



**EU'S GREEN INVESTMENT RULES:
A SEA-CHANGE FOR ESG**

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EU'S LATEST GREEN INVESTMENT RULES MARK A SEA-CHANGE FOR ESG

In April, the European Commission (EC) published new rules that will be pivotal in advancing its sustainable finance agenda under the Green Deal and enabling the EU's transition to a carbon neutral EU economy by 2050.

The EC's latest sustainability package sets out technical criteria that will guide the implementation of the pioneering EU Taxonomy, a new classification system that establishes firm parameters around what companies can class as sustainable activities or investments and what public disclosures they need to make about their exposure to environmental, social and governance (ESG) risks.

To meet the objective of driving a dramatic shift towards investment that is truly environmentally or socially sustainable, the private sector's activities will, for the first time, need to measure up publicly against a range of fixed criteria.

The EC has also recently published a draft version of a new Corporate Sustainability Reporting Directive (CSRD), which sets out new legal requirements for companies to disclose their ESG risks and their broader social and environmental impact. Under the CSRD, companies will have to follow new EU sustainability reporting standards to account for both the risks faced by the company and their negative impact on issues such as climate change or human rights, including within their supply chains. These disclosures will be linked to the EU Taxonomy's requirements and provide similar information to that already being asked of companies by investors and financial institutions, who are already reporting under a separate piece of regulation, known as the Sustainable Finance Disclosure Regulation (SFDR).



THE EU TAXONOMY

The EU Taxonomy seeks to provide companies, investors, and consumers with a clear definition of whether or not individual economic activities qualify as environmentally sustainable. From January 2022, companies will be asked to disclose what proportion of their activities – by turnover, capital expenditure and operating expenditure – are Taxonomy-aligned, based on this system of classification.

Activities that qualify as environmentally sustainable fall into six categories, the first two of which cover climate change and will apply from January 2022, the other four will apply from January 2023:

- climate change mitigation
- climate change adaptation
- sustainable use of water/marine resources
- transition to a circular economy
- waste and pollution prevention, and
- biodiversity and healthy ecosystems.

Activities within these pools will qualify as environmentally sustainable if they meet four fixed requirements:

1. They substantially contribute to one or more of the six environmental objectives (please see above).
2. They do not significantly harm any of the environmental objectives.
3. They comply with minimum safeguards based on certain international human rights standards.
4. They comply with the technical criteria for climate change mitigation or climate change adaptation.

The technical criteria published by the EC in June cover the first two categories of climate change mitigation and climate change adaptation. Further screening criteria for the other four are expected by the end of the year. As well as meeting the environmental criteria, businesses will also have to meet minimum human rights obligations set out in the OECD Guidelines on Multinational Enterprises and UN Guiding Principles on Business and Human Rights to align themselves fully with the Taxonomy.

The EU Taxonomy will impact businesses within and beyond the EU. Companies outside the EU, but who do business with or have investors based in the bloc, are likely to be asked to report their activities against the classification system. Global operations of EU-domiciled companies will also be in scope. Meanwhile, other countries such as the UK, Canada, and Japan, are expected to soon introduce their own taxonomies. Not only are these likely to be adapted from the EU's model, but given the prevalence of global supply chains and the countries' broader membership of groups like the Organisation for Economic Co-operation and Development (OECD), there is an increasingly strong case for alignment.

