Clients&FriendsMemo

ESMA Proposes Rules for Taxonomy-Alignment of Non-Financial Undertakings and Asset Managers

10 March 2021

Further to our Clients & Friends Memo of 22 June 2020, the Sustainability Taxonomy Regulation (2020/852) (the "**Regulation**") was published in the Official Journal on 22 June 2020 and entered into force on 12 July 2020. The Regulation established an EU-wide framework for classifying economic activity as environmentally sustainable and aims at (1) reducing "greenwashing", where financial products are marketed as environmentally sustainable without sufficient factual basis for their claims and (2) improving the efficiency of private investment in sustainable projects.

An economic activity is classified as an environmentally sustainable activity (an "**Activity**") if it:

(i) contributes substantially to one or more of the environmental objectives (set out in Article 9 of the Regulation) (the "**Objectives**"), or directly enables other activities to make a substantial contribution to one or more of them;

(ii) does not significantly harm any other Objective;

(iii) complies with applicable technical screening criteria (the "**Technical Screening Criteria**") set out in delegated acts of the Commission that have yet to be developed; and

(iv) is carried out in compliance with certain safeguards.

The provisions of the Regulation will apply: (i) from 1 January 2022, for activities that substantially contribute to climate change mitigation or climate change adaptation (Articles 10 and 11 of the Regulation); and (ii) from 1 January 2023, for economic activities substantially contributing to the four remaining Environmental Objectives (Articles 12 - 15 of the Regulation).

The Commission shall review the Technical Screening Criteria regularly and amend the relevant delegated acts according to scientific and technological developments (Article 19(5) of the Regulation).

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Article 8(1) of the Regulation requires the undertakings, which fall within the scope of the Non-Financial Reporting Directive ("NFRD"), to include non-financial information on how they are associated with the Activities in their non-financial statement or a separate report. Article 8(2) of the Regulation requires such non-financial undertakings to disclose three key performance indicators ("KPIs"):

(i) Turnover KPI: the proportion of their turnover derived from products or services associated with the Activities;

(ii) CapEx KPI: the proportion of their capital expenditure related to assets or processes associated with the Activities; and

(iii) OpEx KPI: the proportion of their operating expenditure related to assets or processes associated with the Activities.

The content, methodology and presentation of such information shall be specified in a separate delegated act of the Commission, which shall be adopted by 1 June 2021 (Article 8(4) of the Regulation).

The Regulation does not specify any KPIs for financial undertakings (including asset managers), which are subject to the disclosure requirements for non-financial information in the Accounting Directive (2013/34/EU).

On 29 July 2020, the Commission published a consultation on a roadmap for the delegated regulation on taxonomy-related disclosures by undertakings reporting non-financial information.

On 15 September 2020, the European Securities and Markets Authority ("**ESMA**") received a call requesting its input on specifying the three KPIs and on 5 November 2020, it published the corresponding consultation paper.

On 1 March 2021, ESMA published its final report (ESMA30-379-471), which summarises responses to its consultation paper from 77 entities, as well as the Securities and Markets Stakeholder Group.

Following the consultation, ESMA advised as follows in relation to the disclosures by:

1 NON-FINANCIAL UNDERTAKINGS:

1.1 Content of KPIs

(i) All three KPIs:

- non-financial undertakings shall apply their best judgement in splitting turnover between CapEx and OpEx across their activities, but while doing this shall avoid (1) unduly inflating the proportion of the Activities and (2) double-counting; and

- the Commission shall establish requirements for KPIs to be accompanied by information on how the KPIs were prepared and what they cover;

(ii) Turnover KPI:

- non-financial undertakings should use the definition of net turnover in Article 2(5) of the Accounting Directive as the reference point when calculating their turnover;

(iii) CapEx KPI:

CapEx should be defined as:

- where IFRS is applied: the costs accounted for based on specific paragraphs of IAS 16, IAS 38 and IAS 40-41 and IFRS 16; and

- where national GAAP is applied: the costs accounted for under the applicable GAAP and leases (which do not lead to the recognition of a right-of-use asset) should not be counted as CapEx;

(iv) OpEx KPI:

- OpEx shall be defined as the following non-capitalised costs: (1) R&D, (2) building renovation measures, (3) short-term leases, (4) maintenance and repair, and (5) any other direct expenditures relating to the day-to-day servicing of items of property plant and equipment necessary to ensure the continued and effective functioning of such assets;

- non-financial undertakings applying national GAAP and not capitalising right-of-use assets shall include lease costs in the definition of OpEx; and

- only direct costs should be included.

