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# Navigating Sustainable Finance

## ARE ESG REQUIREMENTS IN THE EU COHERENT?

The European Commission sees sustainable finance as key to delivering its policy objectives under the European Green Deal as well as its international commitments with regard to climate change.

Financial intermediaries are regarded as enablers of the green transition and will act as channels for the allocation of capital to sustainable economic activities.

What are to be regarded as sustainable activities, and how they are to be disclosed, is currently being specified in three pieces of legislation that form the bedrock of sustainable finance: the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR), and the Non-Financial Reporting Directive (NFRD). In practical terms – the obligations introduced to promote sustainable finance consist principally of a classification system, non-financial reporting requirements and disclosure obligations on sustainability impacts.

The political importance of the sustainable finance package, albeit justified, has resulted in a bewildering array of Environmental, Social and Governance (ESG) related requirements, which are myriad and closely interrelated but distributed across different pieces of legislation. Accordingly, requirements related to ESG can be difficult to navigate.

The Taxonomy, the SFDR and the NFRD – while separate – are interdependent with multiple and often confusing cross-references and links to one another. This results in sometimes overlapping, conflicting, or unclear requirements.

This briefing aims to describe and clarify the interrelationship between the three flagship pieces of legislation promoting sustainable finance – the Taxonomy, the SFDR and the NFRD.

## 1 THE TAXONOMY

At its most fundamental the Taxonomy is a classification system. The aim of the Taxonomy is to determine whether economic activities qualify as environmentally sustainable – based on objective and scientific criteria – and classify them accordingly.

In theory, while use of the Taxonomy is voluntary, it should allow investors to identify economic activities that are environmentally sustainable and take investment decisions accordingly.

During the legislative process, the Taxonomy was broadened to encompass activities that would enable or contribute to the transition to a more sustainable economy – the so-called 'enabling activities' and 'transition activities'.

**The Taxonomy also outlines core environmental objectives that investments can pursue. Article 9 of the Taxonomy lists the 6 environmental objectives that the Regulation facilitates:**

1. Climate change mitigation
2. Climate change adaptation
3. Sustainable use & protection of water & marine resources
4. Transition to a circular economy
5. Pollution prevention & control
6. The protection and restoration of biodiversity & ecosystems

In order for an investment to qualify as Taxonomy aligned it must pursue one of these objectives – investing in activities that are classified as either environmentally sustainable, transition or enabling.

The Commission is required to elaborate so-called **Technical Screening Criteria** at that will specify the conditions an economic activity must satisfy in order to substantially contribute to an environmental objective, provided it does **not significantly harm** any of the other objectives.

Fundamental to the Taxonomy is the principle of Do No Significant Harm (DNSH). However, the DNSH principle is a source of some confusion. Firstly, what constitutes 'significant harm' is yet to be fully elaborated in the Technical Screening Criteria. Secondly, the principle or variations of the principle also appear in the SFDR. For instance, the definition of 'sustainable investment' provided in the SFDR requires that investments – in order to qualify as sustainable investments – must make a material contribution to one or more environmental and/or **'social objectives'** – 'provided that such investments **do not significantly harm** any of those objectives'.

## 2 SFDR

The SFDR introduces comprehensive disclosure obligations for financial market participants that employ over 500 people. The SFDR requires entities in scope to make disclosures on the ESG performance of their aggregate investments (entity-level disclosures) and on the ESG performance of their products (product-level disclosures).

ESG performance will be measured according to **principal adverse impact** (PAI) indicators to be specified by the European Supervisory Authorities (ESAs). For this purpose, the Joint ESAs held a public consultation on draft technical standards which ran until September 2020.

The original deadline for the ESAs to submit the finalised disclosure requirements to the Commission was 30 December 2020. However, due in part due to the disruption caused by COVID-19, the ESAs will be unable to finalise the disclosure requirements until January 2021.

With the late delivery of the PAI indicators the Commission decided to defer the application of these disclosures, originally March 2021, until 2022. Instead, financial market participants in scope are expected to comply broadly with the principles of the legislation – with little practical guidance on how to do so.

In the draft measures the ESAs adopted a maximalist approach by requiring disclosures on 32 mandatory PAI indicators (16 climate & environment-related and 16 social & governance-related). Moreover, an additional two PAI indicators must be selected – one from two separate lists setting out a further 18 optional indicators. This would bring the total number of PAI indicators included in the disclosures up to 34.

The ESG performance of all products according to the PAI indicators must be disclosed on a comply or explain basis.

