THE EU IS DEFINING GREEN BUSINESS – NOW IT HAS SOCIAL FACTORS IN ITS SIGHTS

Global
Legal Briefings – By **Antony Crockett**

Brussels considers extending the Taxonomy Regulation to include social objectives like human rights. The implications – and complications – are huge

If nothing else, it's clear Brussels policymakers like a challenge. Last summer we reported on the Platform on Sustainable Finance, the body handling technical tasks for the implementation of the Taxonomy Regulation, a core element of plans to decarbonise EU economies by 2050.

The Taxonomy Regulation is charged with facilitating sustainable investment in what promises to be the most ambitious global attempt to cut through the mass of conflicting criteria for defining green activities. To this end, it establishes benchmarks for determining whether an economic activity is environmentally sustainable (we discuss the framework in more detail here). The ultimate aim is audacious: directing trillions of euros of investment towards genuinely sustainable activity… and sending the sharpest of economic signals to business to get its environmental house in order.

Under the Taxonomy, an activity (and the investment backing it) qualifies as sustainable if it:

A. contributes substantially to one of six defined environmental objectives, being: (i) climate change mitigation, (ii) climate change adaptation, (iii) sustainable use and protection of water and marine resources, (iv) transition to a circular economy, (v) pollution prevention and control, and (vi) protection of healthy ecosystems (**Environmental Objectives**);

B. does no significant harm to any of the Environmental Objectives;

C. meets minimum social and governance safeguards set out in Article 18 of the Taxonomy Regulation; and

D. complies with technical screening criteria to be established by the European Commission.

A dedicated subgroup (**Subgroup 4**) of the Platform on Sustainable Finance is advising the Commission on minimum social safeguards and the possibility of extending the taxonomy to social objectives. Subgroup 4 is also advising on the rollout of minimum social and governance safeguards under Article 18 of the Taxonomy.

Last month, Subgroup 4 published its first draft report on the merits and possible structure of a social taxonomy. A further report on the implementation of Article 18 will be issued by the end of 2021.

PROS AND CONS OF EXTENDING THE TAXONOMY TO SOCIAL FACTORS

The draft report notes the merits of extending the Taxonomy to social objectives include:

1. The need for investment in social sustainability, which means preventing social harm (for example, by ensuring companies respect human rights) and improving provision of basic goods and services, especially for vulnerable people and groups.
2. The need for investment in a just transition, maximising the benefits of the move to a sustainable economy while minimising hardship for workers, consumer and communities affected by that shift.
3. Meeting investor demand for socially orientated investment.
4. Managing sustainability risks, including investment risks relating to human rights, labour standards and other social risks.
5. The need to develop the definition and measurement of the essential characteristics of social investment.

The report also identifies arguments against extending the Taxonomy to cover social objectives. Concerns include:

1. That objectives of a social taxonomy go beyond EU competences in social affairs, which are predominantly managed at a national level. Relatedly, it is argued it is not possible to define activities as "socially sustainable" or causing no significant harm without regard to national social contexts.

2. A taxonomy might favour companies located in countries with more stringent social legislation, for example, in relation to labour standards.

3. Potentially directing investment to certain companies, detracting from the need to support all companies to contribute to social sustainability, including job creation.

4. Increasing an already heavy reporting burden for companies.

The draft report indicates these concerns will be taken into account in final recommendations to the Commission.

POSSIBLE STRUCTURE OF A SOCIAL TAXONOMY

As noted, the Taxonomy is based on six Environmental Objectives and establishes minimum safeguards to ensure social and governance impacts are addressed. Economic activity qualifies as sustainable if it contributes substantially to at least one of the defined environmental goals, does no significant harm to any environmental objective and also complies with minimum safeguards and technical criteria.

In the draft report, the possible structure of a social taxonomy is based on the existing approach in the Taxonomy Regulation. In particular, it would define social objectives and establish criteria reflecting the "do no significant harm" principle in relation to other objectives. It is recognised that a social taxonomy may need to include minimum environmental safeguards depending how it is combined with social and environmental standards.

The draft report suggests key differences between environmental and social considerations which must be addressed.

1. Environmentally sustainable activities aim to reduce or reverse adverse environmental impacts and some economic activities will have no environmental benefits. In contrast, most economic activities have inherent social benefits (e.g., job creation and contribution to taxation). The role of a social taxonomy is therefore to differentiate between *inherent and additional* social benefits; an example is given in the pharma sector where it is suggested that producing drugs cannot be considered a substantial contribution to a social objective but improving access to drugs for certain groups might

represent an additional benefit. In short, a substantial contribution in a social taxonomy is largely defined in terms of *additional* beneficial impacts, whereas an environmental taxonomy focuses mainly on avoiding detrimental impacts.

2. Crucial aspects of a social taxonomy would relate to processes (such as human rights due diligence) that aim to reduce adverse impacts and maximise positive outcomes for stakeholders. It is argued these processes often function at the level of an economic entity (e.g., are implemented by a company or corporate group on a horizontal basis) rather than in relation to a specific economic activity. A social taxonomy may therefore need to include criteria at both entity and activity levels.

3. The environmental taxonomy is based on natural science and international treaties such as the Paris Agreement, whereas a social taxonomy cannot rely on sciencitic consensus in the same way. Instead, it is recommended that internationally agreed social norms and standards form the basis of a social taxonomy.

4. It will be more difficult to develop quantifiable criteria for a social taxonomy, although the draft report notes some "*promising attempts*" to translate qualitative objectives into quantitative indicators (such as in the UN Development Programme's annual report on human development).