1.2 Methodology for preparing KPIs

- disclosure should be provided by economic activity along with a total per KPI across economic activities at the level of the undertaking or group;

- non-financial undertakings should identify economic activities that are enabling (Article 16 of the Regulation) and transitional (Article 10(2) of the Regulation);

- non-financial undertakings should disclose the KPIs by enabling and transitional economic activity along with a total per KPI across enabling and transitional economic activities at the level of the undertaking or group;

- disclosure should be provided by environmental objective along with a total per KPI at the level of the undertaking or group across all environmental objectives; and

- the Commission should introduce the reporting of the KPIs gradually.

1.3 Presentation of KPIs

- disclosure should be provided in a standardised table; and

- non-financial undertakings should ensure coherence and consistency between the content of the tables relating to the three KPIs.

2 ASSET MANAGERS:

2.1 Content of KPIs

- the KPI for asset managers should consist of a ratio of Taxonomy-aligned investments (which shall include both collective and individual portfolio management activities), where:

  (i) the numerator should consist of (1) the value of green bonds complying with the EU Green Bond Standard and (2) a weighted average (based on the share of Taxonomy-aligned activities of the investee companies measured by turnover) of the value of the investments invested in Taxonomy-aligned activities of investee companies; and

  (ii) the denominator should consist of the value of all investments of the asset manager; and

- the accompanying information to the KPI should identify the share of assets in the denominator (e.g., sovereign bonds) that "may fund environmentally sustainable environmental activities but cannot be reliably assessed".

2.2 Methodology for preparing KPIs

- the Commission should develop a methodology to estimate the share of environmentally sustainable economic activities funded by sovereign bonds (for sovereign bonds to be included in the numerator – see above);

- the Commission should develop a methodology to allow KPI calculation to cover investments in companies, which do not fall within the scope of the NFRD;

- this methodology should be elaborated and maintained by an independent body (e.g., the European Commission's Joint Research Centre), which would be responsible for maintaining and updating it; and

- the calculation should allow netting for the investments, derived from the methodology used to calculate net short positions in the Short-Selling Regulation but should not cover derivatives in the numerator except for contracts for differences.

2.3 Presentation of KPIs

- disclosure should be provided using a template set out in the Report;

- the disclosure should identify which environmental objectives the investments contribute to and whether the activities are transitional (Article 10(2) of the Regulation) or enabling activities (Article 16 of the Regulation) for each environmental objective; and

- the disclosure should also have appropriate accompanying information, such as a link to disclosures on the adverse impacts of investment decisions on sustainability factors under Article 4 of the Sustainable Finance Disclosure Regulation (2019/2088).

According to authority's chair Steven Maijoor, ESMA views these disclosures as essential for providing investors with the information, needed to direct investments towards environmentally sustainable activities and a "key building block" for the reporting of other financial market participants under the EU taxonomy.

Application of the Regulation in the UK

The UK formally left the EU on 31 January 2020 and entered into a transition period, which ended on 31 December 2020. After this date, EU law ceased to apply in the UK.

Although the Regulation entered into force on 12 July 2020, the key operative requirements (e.g. disclosure obligations) will only start applying after 31 December 2021 and will therefore fall outside the retained EU law, unless the UK chooses to incorporate them into its domestic legislation.

On 9 November 2020, Chancellor of the Exchequer Rishi Sunak set out the UK government's plans for the future of financial services post-Brexit. The announcement emphasised the UK's commitment to remain a green finance leader and the Government's intention to implement the EU taxonomy, with adaptations, to be developed by the UK Green Technical Advisory Group.

Further details of the implementation plans are set out in the Interim Report and Roadmap, published by the Taskforce on Climate-related Financial Disclosures ("**TCFD**") on 9 November 2020. These plans include making TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Michael Sholem	+44 (0) 20 7170 8545	michael.sholem@cwt.com
Joanna Valentine	+44 (0) 20 7170 8640	joanna.valentine@cwt.com
Dmitry Morgan	+44 (0) 20 7170 8737	dmitry.morgan@cwt.com