On 18 June 2020, the European Parliament adopted the regulation on the establishment of a framework to facilitate sustainable investment[^1] (the Taxonomy Regulation), a milestone in the EU’s Action Plan on Sustainable Finance (the Action Plan). It has since been published in the Official Journal and entered into force on 12 July 2020. The EU-wide green taxonomy set out by the Taxonomy Regulation represents one pillar of the regulatory proposals under the Action Plan and is due to be implemented in stages, commencing from 10 March 2021. As businesses and financial market participants begin preparing for the implementation of the Taxonomy Regulation, we take a closer look at its scope and operation.

**CONTEXT**

The European Commission launched the Action Plan on Financing Sustainable Growth (Action Plan) in March 2018, following recommendations from the High-Level Expert Group on Sustainable Finance. The Action Plan’s stated objectives are to (i) reorient capital flows towards sustainable investment, (ii) manage the financial risks arising from climate change, environmental degradation and social issues, and (iii) foster transparency and long-termism in financial and economic activity.[^ii] The key legislative proposals emerging from the Action Plan include the Disclosures Regulation[^ii] and amendments to the EU Benchmark Regulation[^iii]. Other legislative proposals emerging out of the EU include amendments to the Non-Financial Reporting Directive (NFRD) and the Shareholder Rights Directive. These regulatory proposals have received further impetus from the EU’s Green Deal which was presented by the European Commission in December 2019 as the roadmap to its “just and inclusive transition” to a sustainable and climate-neutral economy.
A possible outcome of the COVID-19 pandemic is a dilution of the emphasis on the EU’s “ESG-roadmap”. However, indications are that sustainability will feature heavily in the recovery from the pandemic and our observations are that a broad range of market participants are still focused on their ESG-related agendas. The European Commission has launched a number of consultations earlier this year directed at implementing the Action Plan and European Green Deal. The Commission also recently emphasised the significance of the COVID-19 crisis in highlighting “the subtle links and risks associated with human activity, climate change, and biodiversity loss, as well as the subsequently critical need to strengthen the sustainability and resilience of our societies and economies”, and has attached “green strings” to the proposed €750 billion post-pandemic recovery plan and updated seven-year €1 trillion budget, confirming that any spending will be subject to the Taxonomy Regulation’s “do no harm” principle.

A key component of the Action Plan, and the focus of this article, is the development of an EU-wide green taxonomy on environmentally sustainable activities (the Taxonomy) which is intended to provide a common language for the regulatory proposals under the Action Plan. On 18 June 2020, the European Parliament adopted the text of the Taxonomy Regulation which will form the legal basis for this Taxonomy. This endorsement comes after two years of political negotiation and consultation, including the publication of recommendations by the European Commission’s Technical Expert Group on Sustainable Finance in March 2020 (the TEG Recommendations).

Once the Taxonomy Regulation enters into force in December 2021, it will establish the criteria for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment is environmentally sustainable. The Taxonomy Regulation introduces new disclosure obligations on financial market participants (such as asset managers), supplementing the obligations under the Disclosures Regulation that are expected to apply from March 2021. The Taxonomy Regulation also introduces new disclosure obligations for some corporates, supplementing the disclosure obligations under the Non-Financial Reporting Directive. These disclosures are intended to enable asset owners, asset managers and investors to make “like-for-like” comparisons between financial products and investee companies; the theory being that this will tackle one of the most significant obstacles in the ESG markets today (see our earlier blog). The Taxonomy Regulation will be supplemented by delegated acts containing technical screening criteria, drafts of which are expected to be published in stages. The technical screening criteria will be informed by the TEG Recommendations, although there may be some points of difference.

WHAT DOES THE TAXONOMY REGULATION DO?

