New Sustainability Reporting Obligations under the Taxonomy Regulation

Executive Summary

- The **EU Taxonomy Regulation** establishes new disclosure obligations which will enter into force as of **1 January 2022**. They will apply to reports for the financial year 2021.
- The new disclosure obligations apply to large **public-interest entities** which are also subject to Directive 2014/95/EU and already publish **non-financial information**.
- Entities in the scope of the new reporting requirements will have to publish the proportion of their **turnover, CapEx and OpEx** associated with taxonomy-aligned sustainable assets, services or activities.
- Indirectly, all businesses active in sectors considered most critical for climate change, such as **real estate, energy, IT** and **mobility** will be affected. They will be required, either directly or through their investors, to track and screen the **taxonomy-alignment** of their economic activities and assets.

As part of the EU's sustainable finance agenda, ESG and sustainability disclosure became subject to significant regulation. The Commission is currently reviewing the Non-Financial Reporting Directive 2014/95/EU in an effort to further standardize non-financial reporting[1]. This GSK Update focuses on the scope and implications of the new disclosure requirements under the Taxonomy Regulation (EU) 2020/852 (**Taxonomy**). Further ESG disclosure obligations apply under the Sustainable Finance Disclosure Regulation (EU) 2019/2088 (**SFDR**).

Main takeaways for businesses

To prepare for challenges and opportunities ahead, we recommend the following:

1. Clarify **whether** you or your key investors fall in the **scope** of the new non-financial reporting requirements under the Taxonomy. This might already impact your annual reports as of 2021 and you might need to dedicate resources to set-up suitable processes immediately.

2. Identify your **exposure** to the two objectives 'climate change mitigation' and 'climate change adaptation'. You will most likely be affected by the new reporting requirements, either directly or indirectly, if your business is active in the sectors real estate, energy, water, waste management, IT, manufacturing, agriculture or mobility.

3. **Screen** your business activities to identify assets and services which might qualify as taxonomy-aligned. Investor demand of such assets and services will further increase. You therefore might want to lift non-aligned activities up to that category.

4. Prepare for increasing demand for sector-specific sustainability-related **data**. You might need to implement suitable data processes to track non-financial performance indicators, such as CO[2] emissions, water consumption or energy efficiency, or to monitor your exposure to certain hazardous substances.

[1] Please refer to our GSK Update (March 2020): [Non-Financial and ESG Reporting: A New Era of Sustainability Reporting?]

Who is concerned?

a) Scope of the Taxonomy

The disclosure requirements under the Taxonomy apply to any company which fulfills the following requirements on a stand-alone and/or consolidated basis:

1. It qualifies as a **public interest entity**[2].

2. It exceeds, on its balance sheet date and during two consecutive financial years the numerical thresholds of at least **two out of three** of the following criteria:

   - Balance sheet total: EUR 20 million;
   - Net turnover: EUR 40 million;
   - Average number of full-time staff employment during the financial year: 250.

3. It exceeds, on its balance sheet date the average number of **500 employees** during the financial year.

b) Scope of the SFDR

The disclosure requirements under the SFDR, on the other hand, are addressed to **financial market participants and financial advisers**, such as AIFMs as well as investment firms, credit institutions and insurance undertakings providing investment advice or portfolio management. The SFDR disclosures concern sustainability-related information with respect to their **investment policies and financial products**.

Financial market participants, such as banks and insurances, clearly fall in the scope of both the SFDR and the Taxonomy. For these actors, the Taxonomy will be especially relevant to determine whether an investment can qualify as environmentally sustainable.

c) Entities outside the scope

Entities outside the scope of the SFDR and Taxonomy will be impacted as well. Particularly businesses active in a sector considered crucial for climate change purposes, such as **real estate, energy, water, waste management, IT, manufacturing, agriculture** or **mobility**, will have to prepare for an increased demand for climate-related data by their investors. Those actors closest to the climate-relevant assets or services, such as asset managers, project developers or manufacturers with substantial water or energy consumption, should not only identify and monitor their climate-relevant KPIs, but also actively work towards improving them.

The taxonomy disclosure requirements in a nutshell

All undertakings within the scope of the disclosure obligations under the Taxonomy shall include in their non-financial statements information on **how and to what extent** the undertaking's activities are associated with **environmentally sustainable economic activities** within the meaning of article 3 and 9 of the Taxonomy.

In particular, non-financial undertakings shall disclose the proportion of their:

- **Turnover** derived from products or services;
- **Capital expenditure (CapEx)** related to assets or processes; and
- **Operating expenditures (OpEx)** related to assets or processes,

which are associated with environmentally sustainable economic activities as defined in the Taxonomy.

The Commission is expected to adopt a delegated act by 1 June 2021 specifying the content and presentation of the information to be disclosed, including the methodology to be used. In this context, the Commission called the European supervisory authorities ESMA, EBA and EIOPA for advice. ESMA published a consultation

[2] Public interest entities within the meaning of Directive 2013/34/EU are: (1) EU entities whose transferable securities are admitted to trading on a regulated market within the meaning point (14) of Article 4(1) of Directive 2004/39/EC, (2) credit institutions, (3) insurance undertakings, and (4) other public interest entities, designated as such by an EU member state.

paper containing its draft advice[3] and will report back to the Commission before March 2021.