As such, the suggested foundations of a social taxonomy are internationally accepted human rights and other social standards including, for example, international and regional human rights treaties, the UN Guiding Principles on Business and Human Rights (**UNGPs**), the UN Global Compact and the OECD Guidelines for Multinational Enterprises. The report also indicates that the proposed taxonomy should consider existing market standards, such as the International Capital Market Association Social Bond Principles.

The draft report suggests these principles and standards can be applied in two ways. First, they can define benchmarks for processes which may be applied within economic entities to avoid and address adverse impacts (e.g., impacts on human rights). Second, they can define what activities may contribute towards fulfilling economic and social rights.

The proposed social taxonomy would therefore have vertical and horizontal dimensions. The vertical dimension would include an objective of promoting adequate living standards, which includes improving accessibility of products and services catering to basic human needs, such as water and sanitation, food, housing and healthcare.

The horizontal dimension would have an objective of promoting positive impacts more broadly and addressing adverse impacts on affected stakeholders. Examples include ensuring decent work, promoting consumer interests, enabling sustainable communities, ensuring good corporate governance and non-aggressive tax planning.

Importantly, the process-related horizontal dimension of the proposed social taxonomy is based on the UNGPs, the OECD Guidelines for Multinational Enterprises, the ILO Declaration on Fundamental Rights and Principles at Work and the European Social Charter. The selection of these standards, and the draft report itself emphasises that "*respect for human rights will be crucial for the development of criteria that apply the principle of doing no significant harm*".

In relation to the detailed development of taxonomy criteria, it is suggested the vertical dimension would be more focused on substantial contribution to a social objective whereas the horizontal criteria would focus on implementing the principle of "*do no significant harm*" (**DNSH**). The latter might include criteria for processes to assess, avoid and address adverse impacts on human rights.

TACKLING GOVERNANCE

As noted above, Article 18 of the Taxonomy Regulation requires that sustainable economic activities should meet minimum governance standards, specifically the OECD Guidelines for Multinational Enterprises which address, in addition to human rights and environment, labour rights, corruption, tax evasion, consumer protection, science and technology and fair competition.

The draft report states that while governance is a separate topic from the proposed social taxonomy, governance factors can be relevant to both environmental and social benchmarks. Good governance may benefit social and environmental performance and assist to mitigate or avoid risks stemming from social and environmental factors.

It is noted that a taxonomy would not need to include the full range of "hard" corporate governance factors but should focus on topics such as those covered in the OECD Guidelines. It is likewise suggested as part of an environmental and social taxonomy, that two governance objectives – "*good sustainable corporate governance*" and "*transparent and non-aggressive tax planning*" – should be included.

Criteria and topics proposed for further consideration in relation to these objectives include:

- diversity of the highest governance body, including employee participation
- diversity in senior management
- executive remuneration linked to environmental and social factors
- anti-bribery and anti-corruption
- responsible auditing

- responsible lobbying and political engagement

METRICS FOR A SOCIAL TAXONOMY

The draft report briefly discusses the need for indicators measuring performance against objectives in a social taxonomy and indicates the range of criteria deployed to develop such metrics. This includes the need for indicators to:

- relate to a norm, process or goal established in international standards
- be specific enough to relate to an economic activity or entity
- relate to data available at a reasonable cost
- avoid creating perverse incentives, such as driving divestments from the SME sector

SIGNIFICANTLY HARMFUL ACTIVITIES

The draft report observes that the environmental taxonomy excludes power generation using solid fossil fuels on the basis that such activity cannot be compatible with the Paris Agreement. A social taxonomy following the same approach should exclude activities causing significant social harm or adverse impacts. Examples of activities which might be excluded under this rationale include weapons and tobacco, a proposal with significant investment implications for those industries.

THE RELATIONSHIP BETWEEN ENVIRONMENTAL AND SOCIAL BENCHMARKS

The draft report discusses a spectrum of approaches to the potential relationship between environmental and social taxonomies.

One end of the spectrum would be a single taxonomy defining activities which are both socially and environmentally sustainable. The key problem with such an approach is that it might reduce the number of sustainable activities drastically. On this basis, the approach is probably not practical.

The opposite approach would leave the two taxonomies entirely separate. The draft report concludes, however, that this option is already ruled out by the Taxonomy Regulation because the minimum safeguards in Article 18 already link the environmental taxonomy to social factors.

Various options are said to exist in between these two extremes. Two models are floated.

Model 1 treats the separate taxonomies as equivalent. In the same way as the environmental taxonomy is already subject to minimum social safeguards, a social taxonomy would be subject to minimum environmental safeguards, based on the OECD Guidelines for Multinational Enterprises. Both regimes would be subject to minimum governance safeguards.

Model 2 would require that activity makes a substantial contribution towards a defined social or governance objective. In addition, all activities would need to comply with environmental and social DNSH criteria. In this model, minimum safeguards in the environmental taxonomy would be replaced by more detailed social DNSH criteria and the existing environmental DNSH criteria in the Taxonomy Regulation would apply to the social taxonomy.

Model 2 is touted as creating a more compact taxonomy with a list of defined environmental and social objectives alongside common DNSH criteria. It is recognised, however, that, depending on the strictness of the DNSH criteria, there may be fewer activities that qualify as sustainable.

WHY IS THE PROPOSAL IMPORTANT?

The proposed social taxonomy reflects rapidly shifting social expectations in relation to corporate conduct and represents the latest example of a wider trend towards the incorporation of international 'soft law' standards, such as the UNGPs, into domestic regulation. The introduction of a social taxonomy would have significant implications for sustainable investment, and potentially quite costly implications for certain sectors which might not, under the proposed criteria, qualify as sustainable.

WHAT HAPPENS NEXT?

A call for feedback on the draft report is open until 27 August. A final report will be submitted to the Commission in the autumn and then the Commission is expected to publish its own report on a possible social taxonomy by the end of the year.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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