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The SFDR mandates additional disclosures for so-called **Article 8 products** (which promote environmental or social characteristics) and **Article 9 products** (that pursue sustainable investment as their objective). The additional Article 8 and Article 9 product disclosures must demonstrate how those products qualify as such.

Article 8 and Article 9 products are also where we find the most concrete link between the Taxonomy and the SFDR.

## 3 INTERPLAY BETWEEN THE TAXONOMY REGULATION AND SFDR

From a practical standpoint the Taxonomy supplements the disclosure obligations required by Article 8 (transparency of the promotion of environmental or social characteristics in pre-contractual disclosures) and Article 9 (transparency of sustainable investments in pre-contractual disclosures) by introducing the obligation for financial market participants to illustrate how those products relate to or align with the taxonomy.

Article 5 of the Taxonomy supplements the disclosures relating to Article 9 products under SFDR.

Article 6 of the Taxonomy supplements the disclosures relating to Article 8 products under SFDR.

### Link between Article 5 of the Taxonomy & Article 9 of SFDR

Article 5 of the Taxonomy stipulates that where a financial product referred to in Article 9(1) of SFDR (sustainable investment) invests in an economic activity that contributes to an environmental objective within the meaning of Article 2(17)[1] SFDR, the information to be disclosed shall include:

a. The information on the environmental objective or environmental objectives set out in **Article 9 of the Taxonomy** to which the investment underlying the financial product contributes.

b. A description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy.

[1] For ease of reference – Article 2(17) of the SFDR defines sustainable investment as "an investment in an economic activity that contributes to an environmental objective as measured – for example – by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy – or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objective and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance."

### Link between Article 6 of the Taxonomy & Article 8 of SFDR

Article 6 of the Taxonomy stipulates that – where a financial product as referred to in Article 8(1) of SFDR (promoting social or environmental characteristic) **promotes environmental characteristics** – the information to be disclosed shall include:

a. The information on the environmental objective or environmental objectives set out in Article 9 of the Taxonomy to which the investment underlying the financial product contributes; and,

b. A description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy.

*Article 6 also requires information disclosed in relation to Article 8 products to be accompanied by the following statement:*

> **"The do no significant harm principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities.**
>
> **The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities."**

*For all other product-level disclosures under the SFDR (products that do not qualify as either Article 8 or Article 9), Article 7 of the Taxonomy requires the following statement to be made:*

> **"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities."**

## 4 DO NO SIGNIFICANT HARM – LINKS IN SFDR AND TAXONOMY

### Article 25 of the Taxonomy & SFDR

Article 25 of the Taxonomy introduces an amendment to the SFDR in the form of Article 2a.

Article 2a requires the ESAs to develop technical standards specifying the content and presentation of information on the principle of **'do no significant harm'** referred to in Article 2(17) **in a manner consistent with the PAI indicators** by 30 December 2020.

The ESAs must outline how financial entities should illustrate that they have avoided significant harm to (i) environmental objectives based on climate & environment-related PAI indicators; and (ii) **'social objectives'** based on social & employee-related PAI indicators.

However, at no point in the text of the SFDR are 'social objectives' outlined. This is unless you consider the definition of 'sustainable investment' in Article 2(17) of the SFDR to stipulate **'social objectives'**, in which case, as per Article 2(17), "…an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities…" is implied to be pursuing a 'social objective'.

Similarly, given the nature of the PAI indicators whereby any positive score represents an adverse impact on sustainability indicators, it is unclear whether a positive score on any of the PAI indicators will automatically represent 'significant harm' to an environmental objective or social objective.

A substantial source of confusion is that Article 17 of the Taxonomy already outlines what constitutes **'significant harm to environmental objectives'**. How the technical standards stemming from Article 2a of the SFDR will interact with Article 17 of the Taxonomy and the Technical Screening Criteria is unclear. Open questions remain, such as: will they merely reflect Article 17 of the Taxonomy?; will they supplement Article 17 of the Taxonomy?; will they clarify how the climate & environment related PAI indicators related to the outcomes regarded as constituting significant harm according to Article 17?

## 5 NFRD

The NFRD requires large, public interest companies to include a non-financial statement as part of their annual public reporting obligations. The NFRD applies to companies with more than 500 employees, so encompassing large listed companies, banks and insurance companies in its scope.

*The NFRD identifies four sustainability issues:*

1. ENVIRONMENT
2. SOCIAL & EMPLOYEE ISSUES
3. HUMAN RIGHTS
4. BRIBERY & CORRUPTION

It introduces the obligation for undertakings in scope to disclose information about their business model, policies, outcomes, risk and risk management, key performance indicators (KPIs) and how they relate to the sustainability issues referred to above.

