

Are You Prepared for the EU Taxonomy, the Sustainable Finance Disclosure Regulation and the Proposed Corporate Sustainability Reporting Directive?



For the EU to reach carbon neutrality by 2050, the European Commission has aligned a number of policies around sustainability. The EU Sustainable Finance Action Plan aims to promote sustainable investment across the member states, while increasing corporate reporting and assurance on sustainable business activities.

The European Parliament and Council have already adopted EU laws implementing these reforms through the:

- **Sustainable Finance Disclosure Regulation** (SFDR), which integrates environmental, social and governance (ESG) considerations into investment advice and portfolio management.
- **Non-Financial Reporting Directive** (NFRD), which requires a non-financial statement as part of annual public reporting for public-interest companies.
- **Corporate Sustainability Reporting Directive** (CSRD), which has been released as a proposed Directive from the EU Parliament, will soon replace the NFRD in the EU.



CSRD

The new proposed Directive, which is different from the original CSRD proposal in some topics, has due diligence rules that will apply to the following companies and sectors:

- **EU companies:**

- Group 1: All EU limited liability companies of substantial size and economic power (with more than 500 employees and more than €150 million in net turnover worldwide).
- Group 2: Other limited liability companies operating in defined high impact sectors (such as the textile, metal or agricultural industry), which do not meet both Group 1 thresholds, but have more than 250 employees and a net turnover of €40 million worldwide and more. For these companies, rules will start to apply two years later than for group 1.

- **Non-EU companies** active in the EU with turnover threshold aligned with Group 1 and 2, generated in the EU.

This proposal applies to the company's own operations, their subsidiaries and their value chains (direct and indirect established business relationships).

Small and medium enterprises (SMEs) are not directly in the scope of this proposal.

In concrete terms, the companies need to:

- Integrate due diligence into policies
- Identify actual or potential adverse human rights and environmental impacts
- Prevent or mitigate potential impacts, as well as bring to an end or minimise actual impacts
- Establish and maintain a complaints procedure
- Monitor the effectiveness of the due diligence policy and measures
- Publicly communicate on due diligence

In addition, group 1 companies need to have a plan to ensure that their business strategy is **compatible with limiting global warming** to 1.5 °C in line with the Paris Agreement.

Scheduled for summer 2022, a first set of requirements and final standards will be published. These will be required for the reporting year 2023. The new update will include guidelines for two main concepts:

The double materiality concept – This concept requires companies to report both on how sustainability issues affect their own performance, position and development (the “outside-in” perspective), and on their impact on people, stakeholders and the environment (the “inside-out” perspective). It will further demand the disclosure of:

- Climate and environmental impact of a company and its supply chain
- Social impact and responsibilities across the value chain
- Climate-related risks and financial uncertainties

Quality of information – Guidelines on how comprehensive data needs to be collected, managed and reported.

A year later, in summer 2023, a set of additional guidelines regarding the reporting standards and its quality will be published. These will focus on the integration of non-financial and financial reporting, the depth of collected and managed data from companies and their supply chains, and future-oriented metrics to improve companies' sustainability performance.

EU Taxonomy

The EU Taxonomy Regulation, which is already effective, establishes a common classification system of economic activities, which, alongside the SFDR, the NFRD and the proposed CSRD, complement the sustainable finance regulatory regime. At the core of the EU Taxonomy Regulation is the definition of a sustainable economic activity. This definition is based on two criteria. An activity must:

- Contribute to at least one of six environmental objectives listed in the EU Taxonomy:
 1. Climate change adaptation
 2. Climate change mitigation
 3. Sustainable use and protection of water and marine resources
 4. Transition to a circular economy
 5. Pollution prevention and control
 6. Protection and restoration of biodiversity and ecosystems
- Do no significant harm to any of the other objectives, while respecting basic human rights and labour standards

Further, the EU Taxonomy Regulation for the objective assessment of the sustainability of economic activities considers different circumstances and obligations for different economic actors. It is divided into the following three groups:

- Companies (with more than 500 employees) that fall under the NFRD
- Financial market participants, including occupational pension providers, that offer and distribute financial products in the EU (including those from outside the EU)
- The EU and its member states when setting public measures, standards or labels for green financial products or (corporate) bonds

The disclosure obligations under the proposed NFRD and the CSRD Directive will increase corporate transparency and demonstrate a company's attractiveness to investors, with future investments directed at those that enable carbon neutrality by 2050. Companies not subject to the NFRD, including SMEs, may decide to voluntarily disclose their taxonomy-alignment KPIs for the purpose of accessing environmentally sustainable finance, based on alignment with the Taxonomy Regulation or as part of their overall business strategy based on environmental sustainability.

