

BANKING, FINANCE AND CAPITAL MARKETS

EU Taxonomy Regulation

For the first time, the European Union specified the requirements for “*Sustainability*”. To this end, it lays down binding criteria for determining whether certain economic activities and financial products are to be regarded as environmentally sustainable or “*green*”. This is accompanied by new transparency and disclosure obligations for financial market participants.

1. EU ACTION PLAN ON SUSTAINABLE FINANCE

In March 2018, the EU Commission presented an action plan for a sustainable financial system (“**Sustainable Finance**”) intended to support the EU’s climate protection goals. The action plan includes

- a single EU classification system (“**Taxonomy**”) to define sustainability and those areas where sustainable investment can have the greatest possible impact,
- the establishment of an EU label for “*green*” financial products based on the Taxonomy,
- new disclosure obligations for asset managers and institutional investors as to whether and to what extent they take account of the criterion of sustainability in their investment processes,
- new obligations for insurance undertakings and investment firms to provide advice to their clients according to their sustainability preferences,
- the integration of sustainability issues into financial market supervision law and transparency regulations for companies.

As part of the action plan, Regulation (EU) 2019/2088 on sustainability-related disclosure requirements in the financial services sector (“**Sustainability Disclosure Regulation**”) was published on 9 December 2019. Moreover, on 19 December, the member states agreed on a draft of a regulation on the Taxonomy (cf. EU Council Document 14970/19 ADD, dated 19 December 2019 – final compromise on a Proposal for a Regulation of the European Parliament and the Council on the establishment of a framework to facilitate sustainable investment, and amending Regulation 2019/2088 on

sustainability-related disclosures in the financial services sector – “**Taxonomy Regulation**”).

The Sustainability Disclosure Regulation and the Taxonomy Regulation are closely related to each other and introduce for the first time an EU-wide uniform regime on the definition of environmental sustainability and associated transparency obligations. Moreover, they enable future inclusion of further sustainability goals, for example in respect of social responsibility.

2. SUSTAINABILITY DISCLOSURE REGULATION

The Sustainability Disclosure Regulation lays down harmonized rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products.

Financial market participants and financial advisers must inform their clients whether and how they take sustainability risks into account before providing investment advisory services to their clients or investing their clients’ funds. In the case of sustainable financial products, financial advisers must regularly inform their clients about the sustainability impact of the product even after the contract has been concluded. Further disclosure obligations apply with regard to the link between sustainability aspects and remuneration policies. Furthermore, advertising measures must be consistent with the information published on sustainability.

The Sustainability Disclosure Regulation applies to credit institutions and investment firms that provide portfolio management or investment advice, UCITS management companies, as well as managers of alternative investment funds and insurance companies.

3. TAXONOMY REGULATION

The Taxonomy Regulation defines criteria pursuant to which it can be assessed which economic activities and financial products qualify as environmentally sustainable. Also, it stipulates certain transparency obligations linked to such definition.

3.1 DEFINITION OF ENVIRONMENTALLY SUSTAINABLE ECONOMIC ACTIVITIES

Subject to further amendments as well as upcoming level 2 legislation, an economic activity shall generally be considered “*environmentally sustainable*” (“**Environmentally Sustainable Economic Activities**”) if it complies with all of the following requirements:

- (a) Such activity contributes substantially to at least one of the following six environmental objectives, set out in Articles 6–11 Taxonomy Regulation:
 - (i) climate change mitigation (e.g. by generating, transmitting, storing, distributing or using renewable energy, improving energy efficiency, increasing clean or climate-neutral mobility, switching to the use of sustainably sourced renewable materials, producing clean and efficient fuels from renewable or carbon-neutral sources, etc.);
 - (ii) climate change adaptation (e.g. activities which reduce the negative impact of the climate change to a certain economic activity without increasing the risk of an adverse impact on other people, nature or assets);
 - (iii) sustainable use and protection of water and marine resources (e.g. by protecting water from urban and industrial waste water discharges, incl. pharmaceuticals and micro-plastics, protecting human health from the adverse impact of any contamination of water, improving water management and efficiency, etc.);
 - (iv) transition to a circular economy (e.g. by improving the efficiency in the use of natural resources, reducing the use of primary raw materials, resource and energy efficiency measures, increasing the durability, reparability, upgradability, or reusability of products, in particular in designing and manufacturing activities, increasing the recyclability of products, etc.);
 - (v) pollution prevention and control (e.g. by preventing or, where that is not practicable, reducing pollutant emissions into air, water or land, improving levels of air, water or soil quality, preventing or minimizing adverse impacts on human health and the environment of the production, use and disposal of chemicals, or cleaning-up litter and other pollution);
 - (vi) protection and restoration of biodiversity and ecosystems (e.g. by activities which conserve, protect or improve natural and semi-natural habitats and species, by sustainable land use and management, sustainable agricultural practices, or sustainable forest management);

- (b) The activity does not significantly harm any of the above environmental objectives.

Environmentally sustainable activities must not “*significantly*” harm any of the six environmental objectives listed above. Art. 12 Taxonomy Regulation defines what constitutes a significant negative impact in relation to the respective climate objectives. Objective 1 (climate change mitigation) for example is “*significantly*” harmed if the activity leads to “*significant*” greenhouse gas emissions (Art. 12 lit. a Taxonomy Regulation).

