

EU Publishes Final Taxonomy Report to Support its Sustainable Finance Regulations

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Last week, the European Commission's Technical Expert Group on Sustainable Finance (TEG) published its [final report](#) along with a [technical annex](#) setting forth its recommendations regarding the design and implementation of a unified classification system, known as EU Taxonomy, which will define what economic activities are considered environmentally sustainable under the EU's sustainable finance regulations. The final report is the result of a nearly two year long process conducted at the direction of the European Commission to assist in the implementation of the Taxonomy regulation. The European Commission will consider the final report as it develops legislation to implement elements of the Taxonomy regulation.

The Taxonomy Regulation. The Taxonomy regulation is one of a package of three sustainable finance regulations initially proposed by the European Commission in May 2018 (the others cover low-carbon benchmarks, which we previously discussed [here](#), and sustainability disclosures). The European Council and the European Parliament reached political agreement on the text of the Taxonomy regulation in December 2019. As the preamble notes, the Taxonomy regulation "is the most important and urgent action" of the three as it sets the basic ground rules for defining what sorts of economic activities are considered environmentally sustainable. According to the Taxonomy regulation, economic activity must meet three criteria to be considered environmentally sustainable:

1. The activity must make a substantive contribution to one or more of the following six objectives:
 - a. climate change mitigation,
 - b. climate change adaptation,
 - c. sustainable use and protection of water and marine resources,
 - d. transition to a circular economy,
 - e. pollution prevention and control, and
 - f. protection and restoration of biodiversity and ecosystems.
2. The activity must not do significant harm to any of the other objectives listed above.
3. The activity must meet certain minimum social and governance safeguards, including those set forth in the OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights.

The Taxonomy regulation would require companies falling under the scope of the EU's Non-Financial Reporting Directive (essentially large banks, insurance companies and listed companies) to apply these criteria to their operations and disclose the extent to which they are environmentally sustainable consistent with the Taxonomy. Financial market participants offering certain categories of financial products subject to the Sustainability-Related Disclosures regulation must make similar disclosures regarding the investments underlying the financial products if they are promoted for their environmental or social characteristics or have sustainability as their objective or include a disclaimer if they do not. Finally, the Taxonomy regulation would serve as the governing standard for any future regulation by the EU or any EU

member state regarding environmentally sustainable financial products.

The TEG Final Report. The final report provides guidance on how companies and financial institutions are to determine whether an economic activity substantively furthers two of the six objectives: climate change mitigation and climate change adaptation. The report defines economic activities by use of NACE, or Nomenclature statistique des activités économiques dans la Communauté européenne, codes, the European industry standard classification system classifying economic activities. The final report then identifies quantitative or qualitative criteria for determining whether any NACE code activity substantively furthers these objectives as well as whether they do substantial harm to any of the other objectives identified in the regulation. The final report presumes that certain economic activities (such as certain fossil fuel based operations) do not substantively further the climate change objectives and thus their NACE codes are not listed.

Companies subject to Taxonomy disclosure requirements can apply these criteria to assess the various economic activities in which they are engaged and determine the extent to which their operations are environmentally sustainable. Financial firms offering financial products subject to the requirements based on these companies' equity or debt can use their disclosures as inputs in making Taxonomy-based disclosures with respect to their products. For financial products incorporating investments in companies that have not made their own Taxonomy-based disclosures (e.g., they are not subject to the Non-Financial Reporting Directive), the firms offering the products will have to work with the companies to conduct the necessary due diligence to fill the gap. For this reason, it may be advisable for companies seeking access to lenders and investors to conduct Taxonomy-based analyses of their operations even if they are not subject to the Non-Financial Reporting Directive.

Next Steps. The European Commission is expected to adopt legislation by the end of this year implementing the criteria covered by the final report – that is, economic activities that substantially contribute to climate change mitigation or adaptation. If adopted by the end of 2020, the legislation would be expected to enter into application by the end of 2021. Legislation covering the criteria for the other four environmental objectives is expected to be adopted by the end of 2021 and enter into application by the end of 2022. Further development of the EU Taxonomy will take place via a new Platform on Sustainable Finance, which is expected to be operating by this fall.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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