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EU ESG Fund Disclosure: Final Taxonomy Report from EU Technical Expert Group

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MiFID, EMIR, AIFMD, UCITS V RE: EU ESG Fund Disclosure: Final Taxonomy Report from EU Technical Expert Group

The European Commission-appointed Technical Expert Group on sustainable finance (TEG)[\[1\]](#) recently released a final Technical Report[\[2\]](#) that makes recommendations to the European Commission on qualitative and quantitative thresholds for determining whether an economic activity qualifies as environmentally sustainable under the EU Taxonomy Regulation[\[3\]](#) (i.e., the activity is Taxonomy-aligned). The Report also provides 14 pages of guidance[\[4\]](#) on how financial market participants (e.g., asset managers) would use this information to provide the required Taxonomy disclosure for relevant products (e.g., ESG funds and separate accounts).

One of the key implementation challenges will be obtaining Taxonomy-alignment data from companies in which funds are invested and then determining the degree to which the fund's investments are Taxonomy-aligned. The TEG's Report attempts to address this data availability gap, anticipating that asset managers will do "due diligence" on companies' sustainability impact as a means of obtaining and assessing information about an investment's alignment with the Taxonomy. The Report's discussion of "due diligence" in line with the OECD Guidelines on Multinational Enterprises (on responsible business conduct) and the UN Guiding Principles on Business and Human Rights raises questions about what this analysis will look like in practice.

Although the TEG Report's recommendations are not binding, the Commission is expected to largely adopt these recommendations in level 2 legislation.

I. Taxonomy Defines "Environmentally Sustainable" Economic

Activities

The Taxonomy Regulation defines economic activities that qualify as “environmentally sustainable” for the purposes of establishing the degree of environmental sustainability of an investment.

To qualify, an economic activity must meet the following three elements:

1. “Substantially contribute” to one of six environmental objectives: climate change adaptation, climate change mitigation, sustainable water use, circular economy, pollution prevention, or healthy ecosystems.
2. “Do no significant harm” to any of those six objectives.
3. Meet certain minimum “social safeguards,” meaning the standards embedded in the OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, with specific reference to the ILO Core Labour Conventions.

The European Commission appointed the TEG to assist it in developing technical screening criteria (i.e., qualitative and quantitative thresholds) for assessing whether an economic activity meets each of the above three elements and therefore qualifies as Taxonomy-aligned.

II. TEG Report’s Guidance on ESG Fund Disclosure Required by the EU Taxonomy

The Taxonomy also includes mandatory financial product disclosure requirements that will have a significant impact on ESG funds (as defined in Disclosure Regulation Articles 8 and 9). Please note that a prior ICI Global memo (attached) sets forth the Taxonomy and Disclosure Regulation’s product disclosure requirements in detail, including an appended chart with the details for each new disclosure requirement, with the source of the requirement in the Disclosure or Taxonomy Regulation, location of the disclosure (e.g., prospectus), specific disclosure required, compliance date, and the status of any ongoing technical work.

The TEG Report provides guidance[\[5\]](#) on how financial market participants (e.g., asset managers) can meet the following Taxonomy disclosure requirements for relevant products (e.g., ESG funds and separate accounts):

1. How and to what extent the asset manager has used the Taxonomy in determining the sustainability of the fund’s underlying investments.
2. To what environmental objective(s) the investments contribute.
3. The proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage of the investment, fund, or portfolio.

ESG funds must provide this disclosure in their prospectuses and annual reports. The TEG Report recommends that the prospectus disclosure focus on ex-ante information, including the environmental objectives of the fund (and any Taxonomy-related targets), and how the Taxonomy will be used to achieve these objectives (e.g., portfolio construction or as the basis of engagement with companies).[\[6\]](#) For annual report disclosure, the Report recommends focusing on ex-post information, including how the strategies have been implemented in practice, and a point-in-time calculation of the Taxonomy percentage.[\[7\]](#)

One key challenge is how funds will obtain this data for their portfolio investments. The Taxonomy requires large listed companies subject to the Non-Financial Reporting Directive

(NFRD)[8] to disclose how their activities align with the Taxonomy. Non-EU companies, as well as EU companies and bond issuers that do not fall under the scope of the NFRD, will not have a legal obligation to disclose the extent to which their revenue is Taxonomy-aligned. EU UCITS that invest in those companies or bonds nevertheless will still be required to disclose the percentage of alignment of their portfolio investments. The Report acknowledges the obstacles that this data gap presents for asset managers, including that companies will need to voluntarily provide this information to managers.

A. Disclosure requirement #1: Narrative disclosure on use of the Taxonomy

For the first requirement, the Report characterizes this narrative disclosure as “an important companion to the quantitative (percentage) disclosure requirements.”[9]

The Report provides the following examples of scenarios where an asset manager may wish to use this narrative disclosure to explain elements of their investment strategy or approach, especially where the fund’s percentage of Taxonomy-alignment is low:

- Products targeting companies whose ESG performance is low but improving over time may wish to describe the methods used to identify and engage companies and the expected time frame for that improvement.
- For products using a different methodology for determining environmental performance, the TEG considers it best practice to explain the strategy, its environmental objectives, and main points of variance from the Taxonomy.
- The asset manager may also wish to explain how it considers metrics, such as Taxonomy-aligned capex, when evaluating the sustainability of underlying investments and their trajectory towards the criteria.
- Asset managers who appoint external fund managers may wish to disclose details of how they use the Taxonomy when engaging with these external managers.