The disclosure requirements are expected to lead to investor-friendly, **easily comparable** figures, prominently placed in the companies' annual reports. Reporting entities who have so far promoted their sustainability performance in words only will now face the expectation to report on concrete performance targets. To underline their sustainability claims, they will have a strong incentive to report significant proportions of taxonomy-aligned activities contributing to their turnover, CapEx and OpEx. Consequently, all businesses directly in the scope as well as those whose investors fall under the reporting obligations will face increasing pressure to deliver taxonomy-aligned activities and assets.

In order to justify the allocation of activities to the category 'taxonomy-aligned', all businesses reporting on such activities, whether by law or by choice, will need to **systematically screen their economic activities**. They should be prepared for scrutiny: With increasing transparency, regulators, investors as well as traditional and social media will be able to expose any greenwashing attempts.

Which economic activities are taxonomy-aligned?

The crucial question for everyone will therefore be: which economic activities are 'taxonomy-aligned'? The answer is not yet final, but will have to be rather concrete. The affected companies must prepare soon and dedicate resources to gather and report data they might not have had on their radar before.

Fundamentally, economic activities must fulfill the following requirements to qualify as **environmentally sustainable** within the meaning of article 3 of the Taxonomy. They must:

- contribute substantially to one or more of the environmental objectives of the Taxonomy;
- not significantly harm any of the other environmental objectives of the Taxonomy;
- be carried out in compliance with the minimum safeguards laid down in the Taxonomy; and
- comply with the technical screening criteria to be established by the Commission.

The **environmental objectives** under article 9 of the Taxonomy are:

- Climate change mitigation;
- Climate change adaptation;
- The sustainable use and protection of water and marine resources;
- The transition to a circular economy;
- Pollution prevention and control;
- The protection and restoration of biodiversity and ecosystems.

As of 1 January 2022, the reporting obligations will only apply with respect to the first two objectives 'climate change mitigation' and 'climate change adaptation'. Full reporting obligations with respect to all environmental objectives will apply only as of 1 January 2023.

In order to comply with the **minimum safeguards**, the relevant businesses must ensure the alignment with, among others, the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

Finally, the most defining element will be the **technical screening criteria** as set out in the delegated acts by the Commission. After consultation with its Technical Expert Group, the Commission published a draft delegated regulation in November 2020 detailing the screening criteria with a sector-by-sector approach on more than 500 pages[4]. Due to the overwhelming feedback received, the Commission postponed its adoption, planned to occur by 31 December 2020, until spring 2021.

[3] available under the following link: [ESMA specifies obligations on environmentally sustainable activities (europa.eu)]

[4] available under the following link: [Sustainable finance – EU classification system for green investments (europa.eu)]

What we offer

GSK Stockmann offers a variety of services in connection with sustainable finance generally and non-financial and ESG disclosure in particular, such as:

- Helping you determine and navigate your ESG and non-financial disclosure obligations;
- Assisting you with the analysis of your assets and services;
- Assisting you with your non-financial reports;
- Helping you find products and solutions to benefit from your taxonomy-aligned services;
- Helping you set up governance structures and policies to achieve your ESG goals;
- Training your management and staff with our tailor-made ESG academy.

Our sustainable finance experts in Luxembourg and Germany are happy to help your business navigate this fast-paced topic.

Conclusion

When it comes to reporting obligations under the Taxonomy, regrettably, very little is sure yet: The Commission is still in the process of finalizing its detailed reporting requirements and technical screening criteria. However, businesses in the most climate-relevant sectors such as real estate, energy, IT and mobility, should prepare now: As of the financial year 2021, they might have to explain their impact on climate change mitigation and adaptation on the basis of tangible performance indicators. This less than straightforward exercise will require significant preparation and data sourcing. Increased demand for taxonomy-aligned activities will also impact business strategy in the long-term: Those who ignore it now, will be put behind in the years to come.

Dr. Philipp Moessner
Partner
GSK Stockmann SA
philipp.moessner@gsk-lux.com

Anna Lindner
Senior Associate
GSK Stockmann SA
anna.lindner@gsk-lux.com

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www.gsk-lux.com

GSK STOCKMANN

BERLIN
Mohrenstrasse 42
10117 Berlin
T +49 30 203907-0
F +49 30 203907-44
berlin@gsk.de

HEIDELBERG
Mittermaierstrasse 31
69115 Heidelberg
T +49 6221 4566-0
F +49 6221 4566-44
heidelberg@gsk.de

FRANKFURT/M.
Taunusanlage 21
60325 Frankfurt am Main
T +49 69 710003-0
F +49 69 710003-144
frankfurt@gsk.de

MUNICH
Karl-Scharnagl-Ring 8
80539 Munich
T +49 89 288174-0
F +49 89 288174-44
muenchen@gsk.de

HAMBURG
Neuer Wall 69
20354 Hamburg
T +49 40 369703-0
F +49 40 369703-44
hamburg@gsk.de

LUXEMBOURG
GSK Stockmann SA
44, Avenue John F. Kennedy
L-1855 Luxembourg
T +352 2718 02-00
F +352 2718 02-11
luxembourg@gsk-lux.com