First and foremost, the Taxonomy Regulation establishes a set of criteria for determining whether an economic activity qualifies as environmentally sustainable for the purposes of establishing the degree to which an investment is environmentally sustainable.
Under the Taxonomy Regulation, an economic activity qualifies as environmentally sustainable if it:

A. contributes substantially to one of the six environmental objectives defined in the Taxonomy Regulation, 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 (together, the **Environmental Objectives**);

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

C. is carried out in compliance with minimum social and governance safeguards set out in the Taxonomy Regulation (these safeguards align with the OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights); and

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

Secondly, the Taxonomy Regulation provides that the criteria established by it shall be applied by Member States and the Union for the purposes of any measure setting out requirements for financial market participants or issuers in respect of financial products or corporate bonds that are made available as environmentally sustainable.

Finally, the Taxonomy Regulation supplements the disclosure obligations which apply to financial market participants under the Disclosures Regulation and to corporates under the Non-Financial Reporting Directive as follows -

A. Where a financial product made available in the EU by a financial market participant has sustainable investment as its objective or promotes environmental characteristics, and such a product invests in an economic activity that contributes to an environmental objective, the pre-contractual and ongoing disclosures of such a financial product will need to contain: (i) information on the environmental objective(s) set out in the Taxonomy Regulation to which the investment underlying the financial product contributes; and (ii) a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. The pre-contractual and ongoing disclosures of other financial products will need to include a statement expressly stating that they do not take into account the EU criteria for environmentally sustainable economic activities.
Those corporates that are subject to disclosure obligations under the Non-Financial Reporting Directive will be required to include, in those disclosures, information on how and to what extent the corporate’s activities are associated with economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. This information will need to include: (i) the proportion of the corporate’s turnover derived from products or services associated with economic activities that qualify as environmentally sustainable; and (ii) the proportion of the corporate’s capital expenditure and the proportion of its operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable.

WHICH ECONOMIC ACTIVITIES DOES THE TAXONOMY REGULATION COVER?

Sectors

As outlined above, one of the requirements for an economic activity to qualify as “environmentally sustainable” under the Taxonomy Regulation is compliance with technical screening criteria to be established by the European Commission. These technical screening criteria are expected to be informed by the TEG Recommendations, which set out draft technical screening criteria (the Draft Criteria) for more than 70 economic activities in sectors that currently account for 93.5% of Europe’s emissions (see the Technical Annex to the TEG Recommendations).

Figure 2 shows the sectors covered by the TEG Recommendations and some examples of the types of eligible activities included for each such sector.

Typically energy-intensive activities such as iron and steel manufacturing, public transport, construction, and livestock farming can qualify as environmentally sustainable if they comply with the technical screening criteria. However, power generation from solid fossil fuels has been explicitly excluded.

Whether activities relating to nuclear energy should be capable of qualifying as “environmentally sustainable” has been a point of intense debate, particularly given that some Member States have nuclear-heavy energy sectors. Nuclear energy is currently excluded from the TEG Recommendations on the basis that although the TEG found evidence that nuclear power contributes to climate mitigation, it concluded that more research is needed to determine whether activities in this sector do significant harm to any other Environmental Objectives.

Figure 2 – examples of eligible activities
<table>
<thead>
<tr>
<th>Sector</th>
<th>Examples of eligible activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture and forestry</td>
<td>Afforestation, rehabilitation, reforestation, livestock production and others</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Manufacture of cement, aluminium, iron, steel and others</td>
</tr>
<tr>
<td>Electricity, gas, steam and air conditioning supply</td>
<td>Renewables, hydro-power, co-generation, bioenergy, storage and others</td>
</tr>
<tr>
<td>Water, sewerage, waste and remediation</td>
<td>Collection, treatment, anaerobic digestion, permanent sequestration and others</td>
</tr>
<tr>
<td>Transportation and storage</td>
<td>Passenger and freight rail transport, infrastructure for low carbon transport, inland water transport and others</td>
</tr>
<tr>
<td>Buildings</td>
<td>New constructions and renovations</td>
</tr>
<tr>
<td>Information and Communication Technologies (ICT)</td>
<td>Data processing, data-driven climate change monitoring solutions.</td>
</tr>
<tr>
<td>Financial and Insurance Activities</td>
<td>Non-life insurance</td>
</tr>
<tr>
<td>Professional, Scientific and Technical Activities</td>
<td>Engineering activities</td>
</tr>
</tbody>
</table>

