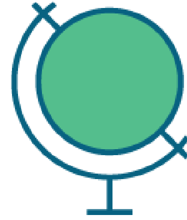

AN INTRODUCTION TO THE EU TAXONOMY

Executive remuneration today is driven by incentives that may no longer align with shareholder interests or reflect broader societal responsibilities.

Reward Value Foundations' mission is to support the development of remuneration policies that contribute to long-term sustainable and inclusive value creation. The Foundation seeks to further the debate on executive remuneration with investors, business schools, and the business community at large to develop evidence-based, long-term, sustainable, and stakeholder-inclusive executive remuneration policies.

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The launch of the European Green Deal in December of 2019 set off a chain of legislative reforms and governmental action planning. While the total number of European Union ("EU")-level reforms exceeds a whopping 25 in just three years, the most important of these texts thus far is the EU Taxonomy[2] and its Delegated Acts,[3] the Sustainable Finance Disclosure Regulation ("SFDR"),[4] and the proposal for the Corporate Sustainability Reporting Directive ("CSRD").[5] One fundamental concept introduced by the Green Deal, which has since been continuously reaffirmed in these subsequent texts, was the need to create a "unified classification system for sustainable activities".[6]

This background note forms part of Reward Value's series on Sustainable Finance developments in the European Union. One of many focusing specifically on the Taxonomy, this note sets out an introductory overview of the structure and functioning of the EU Taxonomy Regulation in its current form. Forthcoming background notes in the Taxonomy bundle focus on the various Delegated Acts, as well as the relationships that exist between the Taxonomy and other pieces of legislation in the sustainable finance framework.

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[2] European Union, 'Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the Establishment of a Framework to Facilitate Sustainable Investment, and Amending Regulation (EU) 2019/2088' (2020).

[3] European Commission, 'Draft Commission Delegated Regulation (EU) Amending Delegated Regulation (EU) 2021/2139 as Regards Economic Activities in Certain Energy Sectors and Delegated Regulation (EU) 2021/2178 as Regards Specific Public Disclosures for Those Economic Activites' (2022).

[4] 'Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on Sustainability-related Disclosures in the Financial Services Sector (Text with EEA Relevance)', 317 OJ L § (2019), http://data.europa.eu/eli/reg/2019/2088/oj/eng.

[5] European Commission, 'Proposal for a Directive of the European Parliament and of the Council Amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as Regards Corporate Sustainability Reporting', *Official Journal of the European Union* 0104, no. 537 (2021): 1–65.

[6] European Union, Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, 2020. Recital 6.