B. Disclosure requirements #2 and #3: Contribution to environmental objectives and proportion of underlying investments that are Taxonomy-aligned

The Report also provides guidance on the disclosure requirements on environmental objective(s) to which the investments contribute and the proportion of underlying investments that are Taxonomy-aligned.

Asset managers will need to determine, for each ESG fund, the percentage of Taxonomy alignment of each portfolio investment and then aggregate those percentages and disclose an overall percentage for the fund. The Report recommends that investors complete this calculation separately for each environmental objective, with specifics on how to analyze a company’s balance sheet with respect to the environmental objectives of climate change mitigation and climate change adaptation.[10] The Report also includes a table with more detailed disclosure methodologies for equity and fixed-income investments (e.g., green bonds).[11]

To calculate a portfolio investment’s percentage of Taxonomy-alignment, an asset manager will need to identify the percentage of the investment’s underlying economic activities that qualify as Taxonomy-aligned. The Report provides guidance on how to make this determination as to whether an economic activity meets each of the Taxonomy’s three elements: (1) “substantial contribution,” (2) “do not significant harm,” and (3) “minimum social safeguards.”

More specifically, the Report recommends that asset managers conduct the following five-step check process (or delegate it to data providers or other third parties)[\[12\]](#):

1. Identify the activities conducted by the company or issuer or those covered by the financial product (e.g., projects, use of proceeds) that could be Taxonomy-aligned, and for which environmental objective(s).
2. For each potentially aligned activity, verify whether the company or issuer meets the relevant screening criteria for “substantial contribution” (e.g., electricity generation <100 g CO₂e/kWh).
3. Verify that the “do no significant harm” criteria are being met by the issuer. Asset managers using the Taxonomy would most likely use a due diligence-type process for reviewing the performance of underlying investees and would rely on the legal disclosures of eligibility from those investees.
4. Conduct due diligence to avoid any violation of the “minimum social safeguards.”
5. Calculate alignment of investments with the Taxonomy and prepare disclosures at the investment product level. The Report recommends disclosing the following information:
 - a. The percentage of the fund that can be demonstrated to align with the Taxonomy (either where full disclosure has been made by the company, or where the asset manager has independently evaluated the Taxonomy eligibility of the company, including with the use of estimated or modelled data).
 - b. The percentage of the fund that is potentially aligned. The asset manager has good reason to believe that the underlying activity is aligned, but full compliance has not been demonstrated. The asset manager should explain which technical screening criteria could not be verified and why, the nature of the due diligence they have conducted, engagement with the company (if undertaken) and results, and how estimates, where appropriate, have been calculated.

1. Determining “substantial contribution” of an economic activity

The Technical Annex to the Report includes a long list of economic activities that the TEG has determined may “substantially contribute” to climate change mitigation or climate change adaptation, which are the first two of the Taxonomy’s six environmental objectives.[\[13\]](#) The TEG has developed detailed metrics and thresholds (referred to as “technical screening criteria”) that each activity would need to meet in order to qualify as making a “substantial contribution” to one of those environmental objectives.

For example, the production of electricity from wind power would qualify as making a “substantial contribution” to the environmental objective of climate change mitigation if the life cycle impacts for producing 1 kWh of electricity are below 100gCO₂e/kWh, using an ISO 14067 or a GHG Protocol Product Lifecycle Standard-compliant Product Carbon Footprint (PCF) assessment. Attached is an excerpt from the TEG Report showing the detailed technical screening criteria for production of electricity from wind power.[\[14\]](#)

EU companies subject to the NFRD will be required to disclose this information. For investments in companies not subject to the EU reporting requirements, the Report recommends that asset managers attempt to obtain the information from issuers or delegate to data providers or other third parties. If an asset manager believes that an underlying economic activity is Taxonomy-aligned, but “full compliance has not been demonstrated,” then the Report recommends that the manager explain which technical screening criteria could not be verified and why, the nature of the due diligence they have

conducted, engagement with the company (if undertaken) and results, and how estimates, where appropriate, have been calculated.[\[15\]](#)

2. Determining “do no significant harm” and “minimum social safeguards” for an economic activity

The TEG’s list of technical screening criteria for each economic activity also includes detailed parameters for determining that the activity “does no significant harm” to any of the Taxonomy’s six environmental objectives.