**Contributing, enabling and transition activities**

Activities which may qualify as “environmentally sustainable” include **contributing activities** and **enabling activities**:
Contributing activities are activities that **make a substantial contribution based on their own performance** to one of the Environmental Objectives (e.g. construction of a solar PV park).

Enabling activities are activities that **enable other activities to make a substantial contribution** to one or more Environmental Objectives (e.g. supplying equipment for the construction of solar PV panels).

The Draft Criteria propose that enabling activities should be subject to several safeguards, in particular the requirements that (i) such activities do not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets, and (ii) the activity has a substantial positive environmental impact, on the basis of life-cycle considerations.

The Taxonomy Regulation also recognises a third category of activity: **transition activities**. This category incentivises capital flow towards improvement measures consistent with the 1.5 °C pathway (i.e. a limit in global warming levels of 1.5°C above pre-industrial levels) in economic activities and sectors for which no feasible low-carbon alternative exists. In order to be Taxonomy-aligned, such transition activities must: (i) generate substantially lower greenhouse gas emissions than the sector or industry average, (ii) not hamper the development and deployment of low-carbon alternatives, and (iii) avoid locking-in assets to processes that undermine long-term environmental goals.

**Figure 3 - examples of contributing, enabling and transition activities**

<table>
<thead>
<tr>
<th>Type of activity</th>
<th>Technical screening criteria</th>
<th>Examples</th>
</tr>
</thead>
</table>
| 1) Activities that are already low on carbon: Already compatible with a 2050 net zero carbon economy | Likely to be stable and long-term | • Zero emissions transport  
• Near to zero carbon electricity generation  
• Afforestation |
| 2) Activities that contribute to a transition to a zero net emissions economy in 2050 but are not currently operating at that level | Likely to be subject to regular revision, tending towards zero emissions. | • Building renovation;  
• Electricity generation < 100 CO2/kWh  
• Cars < 50g CO2/km |
| 3) Activities that enable those above. | Likely to be stable and long-term (if enabling activities that are already low carbon) or subject to regular revision tending to zero (if enabling activities that contribute to transition but are not yet operating at this level). | • Manufacture of wind turbines  
• Installing efficient boilers in buildings |
“Brown” or “shaded” taxonomy

The requirement for an activity to “substantially contribute” to at least one of the Environmental Objectives sets a high bar for companies looking to access forms of green finance that are expressly conditional on Taxonomy-aligned thresholds. Incremental improvements with respect to activities which are significantly harmful to environmental objectives are not captured under the Draft Criteria. The rationale for this high threshold is to mitigate the risk of minor improvements being labelled as “green” or “sustainable”.

However, this approach effectively limits the sources of finance available to a large proportion of companies in carbon-intensive sectors, whose engagement and buy-in is crucial to the pathway to a lower-carbon economy. The TEG Report notes that the taxonomy will only be “fully realised” when it also includes technical screening criteria to help companies in “brown” industries demonstrate incremental improvements in their activities. With this in mind, the TEG Report specifically recommends that “brown” technical screening criteria be developed for activities which either do no significant harm to the environment or which provide “neither substantial contribution nor significant harm” activities. The introduction of these “shaded” technical screening criteria would create commercial incentives for companies whose activities cannot currently comply with the Draft Criteria to work towards moving into “greener” tiers in the long-term.