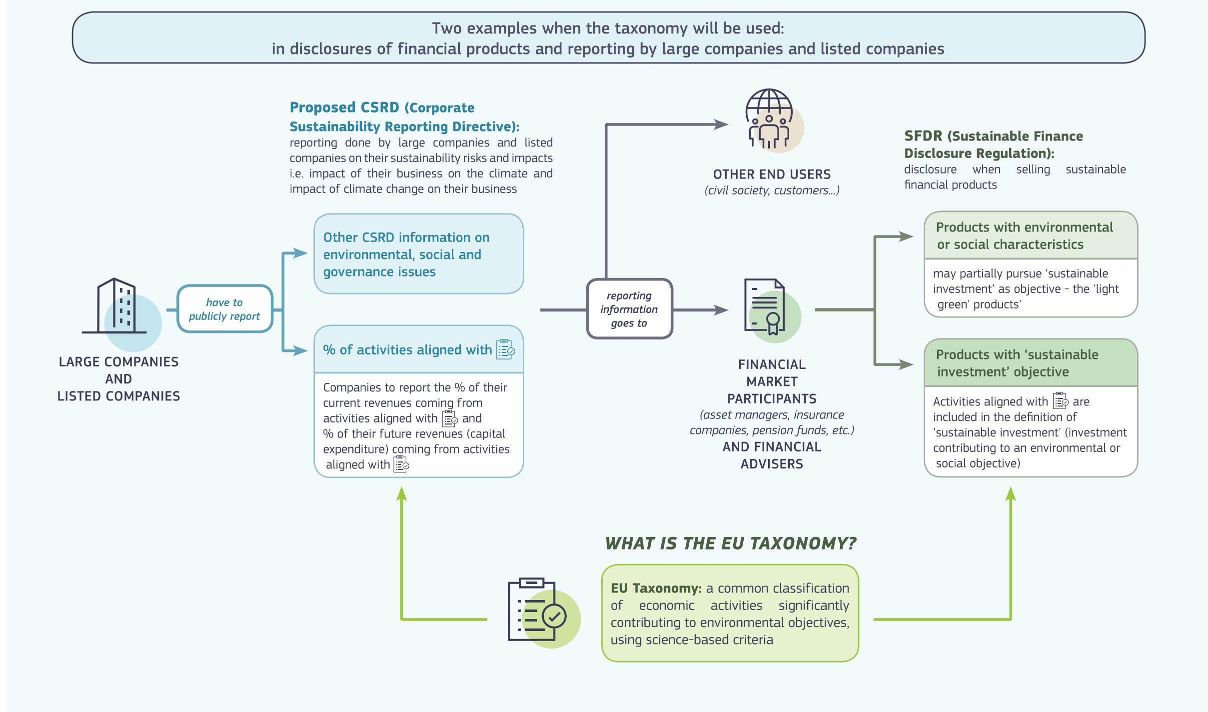

Figure 1: How does the EU Taxonomy fit within the Sustainable Finance Framework?[7]

BACKGROUND

Perhaps the first mention of the term 'taxonomy' was made in the action plan of 2018 communicated by the European Commission to the European Parliament and Council.[8]

The main objective and role of the Taxonomy Regulation is to provide a "common language" for society, by highlighting and distinguishing between economic activities that contribute to environmental, social and governance ("ESG") objectives. According to this original formulation, once developed, this system would be particularly useful in areas including "standards, labels, green-supporting factor for prudential requirements [and] sustainability benchmarks".[9] After nearly two years of research and consultation, the Commission's Technical Expert Group on sustainable finance released their final

[7] European Commission, 'How Does the EU Taxonomy Fit Within the Sustainable Finance Framework?', European Commission, 2021, https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-factsheet_en.pdf.

[8] European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth' (Brussels: European Commission, 2018), 20.

[9] European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth' (Brussels: European Commission, 2018), 4; European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions: The European Green Deal' (Brussels, 2019), 4.

report which set out detailed recommendations for the design and use of the taxonomy. On 22 June 2020, the Taxonomy Regulation was published.[10]

The EU has cited several key reasons why the creation of a "common language" for sustainable economic activities is necessary:

"[to] create security for investors, protect private investors from greenwashing, help companies to become more climate-friendly, mitigate market fragmentation and help shift investments where they are most needed".[11]

By providing a fixed vocabulary on what does and does not constitute 'environmentally sustainable economic activity' (ESEA), the EU not only seeks to reinforce its single market, but uses this strength in its aim to combat greenwashing, contribute to environmental objectives and grow sustainable investment.

Greenwashing or "misleading environmental communication" by companies,[12] is a phenomenon that can be dated back to the 1970s, according to some reports.[13] While there is no standard academic definition that encompasses all instances of this practice, it is generally accepted that it involves the dissemination of "positive information [regarding environmental performance]", despite "poor performance [on these metrics]".[14] The Taxonomy Regulation provides its legal definition of greenwashing as follows:

"The practice of gaining an unfair competitive advantage by marketing a […] product as environmentally friendly, when in fact basic environmental standards have not been met".[15]

Greenwashing can be enacted in different ways and at different levels, either by misrepresenting the sustainability of a company's strategies and overall actions, or by targeting the perceived sustainability of its products. Originally, this phenomenon was largely linked to the broader signaling of firm values and theories of legitimacy. However, in recent years, this issue has become particularly prominent when it comes to matters of climate change and environmental sustainability, as both shareholders and stakeholders have become increasingly aware of - and concerned about - these topics. Essentially, the greenwashing phenomenon demonstrates the inability or unwillingness of companies to match up to society's demands. It has been well recorded since as early as 2011 that stakeholder and shareholder pressures on matters of sustainability and corporate social responsibility can have broad

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[10] European Union, 'EU Taxonomy for Sustainable Activities', European Union, 2021, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en.