The evolving policy landscape necessitates close monitoring to ensure compliance with the developing standards and legal obligations. The precise requirements and applicability at the EU and Member State levels are complicated and vary depending on the size of the company and the type of industry/business.

National administrative authorities appointed by Member States will be responsible for supervising these new rules and may impose fines in case of non-compliance. In addition, victims will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures.



Why Do I Need to Be Prepared?

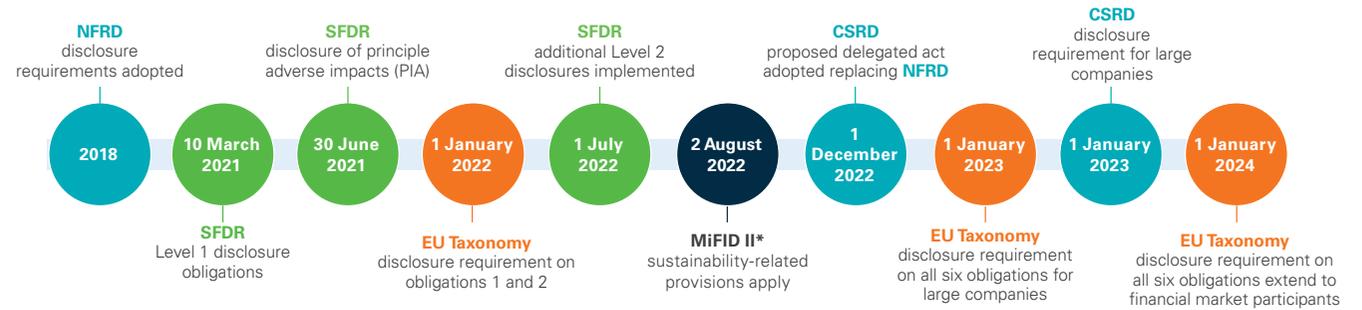
As the EU and Member States improve corporate transparency and governance through formalised reporting and improvements across environmental and nature-based responsible business, we are now seeing banks and lenders setting preferential rates for those with ESG ratings and verified disclosures under the NFRD and proposed CSRD draft Directive relating to the EU Taxonomy Regulation.

Large corporates are already mandated under the NFRD to disclose information on environmental sustainability when reporting on FY 2021, but with the additional criteria expected, and formalised publishing parameters anticipated when the CSRD is adopted in Q3 2022, it is advisable to proactively adapt to the current NFRD reporting requirements and voluntarily disclose such information for both investors and public reputation.

Additionally, it is anticipated that subsidiaries of multinational companies will be classified as large corporates in Member States and, as such, the divergence between the EU and an emerging global standard in Taskforce for Climate-related Financial Disclosures (TCFD) could create substantial additional reporting obligations. Proportionate standards for SMEs are also anticipated in the near future.



Timeframe



*MiFID II is a legislative framework instituted by the EU to regulate financial markets in the bloc and improve protections for investors. As a routine component of financial advice, investment advisers should ask about, and then respond to, investors' preferences regarding the sustainable impact of their investments. Under the amended Delegated Regulation, from 2 August 2022, sustainability factors, risks and preferences will need to be integrated into certain organisational requirements and operating conditions for MiFID investment firms, including in respect of sustainability assessments.



Checklist

We have developed a quick checklist to help you to evaluate and assess how prepared you are for the forthcoming legislative changes:

	Yes/No
Does your company currently have subsidiaries within the EU with more than 500 members of staff and which have either a balance sheet total of more than €20 million or a net turnover of more than €40 million, so that the NFRD is applicable on a group-wide basis?	
Do your existing policies meet the current NFRD obligations?	
Do you use for reporting a voluntary framework or do you use national, European or international guidelines, such as the UN Global Compact , the OECD guidelines for multinational enterprises or the ISO 2600 according to the EU Commission?	
Do you need to develop, redesign or overhaul your ESG-related reporting based on new guidelines?	
Do you report on business development, performance, impact and pre-defined lists of non-financial issues?	
Do you disclose a description of your business model and policies, the result of such policies, the associated risks and non-performance indicators?	
Have your internal reporting policies been reviewed to ensure they appropriately mitigate ESG risk associated with the key stakeholders and third parties for your business, including social media?	
Do you have a system to effectively monitor and mitigate ongoing ESG risks?	
Do you have an effective monitoring system to measure environmental and social impact against KPIs?	
Do you report on your environmental and social impacts?	
Have you scoped mandatory NFRD compliance obligations?	
Have you designed and implemented a roadmap to meet your NFRD obligations?	
Are you listed on an EU regulated market or do you fulfil the following criteria under the proposed CSRD: more than 250 employees, €150 million+ in net turnover worldwide?	
Are you prepared for reporting and assurance obligations under the proposed CSRD?	
Are you prepared to report on the impact of sustainability matters on your company value and the impact that this has on the environment, people and the economy?	
Are you prepared for a third-party audit under the CSRD?	
Are you prepared to report on your strategy, business model, targets and engagement of board and management?	
Are you prepared to report in accordance with the EU's mandatory sustainability reporting standards in digital format?	
Are you prepared for reporting and assurance obligations under the EU Taxonomy?	
Have you scoped your percentage of turnover, CAPEX and OPEX aligned to the EU Taxonomy sustainable objectives?	
Are ESG risks considered by the board or executive/senior management team?	
Have you identified someone at board level responsible for ESG?	

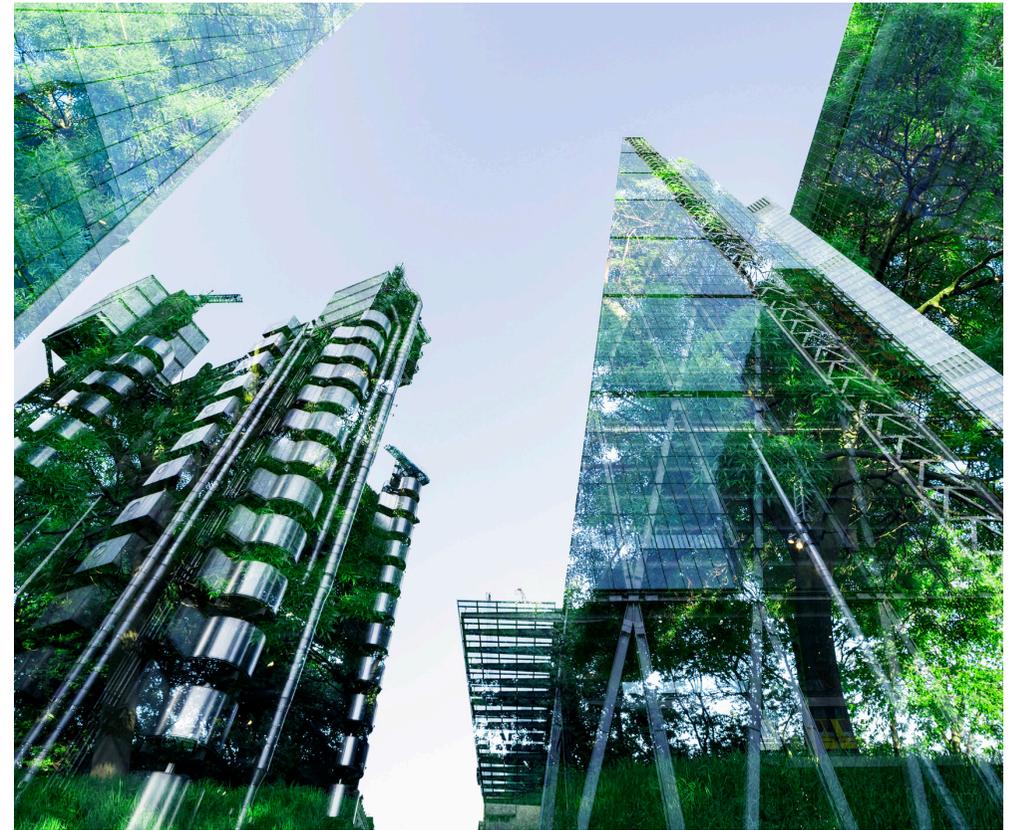
Environmental Issues for Corporates Under the Taxonomy Regulation, NFRD and the Proposed CSRD Directive

Careful risk management and corporate governance must also include sustainability risks. The difficulty for companies, however, is often where to start. Sustainability law is a classic cross-sectional subject with a fragmented legal framework in many different laws. Only selected industries (e.g. the financial services industry) already have an explicit legal framework and guidance from regulators (although enough questions still remain). For most companies, this does not apply. In addition, there are many case-by-case case laws, especially in the greenwashing area, which are highly relevant in practice.