A “shaded” taxonomy could also improve engagement from companies and financial institutions in the emerging markets, which may face greater challenges than their European counterparts in achieving the minimum social and governance safeguards set out in the proposed Taxonomy. Regulators could also make use of the different “shades” to assign different risk profiles and capital requirements to participants, as the European Central Bank has recently suggested.[8]

The ongoing consultation [embed hyperlink: https://ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_en] on the Renewed Sustainable Finance Strategy invites stakeholders to express views on introducing a “brown” or “shaded” taxonomy for economic activities that are most exposed to the transition to a low-carbon economy because of their negative environmental impact. The European Commission has indicated that it will review the potential inclusion of "brown" screening criteria by 31 December 2021.

HOW DO YOU USE THE TAXONOMY REGULATION?

In relation to disclosure by both financial market participants and corporates, the Taxonomy Regulation requires the adoption of a “bottom-up” approach.
Disclosures by corporates involve the following key steps:

**Step 1**: Identify economic activities engaged in by a corporate, using NACE Codes

**Step 2**: Allocate the corporate’s turnover, capital expenditure and operating expenditure across each such economic activity

**Step 3**: Assess these economic activities using the criteria established by the Taxonomy Regulation (outlined above) to determine whether each of them is environmentally sustainable – if no technical screening criteria have been established for an activity, it cannot be considered environmentally sustainable for these purposes

**Step 4**: On the basis of the assessment carried out in Step 3, determine the proportion of a corporate’s turnover derived from, or capital expenditure and/or operating expenditure related to, products, assets or services associated with activities that qualify as environmentally sustainable under the Taxonomy Regulation. This is the information to be disclosed by corporates pursuant to the Taxonomy Regulation, as part of the disclosures they are required to make under the NFRD.

**Corporate reporting: An illustrative example**

A road maintenance company, X PLC, wants to replace its vehicle fleet, which currently runs on fossil fuels, with electric vehicles.

- According to the technical screening criteria, low emission vehicles contribute substantially to climate mitigation.
- X PLC confirms that its fleet replacement complies with the other Taxonomy criteria (“do no harm” principle and minimum safeguards).
- The overall costs of replacing the fleet are £10 million, which represents 50% of the company’s capex.
- The company can subsequently report that 50% of its capex as Taxonomy-aligned (assuming no other activities also contribute and comply with the criteria).
- If X PLC needs to raise funds for the investment, it can issue a bond or take out a loan which, if used only for the fleet replacement project, would qualify as a taxonomy-aligned investment. There is also nothing preventing it seeking equity funding, although the investor (if a financial market participant such as a fund) would only be able to count the Taxonomy aligned proportion in its own disclosures – see further below)
Financial market participants are required to carry out the four steps above in relation to each investee company in the relevant financial product’s portfolio. In cases where a financial product invests in corporates making the relevant disclosures pursuant to the NFRD, it is expected that the financial market participant will be able to place reliance on these disclosures. In addition, the financial market participant needs to carry out two additional steps, in the case of equity funding: **Step 5**: Determine the weighting of each investee company in the portfolio

**Step 6**: Multiply the weighting of each investee company by the proportion of its turnover, capital expenditure or operating expenditure which is aligned with the Taxonomy Regulation (as calculated in Step 4 above), in order to arrive at the degree to which the portfolio of the financial product is aligned with the Taxonomy Regulation.

**Financial market participant reporting: An illustrative example**

- A private equity fund X PLC, holds equity investments in three companies in the following proportion: 50:25:25.
- The turnover of Companies A, B and C is 10%, 54% and 20% Taxonomy-aligned respectively.
- The fund must therefore disclose that it is 23.5% Taxonomy-aligned.\[9\]

Source: TEG Supplementary Report to Using the EU Taxonomy (June 2019)
WHEN DOES THE TAXONOMY REGULATION COME INTO FORCE?

IS THE TAXONOMY REGULATION RELEVANT OUTSIDE THE EU?