Objective 4 (circular economy, waste prevention, reuse and recycling) is in particular “*significantly*” harmed if the long-term disposal of waste can cause significant and long-term damage to the environment (Art. 12 lit. d Taxonomy Regulation).

- (c) The activity is carried out in compliance with certain minimum safeguards and complies with certain technical screening criteria.

Under Art. 13 Taxonomy Regulation, companies that engage in environmentally sustainable activities must guarantee a certain minimum level of protection for employees. This includes:

- the OECD Guidelines for Multinational Enterprises, for example on trade unions, environmental protection, anti-corruption and protection of consumer interests,
- the UN Guiding Principles on Business and Human Rights,
- the eight fundamental conventions of the International Labour Organisation (ILO), such as the right not to be subject to forced labour, freedom of association, equal pay for men and women for work of equal value and the prohibition of child labour.

According to Art. 14 Taxonomy Regulation, the Commission shall also establish by delegated acts detailed technical screening criteria to determine under which circumstances an activity contributes “*significantly*” to or adversely affects an environmental objective. According to Art. 14 para. 4 Taxonomy Regulation, the criteria will be reviewed “*regularly*”, the criteria for transitional activities “*at least every three years*”.

These criteria should, where possible, be quantitative and include thresholds. Energy production through the use of solid fossil fuels – coal, oil – cannot be classified as “*sustainable*” (Art. 14 para. 2a Taxonomy Regulation).

The Commission should also take into account the market effects of the transition to a more sustainable economy when defining the criteria. These include the risk of massive losses in the value of assets (“*stranded assets*”), the risk of creating “*inconsistent incentives*” for sustainable investment and the negative impact on financial markets (Art. 14 para. 1 Taxonomy Regulation).

3.2 APPLICABILITY OF THE CRITERIA FOR ENVIRONMENTALLY SUSTAINABLE ECONOMIC ACTIVITIES FOR FINANCIAL PRODUCTS

The Taxonomy Regulation provides for certain disclosure obligations in respect of sustainability-related financial products.

According to Art. 4 a Taxonomy Regulation, for example, it must be disclosed to which environmental objectives within the meaning of the Taxonomy Regulation the financial product contributes. In addition, it must be explained how and to what extent invested assets are used to promote environmentally sustainable economic activities. According to Art. 4 β Taxonomy Regulation, the same applies *muta mutandis* where a financial product promotes environmental characteristics.

Also, it has to be indicated where a financial product does not take into account the EU criteria for environmentally sustainable investments.

3.3 NEW DISCLOSURE DUTIES FOR NON-FINANCIAL UNDERTAKINGS

Non-Financial Undertakings which qualify as “*public-interest entities*” (cf. below) within the meaning of Article 2 para 1 of the EU Transparency Directive (Directive 2013/34/EU of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings) have to include in their non-financial statements or consolidated non-financial statements information on how and to what extent their activities are associated with Environmentally Sustainable Economic Activities.

“**Public-Interest Entities**” means entities which are organized in the legal form of a stock corporation (*Aktiengesellschaft*), a partnership limited by shares (*Kommanditgesellschaft auf Aktien*) or limited liability company (*Gesellschaft mit beschränkter Haftung*) (if organized under German law) and which are

- credit institutions or insurance undertakings, or
- undertakings whose transferable securities are admitted to trading on a regulated market of any Member State, or
- undertakings designated by a Member State as Public-Interest Entities, for instance due to their significant public relevance because of the nature of their business, their size or the number of their employees.

Non-Financial Undertakings which qualify as Public-Interest Entities shall in particular disclose

- the proportion of their turnover derived from products or services associated with Environmentally Sustainable Economic Activities; and
- the proportion of their total investments (Capital Expenditure) and/or expenditures (Operating Expenditure) related to assets or processes associated with Environmentally Sustainable Economic Activities,

provided that they have more than 500 employees and their balance sheet total exceeds 20 million euros, or their annual turnover exceeds 40 million euros.

The EU Commission shall introduce level 2 measures by 1 June 2021 to further specify technical details and the application, taking into account the particularities of financial and nonfinancial undertakings.

4. COMING INTO EFFECT AND FURTHER STEPS

Being EU Regulations, the Sustainability Disclosure Regulation and the Taxonomy Regulation do not need to be transposed into national law by national legislation but will be directly applicable in all Member States once they come into effect which will gradually, to a major part within 2021.

The Commission shall adopt by early 2021, by means of delegated acts, the technical screening criteria for Objectives 1 and 2 (climate change mitigation and adaptation). From 2022 onwards, these and any associated disclosure obligations will apply to financial market participants, financial advisers and Public-Interest Entities. The technical screening criteria for the other objectives shall apply as of 2023.

5. SUPERVISION AND SANCTIONS

The Member States will designate competent authorities in order to monitor compliance with the regulations. In Germany, this will likely be the Federal Financial Supervisory Authority – *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin). Also, the Member States will have to lay down the rules on measures and penalties applicable to infringements of the regulations. Such measures and penalties shall be effective, proportionate and dissuasive.

6. PRACTICAL IMPLICATIONS

Whether certain economic activities can be classified as ecologically sustainable, must be carefully examined on a case-by-case basis, as the Taxonomy Regulation leaves considerable scope for interpretation and assessment. The new transparency and disclosure obligations also appear problematic. In particular larger companies will, in order to fulfil their disclosure obligations, have to depend on information from suppliers and customers on the extent to which they, for their part, take sustainability aspects into account.



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