Greenwashing

Greenwashing is the use of disingenuous environmental or eco-friendly claims (e.g. "natural", "recyclable" and "organic") by businesses to market products to consumers. This may be done via "statements, symbols, emblems, logos, graphics, colours and product brand names".

With consumers' growing eco-conscience, green claims are likely to remain key components of businesses' marketing strategies. However, it is worth bearing in mind that these environmental claims are [firmly within the radar of the EU Commission](#) and it is likely that more action will be brought against those not complying with EU law and applicable consumer protection legislation.



Rules Applying to Banks and Financial Institutions Under the SFDR

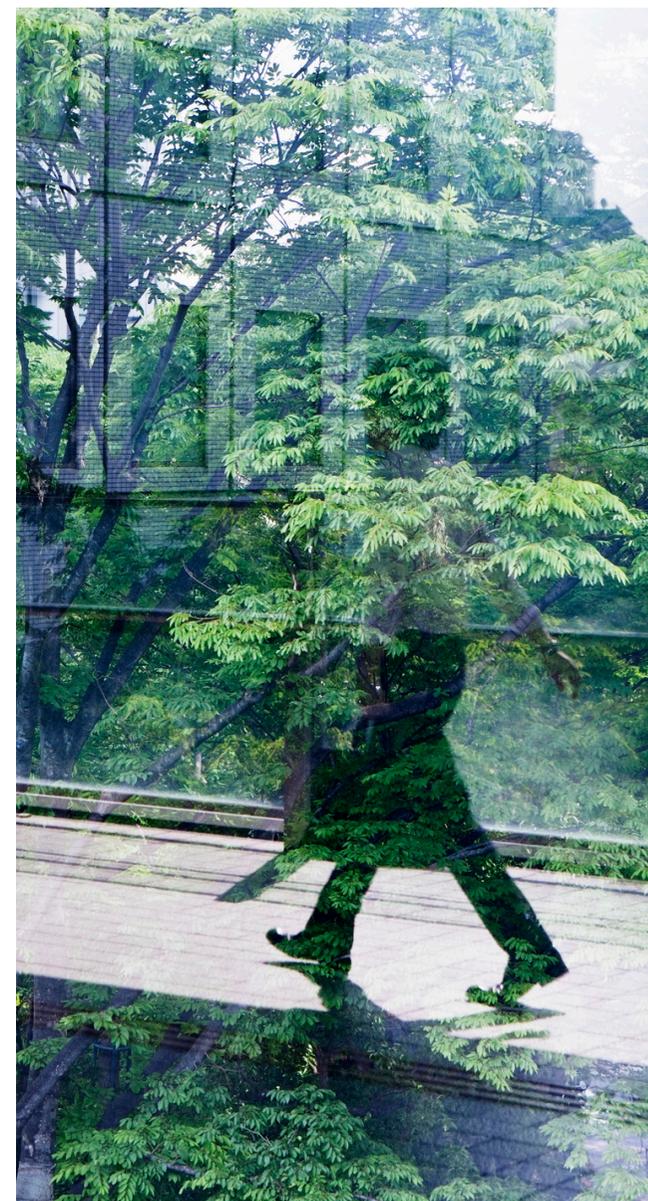
Banks and investment firms are already required to disclose sustainability-related information for certain financial instruments. According to the SFDR, they must fulfil strict transparency obligations on sustainability and sustainability risks either in their role as “financial market participant” (e.g. in portfolio management) or “financial advisor” (e.g. investment advice), both pre-contractually and on an ongoing basis. The information concerns both the company and the product offered to the customer. These obligations under the SFDR have been in force since 10 March 2021 and are as follows:

- The requirements differ for financial market participants and companies that do not offer financial products
- Some companies/financial market participants can fall into both categories (depending on size and economic activity)
- All financial market participants offering financial products, including occupational pensions, in the EU must disclose how and to what extent their economic activity includes, promotes or finances sustainable projects according to the criteria of the EU Taxonomy
- For each relevant product, the following must be disclosed:
 - How and to what extent the EU Taxonomy has been applied in determining the sustainability of the underlying investments
 - To which environmental objective(s) the investments contribute
 - The share of sustainable investments expressed as a percentage of the investment, fund or portfolio based on the criteria of the EU Taxonomy
 - When indicating the shares, a distinction should be made between transition activities and enabling activities
- The information must be provided within the framework of the existing pre-contractual periodic contribution obligation
- If, for specific reasons, the financial product is not subject to the EU Taxonomy, this should be indicated in a disclaimer

The EU Taxonomy applies to all financial products offered by private and public institutions based on equity and debt capital within the EU.