[11] *Idem*

[12] Riccardo Torelli, Federica Balluchi, and Arianna Lazzini, 'Greenwashing and Environmental Communication: Effects on Stakeholders' Perceptions', *Business Strategy and the Environment* 29, no. 2 (2020): 1, https://doi.org/10.1002/bse.2373.

[13] CorpWatch, 'Greenwash Fact Sheet', 22 March 2001, https://web.archive.org/web/20170207224534/http://www.corpwatch.org/article.php?id=242.

[14] M A Delmas and V C Burbano, 'The Drivers of Greenwashing', *California Management Review* 54, no. 1 (2011): 64-87.

[15] European Union, 'Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the Establishment of a Framework to Facilitate Sustainable Investment, and Amending Regulation (EU) 2019/2088' (2020), para. 11.

and intense effects on a given firm's operations. Consequently, greenwashing-firms that have been able to identify these pressure points have learned to take advantage of loopholes in regulation and information asymmetries to exploit the sensitivity of the market to sustainability signaling and reap the benefits of the 'do-gooder' company status.

The regulatory tools encompassed within the Taxonomy framework are not intended to add to the many different pieces of legislation already in place, but rather to supersede them.
In the preamble of the Taxonomy Regulation, the legislator addresses this fact:
"The absence of uniform criteria [across the European Union] would increase costs and significantly disincentivise economic operators from accessing cross-border capital markets for the purposes of sustainable investment".[16]
In essence, by absorbing prior legislative efforts into one single legal tool encompassing the jurisdiction of the EU, the Taxonomy "enable[s] reliable and comparable information".[17] Comparability is an issue that has long formed a part of the debate on sustainability metrics. As with accounting standards, such as those set by the IFRS, comparability enables the market to make key investment decisions that drive the economy as a whole. It is important for sustainability information disclosed by different enterprises and organisations to be comparable not only to enhance coordinated action on a global level, but in order to deliver this same investor navigability as in the case of financial information.

LEGAL STRUCTURE

As a regulation, the Taxonomy has direct application and force in all 27 Member States of the European Union. This means that it requires no transposition into national law and is simply effective (and enforceable) as is.[18] This stands in contrast with several of the Directives that the Taxonomy was created to provide for. The Corporate Sustainability Reporting Directive is one important forthcoming example. In terms hereof, large and publicly listed companies will become obliged to report on various elements of non-financial data. The standards provided through this Directive, known as the European Sustainability Reporting Standards, rely largely on the classification system created by the Taxonomy.[19]

[16] European Union, v. 11.
[17] European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth', 11.
[18] European Union, 'Treaty on the Functioning of the European Union', *Official Journal of the European Union* 326 (2012): sec. 288.
[19] European Commission, 'How Does the EU Taxonomy Fit Within the Sustainable Finance Framework?'; European Commission, 'Proposal for a Directive of the European Parliament and of the Council Amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as Regards Corporate Sustainability Reporting', v. 32.

Many of the other details of the Commission's 2018 action plan also rely on the creation of the Taxonomy. To mention a few: "creating standards and labels for green financial products",[20] "developing sustainability benchmarks",[21] "[developing] prudential requirements for banks and insurance companies".[22]

In its simplest form, the Taxonomy can be understood as a kind of sustainability 'dictionary' to be used by different market participants across sectors. While the Regulation in and of itself provides several minimum safeguards and guidelines regarding sustainable economic activity, its extensions are where the real classification tools come into play. Known formally as the Delegated Acts, these extensions function as a tool for evaluation of companies' performances against technical screening criteria developed by sector experts, known collectively as the Platform on Sustainable Finance.[23] This Platform, created under Article 20 of the Regulation, is a body composed of representatives from various European institutions and agencies, private business sectors and groups of civil society, as well as individual experts sought out for their particular areas of knowledge. There has been much delay in the official publication of the screening criteria owing to the political nature of the decisions taken thereunder. This will be an important topic in our analysis of the Environmental Taxonomy in a forthcoming background note.

