," or EU regulated market listing (other than a micro-enterprise)); or a branch that generated more than €40 million in revenue in the preceding financial year.
- First Taxonomy Delegated Act (2021/2139): sets out technical screening criteria for economic activities having the potential to contribute to climate change mitigation

[1] Listed securities include equity as well as debt securities, and depositary receipts in respect of equity or debt (*see* MiFID (2004/39/EC)). EU regulated markets would not include multilateral trading facilities in the European Union.

and climate change adaptation, these being the first two environmental objectives set out in the Taxonomy Regulation.

- **Minimum safeguards**: set out under the Taxonomy Regulation are to ensure that companies that hold themselves out as engaging in sustainable activities meet certain minimum standards in respect of human rights, bribery, taxation and fair competition. These minimum safeguards cut across all of the EU sustainable finance regulations, the SFDR, the CSRD and the CSDDD. Essentially the minimum safeguards are intended to prevent green investments that otherwise meet sustainability standards from being marketed as sustainable if they violate the broader standards covered by the minimum safeguards.

  It is noteworthy that minimum safeguards explicitly do not supersede more stringent business conduct standards set out in:

  - The OECD Guidelines for multinational enterprises ("OECD-G")
  - The UN Guiding Principles for Business and Human Rights ("UNGP")
  - The ILO Declaration on Fundamental Principles and Rights at Work
  - The UN International Bill of Human Rights

- Platform on Sustainable Finance (the "Platform"): set up by the European Commission as a permanent expert group to assist in developing sustainable finance policies, particularly the further development of the EU taxonomy. Among its priorities, the Platform is to provide advice on the technical screening criteria for environmental objectives, called for by Article 19 of the Taxonomy Regulation. The Platform had issued a report on methodology in March 2022 and a supplemental report (dated October 2022) in November.

- Taxonomy Regulation (June 18, 2020 – 2020/852): establishes the common classification of sustainable economic activities deemed to contribute to environmental objectives. The Taxonomy classification is used in the CSRD and the SFDR. (*See generally* my previous briefing note, available here.)

  Article 3 sets out that whether or not an investment is environmentally sustainable, the relevant criteria being whether the underlying activity:

  - **contributes substantially** to one or more of the six environmental objectives set out in Article 9 (in accordance with Articles 10-16) – where **substantial contribution** means directly enabling other activities to make a substantial contribution to one or more of the objectives, provided the economic activity does not lead to lock-in of assets that undermine the long-term environmental goals and has a substantial positive environmental impact on the basis of life-cycle considerations (Article 16);
  - does not significantly harm ("DNSH") any of the other environmental objectives set out in Article 9 (in accordance with Article 17);
  - is carried out in compliance with minimum safeguards set out in Article 18; and
  - complies with screening criteria established by the European Commission (as contemplated by Articles 10-15, and meeting the requirements of Article 19).

  The Taxonomy will have other applications in the future.

  A visual representation of the Taxonomy is available on the Taxonomy Compass.

- Taxonomy Disclosure Delegated Act (July 6, 2021 - 2021/2178), supplementing the Taxonomy Regulation: specifies 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 Taxonomy.
    - 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, 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.

    This Delegated Act defines, among other concepts,
    - **Taxonomy-aligned economic activity**, which is an economic activity that complies with Article 3 of the Taxonomy Regulation.
    - **Taxonomy-eligible economic activity**, which is an activity described in Delegated Acts adopted pursuant to the Taxonomy Regulation (subparts of Articles 10-15), regardless of whether or not the activity meets the screening criteria in those Delegated Acts. A **Taxonomy-non-eligible economic activity** is any activity not described in the Delegated Acts pursuant to the Taxonomy Regulation (subparts of Articles 10-15).

Corporate Disclosure

- Corporate Sustainability Due Diligence Directive (Council approval December 1, 2022 - 2019/1937) ("CSDDD"), including its Annex (*see* my previous briefing note, available here) establishes a duty of due diligence for companies within its scope. The core elements of the corporate duty are to identify, end, prevent, mitigate and account for "adverse human rights impacts" and "adverse environmental impacts" of the operations of a consolidated group (company and subsidiaries) and their "business partners" in their "chain of activities." Certain companies would be required to have a plan to ensure their strategy is compatible with limiting global warming to 1.5◦C (in line with the Paris Agreement).
- Corporate Sustainability Reporting Directive ("CSRD"): amends the NFRD as well as the Audit Directive (2006/43), the Transparency Directive (2004/109) and the Accounting Directive (2013/34). (*See* my previous briefing note, available here.) The specific disclosure requirements applicable under the CSRD are to be set out in the ESRSs, which are under development by the EFRAG and are to be adopted on a rolling basis as Delegated Acts.