Table 1: Requirements for alignment of economic activities with EU Taxonomy

Economic activities	Activities that are environmentally sustainable under the EU Taxonomy	Requirements for alignment with EU Taxonomy	Minimum safeguards companies should adopt in line with OECD Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights
Revenue	<ol style="list-style-type: none"> 1. Climate change mitigation 2. Climate change adaptation 3. Sustainable use of water/marine resources 4. Transition to a circular economy 5. Waste and pollution prevention 6. Biodiversity and healthy ecosystem 	<ul style="list-style-type: none"> ▪ substantially contributes to one or more environmental objectives; ▪ does not significantly harm (DNSH) any environmental objective; ▪ complies with minimum safeguards based on certain human rights standards; and ▪ complies with the Technical Screening Criteria (TSC), which are the detailed conditions for the first two limbs above. 	Adopt policies at senior management level to express commitment to responsibility to respect human rights
Capital expenditure			Avoid causing or contributing to adverse human rights impacts through their own activities, and address such impacts when they occur
Operating expenditure			<p>Seek to prevent or mitigate adverse human rights impacts that are directly linked to operations, products or services, even if they have not contributed to those impacts</p> <p>Carry out human rights due diligence to identify, prevent, mitigate and account for how they address their adverse human rights impacts</p> <p>Communicate externally about how they address their human rights impacts</p> <p>Provide for a remedy in the event that they have caused or contributed to any adverse impacts</p> <p>Monitor the effectiveness of their response to human rights impacts, including grievance mechanisms.</p>

SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR)

The SFDR came into force on 10 March 2021 and sets out sustainability disclosure requirements across the financial sector, including for investors, pension providers, insurers and other financial services. More in-depth disclosures by investors will require a higher level of ESG data from their respective investee companies, a process that is part and parcel of a broadening engagement on sustainability practices and the market's shift towards more sustainability-conscious activity.

This legislation will compel firms to disclose how they consider adverse impacts on sustainability in their investment decisions and to categorise certain activities according to whether they promote environmental and/or socially (beneficial) characteristics or, applying a higher bar, if sustainability is the overriding investment objective.

Although the legislation was passed by the European Parliament after the UK left the EU and completed its transition period out of the bloc, the SFDR will still apply to UK-based firms that either manage funds domiciled in the EU or market non-EU domiciled funds into the EU. The legislation is extra-territorial and effectively puts the financial sector in the driving seat with regard to the levels of disclosure required from companies on their sustainability risks.

CORPORATE SUSTAINABILITY REPORTING DIRECTIVE (CSRD)

The proposed CSRD will replace the current Non-Financial Reporting Directive (NFRD) and seek to bring consistency to companies' reporting on sustainability risks and impacts in terms of issues like climate or forced and/or child labour.

Reporting on this basis will encompass the concept of double materiality, that is both the risks that affect the market value of the company and the impact of the company's activities on societal and environmental issues.

Disclosures will also have to clearly set out a company's methodology for materiality assessments and provide forward looking information such as reduction targets on emissions. Under the CSRD, companies will also be required to provide third-party assurances to prevent 'greenwashing' and ensure the reliability of their disclosures. The EC has stated that, initially, there will be a "limited" assurance requirement. Over time, however, this is likely to be extended to match that required of financial reporting and "reasonable assurance" may be necessary once EU assurance standards are in place.



A WATERSHED FOR ESG

This raft of new rules is set to provide long-awaited guidance and answers for companies as to what constitutes good ESG and sustainable economic activity. As such, they should serve to direct more investment towards greener parts of the economy. While many more companies have adopted loose ESG goals in the recent past, without mandatory reporting mechanisms it has been all too easy for businesses and financial institutions to adopt ‘greenwashing’ practices through their marketing departments. Equally, in the absence of agreed ESG criteria, specialist ratings agencies’ approach to capturing an organisation’s ESG performance has diverged significantly. Given investors rely on their findings to determine their policies, it is not surprising if their approach appears inconsistent or incoherent. The approach to climate change has driven the adoption of regulation, and in turn more detailed reporting frameworks, such as the Taskforce on Climate-Related Financial Disclosures (TCFD). A similar progression is therefore likely with regard to social issues and human rights as they attract increasing scrutiny from investors and other stakeholders.

To date, the EC has agreed a list of certain industries – manufacturing, transport, waste and water, real estate, among others – that qualify as environmentally sustainable and can align their activities with the Taxonomy. The EC has, however, delayed its decision as to whether to include other, more controversial, sectors until later this year. There has been a heated debate in Brussels about activities such as nuclear and natural gas production. France and Hungary, for example, have lobbied hard for the inclusion of nuclear, in spite of concerns around toxic waste, while Poland, the Czech Republic and several energy firms have pushed to have natural gas labelled as sustainable, on the grounds that it is central to efforts to transition away from coal within the energy mix.