(A) UK COMPANIES AND FINANCIAL MARKET PARTICIPANTS
According to the current Brexit timetable, some key operative provisions of the Taxonomy Regulation will not apply in the UK unless the UK decides to onshore them. The UK Government’s Green Finance Strategy (published in July 2019) committed to “matching the ambition” of the EU’s Action Plan. However, a letter from the UK’s Economic Secretary to the Treasury dated 28 May 2020 has suggested the possibility of future regulatory divergence. In a later written ministerial statement (dated 23 June 2020), the UK’s Chancellor of the Exchequer commented that “rules designed as a compromise for 28 countries cannot be expected in every respect to be the right approach for a large and complex international financial sector such as the UK” and “[w]e will … tailor our approach to implementation to ensure that it better suits the UK market outside the EU”.

Nevertheless, given the commitments made in the Green Finance Strategy, in our view it would be advisable for UK-incorporated companies and financial market participants to proceed on the basis that the UK will implement a taxonomy that is materially aligned with the Taxonomy Regulation, until such time as there is further clarity.

In any event, as discussed below, to the extent that financial market participants based in the UK are offering financial products into the EU, they would likely be subject to the Taxonomy Regulation in relation to disclosures to be made in connection with such financial products. Similarly, UK companies with European shareholders (who may, as financial market participants, be subject to disclosure obligations under the Taxonomy Regulation) may also come under pressure to provide sustainability-related disclosures to enable such shareholders to fulfil their own disclosure obligations.

(B) NON-EUROPEAN ASSET MANAGERS OFFERING FINANCIAL PRODUCTS INTO THE EU

While the Taxonomy Regulation is a piece of EU legislation, it will likely also impact non-European financial market participants offering financial products in the EU. Further, as mentioned above, companies established outside the EU, but which have European shareholders (who may, as financial market participants, be subject to disclosure obligations under the Taxonomy Regulation) may also come under pressure to provide sustainability-related disclosures to enable such shareholders to fulfil their own disclosure obligations.

(C) IMPACT ON REGULATORY FRAMEWORKS OUTSIDE THE EU

The structure and approach adopted by the Taxonomy Regulation may well form the basis for many similar regional and domestic frameworks. For example, similar projects to develop “principles-based” green taxonomies are already at various phases in Canada, Japan and Malaysia. China’s PBC Green Bond Endorsed Project Catalogue, for example, is aimed at harmonising green finance labels (in the bond market specifically). Going forward, the challenge will be to harmonise these region-specific frameworks. The IFC is already developing a green finance protocol to aid the comparison of regional taxonomies. A “taskforce” between Europe and China has also been proposed by China’s green finance leader, Dr Ma Jun, aimed at the harmonisation of the sustainability frameworks being developed in these regions.
If you would like to know more about the Taxonomy Regulation or ESG financing generally, please get in touch with one of the members of our team below.


5. The EU has committed to earmarking 25% of all spending for climate-friendly expenditure throughout the recovery programme and 7 year budget.

6. A ‘financial market participant’ means: (a) an insurance undertaking which makes available an insurance-based investment product (IBIP); (b) an investment firm which provides portfolio management; (c) an institution for occupational retirement provision (IORP); (d) a manufacturer of a pension product; (e) an alternative investment fund manager (AIFM); (f) a pan-European personal pension product (PEPP) provider; (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or (j) a credit institution which provides portfolio management (Disclosures Regulation, Article 2(1)).

7. A ‘financial product’ means: (a) a portfolio managed in accordance with point (6) of this Article; (b) an alternative investment fund (AIF); (c) an IBIP; (d) a pension product; (e) a pension scheme; (f) a UCITS; or (g) a PEPP (Disclosures Regulation, Article 2(12)).


9. The analysis for fixed income investments will be the same, with the difference being that such funds will also need to disclose the percentage of funds which are invested in:

   i. green bonds compliant with the EU Green Bond standard (100% Taxonomy-aligned);

   ii. green bonds partially compliant with the EU Green Bond standard (including % that is Taxonomy-aligned); and
iii. corporate bonds (including % that is Taxonomy-aligned).

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**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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