SULLIVAN & CROMWELL LLP

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EU Authorities Propose Mandatory Sustainability-Related Key Performance Indicator (KPI) Reporting for EU Companies

Proposals Will Inform the European Commission's Delegated Act Under Article 8 of the EU Taxonomy Regulation, Which Requires Certain EU-Listed Companies, Asset Managers, Insurers, Credit Institutions and Investment Firms to Disclose the Extent to Which Their Activities are "Environmentally Sustainable." EU Authorities Have Also Made New Proposals in Respect of Financial Products Under the Sustainable Finance Disclosure Regulation.

BACKGROUND

The EU Taxonomy Regulation

The EU Taxonomy Regulation[1] is an ambitious effort by the European Union (the "EU") to classify what is "environmentally sustainable" and, among other things, require in-scope entities to report on the extent to which their activities and/or financial products qualify as "environmentally sustainable."[2]

The Taxonomy Regulation seeks to standardize the growing universe of sustainable finance products and environmental-related disclosures, aiming to promote investments in environmentally sustainable activities and reduce "greenwashing." Under the Taxonomy Regulation's core classification system, an economic activity is considered "environmentally sustainable" if it (i) contributes substantially to one or more of six specified objectives, (ii) does not harm any of the other objectives, (iii) adheres to minimum social safeguards set forth by the Organisation for Economic Co-operation and Development, the United Nations and the International Labour Organization, and (iv) complies with applicable technical screening criteria set out in delegated acts supplementing the Taxonomy Regulation. The six specified objectives are: (1) climate change mitigation; (2) climate change adaptation; (3) the sustainable use and protection of water and marine resources; (4) the transition to a circular economy; (5) pollution prevention and control; and (6) the protection and restoration of biodiversity and ecosystems.

The Taxonomy Regulation tasks the European Commission (the "Commission") with defining detailed technical screening criteria for each environmental objective through delegated acts (legally binding supplemental provisions of the Taxonomy Regulation), the first of which is currently expected in late April 2021. This delegated act will cover the climate change mitigation and climate change adaptation objectives and will apply from January 1, 2022. The Commission aims to produce a delegated act by the end of 2021 for the other four environmental objectives that will apply from January 1, 2023.

The Taxonomy Regulation applies directly to in-scope entities without the need for implementation at the EU member state level. The United Kingdom indicated in November 2020 that it would implement a separate green taxonomy based on the EU Taxonomy.

Article 8 of the Taxonomy Regulation

Article 8 of the Taxonomy Regulation requires disclosure by an entity, as part of the non-financial information it must disclose pursuant to the EU Non-Financial Reporting Directive (NFRD),[3] of how and the extent to which the activities of such entity are associated with economic activities qualifying as "environmentally sustainable" under the Taxonomy Regulation. These disclosure requirements apply to large EU public interest entities (PIEs) with more than 500 employees, including EU-listed companies, credit institutions, asset managers and insurance companies. The NFRD is currently under review by the Commission, and its scope may be extended beyond large PIEs; the Commission's public consultation on the revision of the NFRD closed on June 11, 2020 and a draft regulation is scheduled for first quarter 2021.

In particular, for non-financial EU-listed EU entities, Article 8(2) of the Taxonomy Regulation identifies three specific KPIs that they are required to disclose in their non-financial statements: the proportions of (1) turnover, (2) capital expenditure and (3) operating expenditure that are derived from or related to activities that are associated with economic activities that qualify as "environmentally sustainable." The content and presentation of these KPIs, as well as others to be disclosed by financial entities, will be set out in a further delegated act to be adopted by the Commission by June 1, 2021.

On February 26, 2021, the three European Supervisory Authorities (the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA), collectively the "ESAs") responded to the Commission's call for advice on implementing Article 8, and published sector-specific proposals for KPIs to be published by financial and non-financial undertakings.