For example, the production of electricity from wind power would qualify as meeting the “do no significant harm” element if it meets specific parameters related to the following issues: underwater noise created in the installation of bottom-fixed offshore wind turbines; the composite waste generated from both on- and offshore wind turbine blades at the end of their lifetime; the possible disturbance, displacement or collision of birds and bats by the construction and operation of wind farms; the possible deterioration of water ecosystem associated to the construction of wind farms, and the possible visual impacts created by landscape change in the installation of wind turbines.[\[16\]](#)

EU companies subject to the NFRD will be required to disclose this information. For investments in companies not subject to the EU reporting requirements, the Report recommends that asset managers conduct “due diligence” on sustainability impact, including screening against controversies.

More specifically, the Report recommends that an asset manager follow the due diligence recommendations of the OECD Due Diligence Guidelines for Responsible Business Conduct[\[17\]](#) to assess whether an economic activity meets the “do no significant harm” and “minimum social safeguards” elements of the Taxonomy. This analysis incorporates the concept of “adverse impact”[\[18\]](#) on sustainability: “The purpose of due diligence is first and foremost to avoid causing or contributing to adverse impacts on people, the environment and society, and to prevent adverse impacts directly linked to operations, products or services through business relationships.”[\[19\]](#)

As an example, where adverse impact information is not available for an equity investment held by an active fund, the Report recommends the following approach:

- Before investment: Conduct research to assess compliance with responsible business conduct (“do no significant harm” and “minimum social safeguards” in the context of the Taxonomy), which includes identifying responsible business conduct risk, prioritizing by severity.
- After investment: Using a risk-based approach, screen the whole public markets portfolio (listed equities and bonds, active and passive) at regular intervals to identify responsible business conduct issues that have emerged. Identify and further assess high responsible business conduct risk companies within the portfolio through further engagement.

The Report addresses the data challenge with respect to adverse impact (i.e., “do no significant harm” and “minimum social safeguards” elements of the Taxonomy) by:

- Pointing asset managers to “credible information sources, such as reports from international organisations, credible civil society and media, as well as established market data providers.”
- Noting that the principle of proportionality applies to asset managers and to the

investment assessed.

The Report includes a detailed discussion of “due diligence” on pages 44-48.

III. Compliance Dates and Next Steps

The financial product disclosure requirements related to the Taxonomy’s first two environmental objectives (climate change mitigation and climate change adaptation) will apply from 31 December 2021, with requirements related to the other four objectives applying from 31 December 2022.

The Taxonomy directs the European Securities and Markets Authority (ESMA), together with the EU banking and insurance regulators, to develop regulatory technical standards (RTS) by 1 June 2021 for financial product disclosure on the Taxonomy’s environmental objectives of climate change mitigation and adaptation and by 1 June 2022 for the Taxonomy's other four environmental objectives.

In the interim, the Commission is expected to finalize the recommendations of the Technical Expert Group in level 2 legislation. Further development of the EU Taxonomy will take place via a new Platform on Sustainable Finance, which is expected to be operating by autumn 2020.[\[20\]](#)

Linda M. French
Assistant Chief Counsel, ICI Global

[Attachment No. 1](#)

[Attachment No. 2](#)

endnotes

[\[1\]](#) More info on the work of the TEG is available at https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en.

[\[2\]](#) *Technical Report: Taxonomy: Final report of the Technical Expert Group on Sustainable Finance* (9 Mar 2020), available at https://ec.europa.eu/info/files/200309-sustainable-finance-teg-final-report-taxonomy_en. The TEG also published a technical annex to supplement the report. *Technical Annex to the TEG Final Report on the EU Taxonomy* (9 Mar 2020), available at https://ec.europa.eu/info/files/200309-sustainable-finance-teg-final-report-taxonomy-annexes_en.

[\[3\]](#) The EU legislators reached political agreement on the text of the Taxonomy Regulation in December 2019, but the final text has not yet been published in the Official Journal. The provisional version of the text is available at <https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf>. Further substantive changes to the text are not anticipated.

[\[4\]](#) The TEG’s guidance to financial market participants on Taxonomy-related financial products disclosure is on p. 37-51 of the Report.

[5] See p. 37-51 of the Report.

[6] See p. 41 of the Report.

[7] See p. 41 of the Report.

[8] The NFRD requires certain large companies to include a non-financial statement as part of their annual public reporting obligations. More information on the NFRD is available at https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en. The Commission is currently reviewing the NFRD and recently launched a consultation on areas such as whether to expand the scope of covered entities and disclosure required. See ICI memo no. 32246 (26 Feb 2020), available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo32246>.

[9] See p. 39 of the Report.

[10] See p. 40 of the Report.

[11] See p. 41 of the Report.

[12] See p. 42 of the Report.

[13] See fn 2.

[14] See p. 218-220 of Technical Annex.

[15] See p. 41 of Technical Report.

[16] See attachment. See also p. 218-220 of Technical Annex.

[17] The OECD Due Diligence Guidance for Responsible Business Conduct are available at <https://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm>.

[18] The concept of “adverse impact” links to the Disclosure Regulation’s Article 4 requirement for financial market participants to disclose adverse impact of investments on environmental and social sustainability.

[19] See p. 46.

[20] This initiative is separate from the International Platform on Sustainable Finance that the European Union launched together with relevant authorities from Argentina, Canada, Chile, China, India, Kenya, and Morocco in October 2019.