The formulation of the Taxonomy and its screening criteria has prompted significant political and corporate lobbying in Brussels. This reflects the potentially significant impact that it and its sister legislation will have on advancing sustainable economic activity. The process of formulating the rules has, inevitably, proved to be a matter of balancing scientific considerations with political and economic ones. This debate also demonstrates the growing fears of being left out of the sustainability club, with its increased marketing potential and better access to investment. It is now a question of ‘When’, not ‘if’ companies will be expected to be more proactive in promoting sustainability and inculcating higher ESG standards.



Table 2: New EU regulation and the implications for financial institutions and businesses.

EU Regulation	Applies to:	Applies from:	Implications for businesses and financial institutions
EU Taxonomy	Institutional investors and asset managers, and by association to investee companies	FY 2021 (from Jan 2022): <ul style="list-style-type: none"> ▪ Climate change mitigation ▪ Climate change adaptation FY 2022 (from Jan 2023) <ul style="list-style-type: none"> ▪ Sustainable use water/marine resources ▪ Circular economy ▪ Pollution prevention ▪ Biodiversity and healthy ecosystems 	Requirement to map economic activities by revenue, capital expenditure and operating expenditure against six high-level objectives, accompanying Technical Screening Criteria, and international standards such as the OECD Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights.
Sustainable Finance Disclosure Regulation (SFDR)	Financial institutions, including investment banks, fund and asset managers, pension providers, insurance investors	10 March 2021	Financial institutions: assess whether they are in scope and assess required level of disclosure about investee companies to comply. Businesses: assess new requirements on their own investors and impact for their own ESG disclosures.
Corporate Sustainability Reporting Directive (CSRD)	<ul style="list-style-type: none"> ▪ Public companies ▪ Large companies which meet 2 of 3 criteria: > 250 employees and/or > €40M Turnover and/or > €20M Total Assets 	FY 2023: first set of EU reporting standards apply FY 2024: second set of EU reporting standards apply	Consider materiality assessment and associated methodology. Establish effective targets (such as for reducing emissions) in line with appropriate ESG benchmarks and the Paris Agreement.

HOW APERIO INTELLIGENCE CAN SUPPORT YOU?

- › Establish whether your organisation is in scope of the SFDR or CSRD
- › Identify those requirements that are relevant to your organisation
- › Map your organisation's economic activities to the EU Taxonomy and Technical Screening Criteria
- › Establish whether your economic activities substantially contribute to and/or do no significant harm (or do not undermine) to the Taxonomy's environmental objectives
- › Identify and disclose information required by investors under the SFDR
- › Assist with materiality assessments and target-setting for emissions



If you would like more information on how Aperio Intelligence can assist you to comply with the new reporting obligations, please contact.

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INFORMATION ON APERIO'S SERVICES

Founded in 2014 and headquartered in London, Aperio Intelligence is a specialist, independent business intelligence and strategic advisory firm. Our staff are drawn from a wide range of professional disciplines, including diplomatic and government services, accountancy, banking, law, industry, and private sector business intelligence and consulting companies. We advise clients on integrity, reputation, governance and geo-political risks globally. We specialise in providing high quality insights to help our clients manage their risk and make better business decisions.

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- Market entry and local partner identification
- Stakeholder mapping and analysis
- Political risk assessment
- Competitor intelligence
- Analysis of government attitudes
- Intelligence for critical negotiations
- Crisis management intelligence

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- Enhanced due diligence
- Integrity due diligence
- Source of wealth assessments
- Examination of political exposure
- Sanctions related due diligence
- Anti-bribery and corruption support
- Senior executive screening

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INVESTIGATIONS

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- Bribery and corruption investigations
- Investigations into misconduct
- Insider trading investigations
- Counter-intelligence
- Litigation strategy support
- Global asset tracing and recovery

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ESG

- ESG due diligence
- ESG benchmarking
- Detailed site assessments
- ESG preparedness assessments
- ESG risk diagnostic
- Stakeholder engagement
- ESG performance improvement planning

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