  The CSRD covers a range of disclosable information (the first five being carryovers from the NFRD):
    - environmental matters;
    - social matters and treatment of employees;
    - respect for human rights;
    - anti-corruption and bribery;

- diversity on company boards (in terms of age, gender, educational and professional background);
- "sustainability matters," which encompasses environmental, social and human rights, and governance factors, including the factors set out in the SFRD, which would pick up anti-corruption and anti-bribery matters; and
- "key intangible resources," which encompasses resources without physical substance on which the business model fundamental depends that are a source of value creation.

The key disclosure topics are:

- business model and strategy;
- time-bound targets related to sustainability;
- the role of the board and management regarding sustainability matters;
- policies relating to sustainability;
- incentive arrangements linked to sustainability;
- the due diligence process in respect of sustainability matters and, where applicable, in line with EU due diligence requirements;
- the principal adverse effects connected to the reporting company and its value chain;
- the principal risks related to sustainability matters;
- actions taken to prevent, mitigate, remediate or bring to an end actual or potential adverse impacts; and
- indicators relevant to the foregoing disclosures.

- EFRAG draft European Sustainability Reporting Standards (ESRS) cover general principles of sustainability reporting, general disclosure principles and sector-focused topics, including
  - climate change;
  - pollution;
  - water and marine resources;
  - biodiversity and ecosystems;
  - resource use and circular economy;
  - business conduct;
  - workers in the value chain;
  - affected communities; and
  - consumer end users.
- EU policy to commit companies to respect human rights and the environment in their global value chains: sets out the principles underlying the CSDDD.
- Non-Financial Reporting Directive (October 22, 2014 – 2014/95) ("NFRD"): the predecessor to the CSRD.

Financial Services Sector

- Sustainable Finance Disclosure Regulation (November 27, 2019 - 2019/2088) ("SFDR") applied from March 10, 2021 (with certain requirements to be phased in). It introduced disclosure requirements for financial market participants that fit within existing disclosure regimes, and established the concept of a "sustainability risk," which it defines as an ESG "event or condition that, if it occurs, could cause a

negative material impact on the value of the investment." In brief, the SFDR (as supplemented by the April 6, 2022 Delegated Act) sets out:

- sustainability disclosure obligations for market participants (asset managers, institutional investors and other entities that offer financial products while managing client money, which it refers to as "financial market participants"), as well as financial advisers in all investment processes, and for financial products that pursue objectives of sustainable investing; and
- disclosure as to adverse impacts of investment decisions on sustainability factors (referred to as "principal adverse impacts" or "PAIs") at entity and financial product levels. Among other things, financial market participants are to disclose the indicators related to PAIs of their investment decisions on sustainability factors and the actions taken/planned to be taken to avoid or reduce the PAIs identified. Financial market participants also are required to describe their policies to identify and prioritise PAIs on sustainability factors and how those policies are kept up to date and applied.

- Delegated Act (April 6, 2022 - 2022/1288), supplementing the SFDR, sets out technical standards specifying:
  - the details of the content and presentation of the information in relation to the principle of DNSH;
  - the content, methodologies and presentation of information in relation to sustainability indicators and PAIs; and
  - the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports.

  The indicators of PAIs of investment decisions on sustainability factors are:
  - GHG emissions;
  - Carbon footprint;
  - GHG intensity of investees;
  - Exposure to fossil fuel sector;
  - Share of non-renewable energy consumption/production;
  - Energy consumption intensity;
  - Negative impact on biodiversity;
  - Emissions to water;
  - Hazardous waste and radioactive waste ratio;
  - Violations of UNGP and OECD-G;
  - Lack of process to monitor UNGP and OECD-G compliance;
  - Unadjusted gender pay gap;
  - Board gender diversity;
  - Exposure to manufacture of controversial weapons;
  - GHG intensity;
  - Investees subject to social violations;
  - Exposure to fossil fuels through real estate; and
  - Exposure to energy-inefficient real estate.

- Regulation to establish a framework to facilitate sustainable investing: sets out the criteria for determining whether an economic activity qualifies as environmentally sustainable, for purposes of the SFDR.