Due to its reliance on scientific material, an important consideration in the design of the Taxonomy's technical screening criteria is their ability to be "regularly updated".[24]
Laws passed in the European Union, as with any other national or supranational structure, are not necessarily static items. During the lifetime of a legislative act, it may be necessary to add to or amend certain elements of its text. This is especially relevant in the context of sustainable finance and ESG overall, which are both subject to rapid scientific, technical, and political change. In the case of the Taxonomy and related policies, the Commission has established the Platform on Sustainable Finance in order to develop these legislative updates, which are to be issued as 'Delegated Acts'.
Delegated Acts are 'non-legislative' in the sense that they do not undergo the same process as other pieces of EU law, which are generally passed by the European Parliament. Rather, as envisaged by Article 290 of the Treaty on the Functioning of the European Union ("TFEU"), this law-making power

[20] European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth', 5.
[21] European Commission, 7.
[22] European Commission, 9.
[23] European Union, Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, 2020, sec. 20.
[24] European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth', 4.

is 'delegated' to the European Commission through the creation of ordinary legislation – in this case, the Taxonomy Regulation, which acts as a framework to the process of delegation and is passed by ordinary legislative methods in the European Parliament.

This power is, however, not universal. Certain elements, such as the "objectives, content, scope and duration of the delegation of power"[25] remain squarely in the scope of the main legislation. Furthermore, the Commission is only entitled to pass delegated acts which amend or supplement 'non-essential' aspects of the legislation at hand. The ordinary legislation, passed by the European Parliament, and which forms the backbone of the Delegated Acts, must therefore remain the principal document.

The institutional understanding of what constitutes 'essential' has formed the basis of a number of debates in the context of delegated acts, as well as delegated Council decisions. In the latter instance, the case of *Parliament v. Council* is instructive, in which the European Court of Justice "tied 'essential elements' to 'political choices' that involve reconciliation of conflicting interests".[26]

The right of the European Parliament and the Council of the European Union to object to Delegated Acts is enshrined in this same Article 290 of the TFEU. Where an objection is raised within the prescribed time period, the Delegated Act cannot enter into force. This time period is prescribed by the ordinary legislation underpinning the Delegated Act, and in practice generally does not exceed two months.[27] In the case of the Taxonomy, this time period for objection by the Parliament or Council is four months.[28]

In essence, the ease with which Delegated Acts are brought into effect, and the fact that their processes may enable decision-making bodies to consult more thoroughly with sector-specific expert groups, makes a strong case for their use in the legislative framework of sustainable finance.

It's important to note that, while the Taxonomy provides useful vocabulary in terms of sustainability, it creates very few legal obligations in and of itself. The few disclosure obligations contained in the Regulation refer largely to additions to be made to information disclosure under other pieces of legislation, such as the Non-Financial Reporting Directive.[29]

[25] European Union, 'Treaty on the Functioning of the European Union', sec. 290.

[26] Deidre Curtin and Tatevik Manucharyan, 'Legal Acts and Hierarchy of Norms in EU Law', in *The Oxford Handbook of European Union Law*, ed. Anthony Arnul and Damian Chalmers, 1st ed. (Oxford: University of Oxford, 2015), 112, https://doi.org/10.1093/oxfordhb/9780199672646.001.0001.

[28] European Union, Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, 2020, sec. 23.

[29] European Union, 'Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 Amending Directive 2013/34/EU as Regards Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups' (2014), https://doi.org/10.1108/medar-06-2019-0504.

When considering the full impact of the Taxonomy Regulation, it is important to keep in mind its role as "the basis for other economic and regulatory measures".[30] As previously mentioned, the Taxonomy informs much of the structure and content of other pieces of existing and forthcoming legislation in the sustainable finance framework.