The NFRD requires companies to disclose information "to the extent necessary for an understanding of the development, performance, position and impact of the company's activities." This means that companies should disclose not only how sustainability issues may affect the company, but also how the company affects society and the environment – the so-called **double materiality principle.**

## 6 INTERDEPENDENCY BETWEEN THE NFRD AND THE SFDR

A significant practical obstacle to the application of the SFDR is the lack of the data needed to calculate principal adverse impacts. The SFDR requires entities in scope to engage with investee companies in order to acquire the necessary information to make their disclosures on a 'best efforts' basis.

However, this approach has the potential to be onerous for both the entities making the disclosures and the investee companies. To make the disclosures required under SFDR practicable, the scope of the NFRD would need to be broadened in terms of the granularity of the information to be reported and the number of companies to which it applies.

A legislative proposal revising the NFRD is expected in Q1 2021. However, it remains to be seen to what extent the scope of the NFRD will be extended, or adjusted to facilitate the disclosures required by SFDR. Fundamentally, the revised NFRD will determine the practicability of the SFDR.

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## 7 LINKS BETWEEN THE TAXONOMY AND NFRD

Article 8 of the Taxonomy requires companies subject to the NFRD to include information on how, and the extent to which, their activities relate to economic activities that align with the Taxonomy, specifically Articles 3 and 9.

In order to comply with Article 8 undertakings must disclose: (i) the proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable, and (ii) the proportion of their capital expenditure (CapEx) and (iii) the proportion of their operating expenditure (OpEx) related to assets or processes associated with economic activities that qualify as environmentally sustainable under Articles 3 and 9 of the Taxonomy.

On 15 September 2020, the ESAs received a call for advice from the Commission requesting that they elaborate further on the taxonomy-related disclosures that undertakings subject to the NFRD are required to make. The ESAs have until February 2021 to submit their advice to the Commission. Each of the ESAs (ESMA, EBA, EIOPA) will be submitting separate advice relating to the market segments under their supervision to the Commission.

## CONCLUSION

**Sustainable finance is certain to remain a key priority of the European Commission. The legislation already adopted, while still in the implementation phase, introduces a wide array of requirements, many of which are still being elaborated.**

As illustrated by this briefing, these requirements are closely interrelated and interdependent although not always well synced. It is essential for the success of the sustainable finance agenda that the legislation on which it is founded be coherent and rationally sequenced. There is a considerable risk of the labyrinth of additional requirements becoming too complex, overly burdensome and, ultimately, counterproductive.

As a result, industry stakeholders, whether in the financial sector or otherwise, should engage proactively on sustainable finance and work constructively with EU policymakers to design ESG requirements that are practicable and fit-for-purpose. Hume Brophy is well positioned to assist in navigating the myriad of sustainability-related initiatives and to facilitate engagement with policymakers.

*Please don't hesitate to contact Hume Brophy's Brussels team if you have additional questions or wish to discuss ESG requirements further.*

**Timeline for the implementation of technical standards essential for the application of the Taxonomy, SFDR and NFRD.**

**TAXONOMY**

- **31 December 2020** — Delegated Acts - Technical screening criteria - climate change mitigation climate change adaptation
- **31 December 2021** — Delegated Acts - Technical screening criteria for remaining environmental objectives
- **1 January 2022** — Application of technical screening criteria for climate change mitigation & climate change adaptation
- **1 January 2023** — Application of Technical screening criteria for remaining environmental objectives

**SFDR**

- **30 December 2020** — ESAs to deliver draft RTS on 'Do No Significant Harm' principle
- **January 2021** — ESAs to deliver draft RTS on PAI indicators
- **10 March 2021** — Date of application of Level 1 on principle basis
- **January 2022** — Application of RTS on PAI indicators (tentative)

**NFDR**

- **Q1 2021** — Proposal revising scope of NFRD

## ABOUT THE AUTHOR

Hugo Gallagher joined Hume Brophy's financial services practice in 2020. Based in Brussels, he specialises in regulatory issues pertaining to securities markets, asset management, financial sector digitalisation and sustainable finance.

Prior to joining Hume Brophy, Hugo was involved in public affairs in Brussels, catering to a range of international clients, including several prominent financial institutions and service providers. He has also garnered experience in the Brussels office of Ibec, the Irish business and employers confederation, and at the Legislative coordination unit of the European Parliament. Hugo's academic background is in history and international relations.

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