Updates on Recent Developments

Disclosure

As expected, on November 28, the European Council formally adopted the CSRD. (*See Press Release*.)

Sustainable Finance

Technical screening criteria. Technical screening criteria for the third, fourth, fifth and sixth environmental objectives are on the horizon, the first and second already having been addressed.

Minimum safeguards. The Platform issued a Draft Report on Minimum Safeguards in July and in November issued its Final Report on Minimum Safeguards.

The Final Report provides guidance on how the minimum safeguards are to flow through the SFDR, CSRD and CSDDD, on substantive topics and compliance. By virtue of the references to the SFDR, the five mandatory social PAIs set out in the SFDR are carried over.[2] With the CSDDD still pending, and the CSRD recently approved, their implementation is uncertain and, therefore, the impact of the minimum safeguards on that legislation is evolving.

The Final Report breaks down compliance, based on the status under the CSRD, as between in-scope EU companies and in-scope non-EU companies, as well as for SMEs and banks/insurance companies, in each case with alternative tests (meeting one of two criteria of non-compliance) for each of the four core categories of human rights, corruption, taxation and fair competition. For example, in the case of minimum safeguards tied to human rights:

- **for an in-scope EU company**, (i) has it failed to establish an adequate human rights due diligence ("HRDD") process per the UNGP or OECD-G or (ii) are there signals that the company did not adequately implement HRDD and/or did it abuse human rights; and
- **for an in-scope non-EU company**, (i) has it failed to implement an adequate HRDD that follows the six steps of the UNGPs (as audit/assurance of these disclosures will be voluntary, an additional check on implementation is necessary, namely an assessment based, for example, on the World Benchmarking Alliance benchmarks) or

[2] Financial market participants are required under the SFDR to disclose the PAI of investment decisions on sustainability outcomes, including environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery. Of the 18 PAI indicators, five are relevant to minimum safeguards: violations of UNGP and OECD-G; lack of process to monitor UNGP and OECD-G compliance; unadjusted gender pay gap; board gender diversity; and exposure to manufacture of controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons).

(ii) are there signals that the company did not adequately implement HRDD and/or did it abuse human rights?

Nuclear and fossil gas: Taxonomy-aligned screening criteria for nuclear and fossil gas activities, which are effective January 1, 2023, have been issued (this followed a vote in the European Parliament in July). In September, the ESAs issued their Final Report on draft Regulatory Technical Standards, for purposes of the SFDR, for information to be provided in pre-contractual documents, on websites and in periodic reports about exposure of financial products to investments in fossil gas and nuclear energy activities.

In September, following amendments to the principal access to justice law (the Aarhus Regulation) allowing individuals and NGOs to challenge EU decisions on environmental grounds, eight Greenpeace organizations and separately various other environmental groups commenced legal action against the European Commission challenging the inclusion of fossil gas and nuclear in the green taxonomy. Austria is seeking to enlist other Member States to sign on to its own legal action against the Commission over the same issue.

Fund names/greenwashing: Also in November, the European Securities and Markets Authority ("ESMA") published a Consultation aimed at developing guidelines on the names of funds with ESG or sustainability-related terms. These guidelines are not intended to interfere with the requirements of the SFDR or the Taxonomy Regulation. The objective of the guidelines is to counter the risk of greenwashing by funds.

Separately, the ESAs have published a Call for Evidence ("CfE") to better understand greenwashing across the entire EU financial services sector. For this purpose, the term "greenwashing" comprehends sustainability-related claims relating to all aspects of ESG (*i.e.*, environmental, social and governance dimensions). The CfE recognizes that the drivers of greenwashing are multifaceted and may include demand for sustainability-related products, data-related issues, the need to build expertise and skills, challenges in the application of new rules, inconsistent interpretations of the legal regime and financial literacy gaps.

ESA Q&As: In November, the European Supervisory Authorities ("ESAs," being the European Banking Authority ("EBA"), ESMA and the European Insurance and Occupational Pensions Authority ("EIOPA")) published their Q&A on the SFDR Delegated Regulation. The European Commission had published a separate Q&A on SFDR matters.