Although a breach of the reporting requirements has not led to any penalty to date, it could have consequences under civil law.

In addition, the new MiFID II rules on “sustainability preferences” will apply from 2 August 2022. Financial service providers must be able to recommend only those financial instruments that match the client’s specific “sustainability preference” in both investment advice and portfolio management. They must also take appropriate account of sustainability risks in their own risk management.



How We Can Help

- **We understand the business and legal implications of legislative and regulatory policy** developments that affect business, and we can provide ongoing monitoring and compliance against current and future developments.
- **We are fully immersed in relevant ongoing regulatory and legislative policy debates within the EU**, including adjacent regulatory issues (e.g. the European Green Deal, EU Climate Law and Carbon Border Adjustment Mechanism).
- **We maintain and continuously cultivate effective working relationships with key stakeholders.** Therefore, we understand the inner dynamics of the EU legislative and regulatory processes, having led and served in key policymaking roles related to federal/national sustainability policy and funding.
- **We develop robust compliance frameworks**, which assist in creating comprehensive compliance programmes and/or enhancing a company's existing programme to effectively manage risks and cover compliance with legal and regulatory requirements. In addition, we offer a holistic assessment of business integrity that takes into account reputational and commercial factors.
- **We help you demonstrate accountability and transparency.** From the governance reviews that provide independent assurance for investors, to strategic guidance on purpose and business integrity processes, our services enable corporates to demonstrate accountability and transparency in their relations with investors and shareholders.
- **We can work with you to review your green claims** to ensure you are not at risk of greenwashing and enforcement action.
- **We offer practical solutions and systems** that our clients can readily implement and monitor.

For businesses looking to design, develop or overhaul their policies and practices in relation to sustainability and ESG, we can:

- Scope your ESG-related policies and mandatory ESG compliance obligations
- Benchmark these against competitor, industry and market practices
- Design and implement a roadmap to meet your objectives in a manner that mitigates your ESG risk
- Provide ongoing monitoring and benchmarking against future developments

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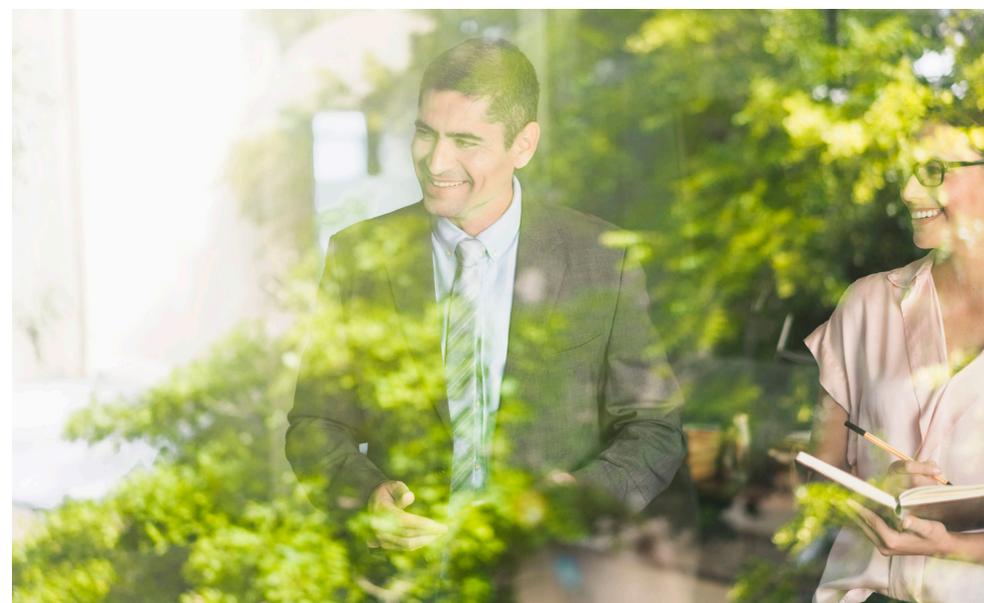
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