The idea that the Taxonomy and its Delegated Acts would be developed over time with respect to its different focuses (environmental, social and governmental) has been an inherent part of its architecture from the time of its inception in 2018, where the Commission detailed in its action plan its commitment to "set up a technical expert group on sustainable finance […] to publish a report providing a first taxonomy with a particular focus on climate change mitigation activities… [and then another for] climate change adaptation and other environmental activities".[31] This, the action plan sets out, would form the foundations of the "progressive development of the EU sustainability taxonomy".[32] This intention was further confirmed by Article 20(2)(j) of the Taxonomy Regulation, wherein the Platform on Sustainable Finance is called upon by the Commission to "advise… on addressing other sustainability objectives, including social objectives".[33]

In its current form, the Taxonomy refers to social aspects only by reference: the minimum safeguards in Article 18 point to the OECD's Guidelines for Multinational Enterprises,[34] the UN Guiding Principles on Business and Human Rights,[35] the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work,[36] and the International Bill of Human Rights.[37] The same can be said for 'governance', which is also only addressed through reference to the abovementioned instruments. However, it has been indicated that further development along the lines of a social taxonomy would include elements of governance. In the Platform on Sustainable Finance's Final Report on the Social Taxonomy, released in February 2022, the link between social sustainability and good governance was confirmed:

[30] European Union, Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, 2020, 16.
[31] European Commission, 'Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions: Action Plan: Financing Sustainable Growth', 4.
[32] *Idem*, 4.
[33] European Union, Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, 2020, sec. 20(2)(j).
[34] OECD, *OECD Guidelines for Multinational Enterprises, 2011 Edition* (OECD, 2011), https://doi.org/10.1787/9789264115415-en.
[35] United Nations High Commissioner, 'UN Guiding Principles on Business and Human Rights' (New York, Geneva: United Nations, 2011), https://www.ohchr.org/sites/default/files/documents/publications/guidingprinciplesbusinesshr_en.pdf.
[36] International Labour Conference, 'ILO Declaration on Fundamental Principles and Rights at Work and Its Follow-Up' (Geneva, 2010), https://www.ilo.org/wcmsp5/groups/public/---ed_norm/---declaration/documents/normativeinstrument/wcms_716594.pdf.
[37] United Nations General Assembly, 'International Bill of Human Rights', accessed 20 April 2022, https://www.ohchr.org/sites/default/files/Documents/Publications/Compilation1.1en.pdf.

"This was further clarified by the Commission during the first plenary meeting in October 2020, where it asked the group to consider good governance practices such as sound management structures, employee relations, remuneration of staff and tax compliance".[38]

CONCLUDING REMARKS

The Taxonomy Regulation is an important legislative tool in the pursuit of linking finance to sustainability goals. Its position, as demonstrated in this brief note, is central to the effective functioning of many other of the European Union's tools designed to drive development in the areas of climate and wider environmental and societal issues. These issues, as well as the solutions proposed, are in a state of constant change. To maintain relevancy and cohesiveness, the Taxonomy is designed to be a "living document",[39] a framework under which Delegated Acts breathe life into the crux of the issue: based on what we know right now, what activity is sustainable, and what is not?

Financial incentivisation towards sustainability is a clear example of the possibility to maneuver capitalism towards the greater good. Its successful implementation, however, relies not only on tying the financial sector to environmental concerns, but also to those of greater societal and governance importance. Moreover, additional financial tools must be utilised in order to fully harness the power of these regulations. Executive remuneration is one such tool.

As previously mentioned, the Taxonomy provides only limited guidance in terms of social and governance aspects of sustainability. These latter elements, of which remuneration forms part and parcel, are expected to be addressed in upcoming legislative areas, such as the Social Taxonomy. However, there is scope for inclusion of this important instrument in other Regulations and Directives, for which Proposals are currently underway, and who will form the subject of our forthcoming background notes in this continued series.

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[38] Platform on Sustainable Finance, 'Final Report on Social Taxonomy', 2022, 60.

[39] Fabien Cobat, 'The European Commission Adopts an Ambitious Sustainable Finance Package Including the Long-Awaited Taxonomy Delegated Acts', Natixis Corporate & Investment Banking, 2021, https://gsh.cib.natixis.com/our-center-of-expertise/articles/the-european-commission-adopts-an-ambitious-sustainable-finance-package-including-the-long-awaited-taxonomy-delegated-acts.