CSDDD: On December 1, the European Council cleared the way (having adopted its "general approach") for the Council presidency to begin negotiations with the European Parliament over the terms of the CSDDD. The November 30 draft of the Directive:

- would provide that it will not apply to Alternative Investment Funds (AIFs) and Undertakings for Collective Investment in Transferable Securities (UCITSs);
- in a move harshly criticized by human rights campaigners, would provide that Member States will have the option of applying the Directive (or not) to the business partners to which financial market intermediaries provide financial services;
- would add the concept of "business partners" (both direct and indirect), which is tied to another new concept (replacing value chain) "chain of activities"[3];

[3] Defined as (i) activities of a company's upstream business partners related to the production of goods or the provision of services by the company, including the design, extraction, manufacture,

- would add a set of provisions for satisfaction of obligations of group companies by the parent company;
- would add a concept of a mapping exercise, allowing companies to focus on the basis of the exercise on areas where adverse impacts are most likely to be present or most significant;
- would allow companies to prioritize impacts where it is not possible to address all adverse impacts at the same time to the full extent;
- would exempt companies from having to terminate business relationships where potential adverse impacts could not be prevented or mitigated if doing so would be more severe than the potential adverse impact that could not be prevented or mitigated or there is no available alternative to that business relationship, that provides a raw material, product or service essential to the company's production of goods or provision of services, exists and the termination would cause substantial prejudice to the company. In these cases, companies must justify the decision to the competent authorities, and monitor the potential impact and periodically reassess its decision not to terminate. The same exemption applies to the obligation to bring actual adverse impacts to an end. In the case of financial institutions, an obligation to monitor has been added where a decision not to terminate a business relationship is permitted and made;
- would eliminate, for those subject to the requirement tying business model to the Paris Agreement goals, a provision to take account of these obligations when setting variable compensation where it is linked to business strategy and long-term interests and sustainability;
- would clarify the civil liability provisions, including that a company cannot be held liable for damage caused only by business partners. Four conditions were added – damage caused to a natural or legal person, a breach of the duty, the causal link between the damage and the breach of the duty and a fault (intention or negligence) – were clarified in the text, and the element of fault was included;
- would delete provisions imposing a specific director duty of care and requiring directors to set up and oversee due diligence and adapt corporate strategy to take account of identified adverse impacts were deleted. The latter instead was rolled into a general obligation on companies to put in place and oversee the mandated due diligence; and
- would provide for phased-in compliance, as follows:

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transport, storage and supply of raw materials, products or parts of the products and development of the product or the service, and (ii) activities of a company's downstream business partners related to the distribution, transport, storage and disposal of the product, including the dismantling, recycling, composting or landfilling, where the business partners carry out those activities for the company or on behalf of the company, excluding the disposal of the product by consumers and distribution, transport, storage and disposal of the product being subject to the export control under Regulation (EU) 2021/821 on export control relating to weapons, munition or war materials, after the export of the product is authorised.

If financial institutions are included by Member States, then "chain of activity" would cover, among others, borrowers, insured parties under insurance contracts and cedents under reinsurance contracts (excluding in each case, SMEs, natural persons and households).

- three years from entry into force: EU companies with over 1,000 employees on average and €300 million in net worldwide annual revenue;
- three years from entry into force: non-EU companies with more than €300 million of EU net annual revenue;
- four years from entry into force: EU companies with more than 500 employees/€150 million in revenue and non-EU companies with more than €150 million of EU net annual revenue; and
- five years from entry into force, the remaining EU and non-EU companies covered by the Directive.

Concluding Thoughts

That there are multiple Directives, Regulations and Delegated Acts, including significant modifications to one Directive (the NFRD amended by the CSRD), are a testament to the complexity as well as the scope of the EU's sustainability undertaking. While the proposed SEC rulemaking release is a single document, focused only on climate and only on disclosures by SEC reporting companies (in effect, listed companies), the EU effort is far broader. First, the effort targets disclosure across a far broader range of ESG themes; second, the effort covers far more than listed companies; and, third, the effort focuses not only on corporate obligations but also on financial market participant obligations.

The benefit of the EU approach is that it integrates, though that common classification system, the entire ecosystem of players that have a role in transitioning to net-zero. This is a dynamic area, with multiple moving pieces. In some cases, the changes are broadening coverage (*e.g.*, the CSRD modifications to the NFRD) and in others retrenching somewhat (*e.g.*,, the scope of the CSDDD and the director duty of care thereunder).

All to say that close attention to legislative and regulatory developments remains necessary. To add to the complexity, recall that Directives (in contrast to Regulations) are not self-implementing and require transposition into national law, which has the potential to create more onerous (but not less onerous) obligations across Member States.

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