THE ESA PROPOSALS

European Securities and Markets Authority (covering non-financial listed entities and asset managers)[4]

ESMA's proposals for non-financial undertakings (i.e., EU-listed EU entities) include:

- Definitions of each KPI required by Article 8(2) and its elements.
- Minimum content requirements for the provision of accompanying information, including information on accounting policies, the assessment of Taxonomy-alignment, one year of comparative information, and contextual information.
- A methodology for reporting of these metrics.
- Presentation of disclosures in the form of standardized tables.

ESMA's proposals also include a new KPI for asset managers, consisting of a ratio of investments that are Taxonomy-aligned to non-aligned investments. ESMA also proposed a methodology for the calculation of this metric and standardized tables for the presentation of such disclosures.

European Insurance and Occupational Pensions Authority (covering insurers and reinsurers)[5]

EIOPA proposes two KPIs in relation to insurers and reinsurers and a methodology for the calculation of these metrics. The proposed KPIs are:

- ***Sustainable investments ratio***: the proportion of the insurer's investments relative to its total investments that are directed at funding or associated with economic activities that qualify as environmentally sustainable under the EU Taxonomy.
- ***Sustainable underwriting activities ratio***: the proportion of non-life gross premiums written relative to total non-life gross premiums written corresponding to insurance activities identified as environmentally sustainable in the EU Taxonomy.

European Banking Authority (covering credit institutions and investment firms)[6]

The EBA's KPI proposals include:

- ***Green Asset Ratio***: the proportion of assets linked to Taxonomy-compliant economic activities as a share of total eligible assets.
- Additional off-balance sheet KPIs:
  - ***Green ratio for financial guarantees*** (of corporates subject to NFRD disclosure obligations)
  - ***Green ratio for assets under management*** (AuM)
  - ***Green ratio for fees and commissions***

The EBA also proposed requiring complementary, qualitative information disclosures, including, for example: contextual information to aid the understanding of quantitative indicators; details and justifications of variations in institutions' levels of Taxonomy-alignment; and a description of the use of the Taxonomy in an institution's business strategy.

ESA CONSULTATION ON THE EU SUSTAINABLE FINANCE DISCLOSURE REGULATION

On March 15, 2021, the ESAs also issued a joint consultation paper[7] seeking input on a draft delegated regulation and proposals as to the content and presentation of disclosures required under the EU Sustainable Finance Disclosure Regulation (the "SFDR")[8], which is a companion law to the Taxonomy Regulation.

The SFDR requires financial market participants such as banks, insurance companies, pension funds, and investment firms and financial advisors[9] to make certain ESG-related disclosures, including in respect of their overall investment decision-making processes and approach to providing financial advice (whether ESG-focused or not) as well as in respect of certain financial products which have sustainable characteristics or objectives. The SFDR generally requires information to be disclosed in three primary ways: on the company's website; in its periodic reports; and/or in its product promotional material.

The ESAs' proposed new delegated regulation aims to create a cohesive system of sustainability disclosures under both the SFDR and the Taxonomy Regulation and to minimize conflicts between the two regulations.[10]

The draft delegated regulation will amend the previously completed SFDR technical standards to require, among other things, disclosure for in-scope financial products on:

- ***How and to what extent the economic activities the product invests in qualify as environmentally sustainable under the Taxonomy Regulation*****:** the methodology for this KPI is, in so far as possible, consistent with the advice given by the ESAs in respect of Article 8 of the Taxonomy Regulation discussed above, and it is proposed that this KPI should be graphically presented.
- ***How the product is Taxonomy aligned*****:** this will require a statement that the product investments comply with the four criteria set out in Article 3 of the Taxonomy Regulation that identify an activity as one that is "environmentally sustainable," and disclosure as to whether this statement has been assessed by a third party.

The closing date for responses to the ESA consultation is May 12, 2021.

IMPLICATIONS

The Commission will now consider the ESAs' proposals in respect of the KPI disclosures required by Article 8 of the Taxonomy Regulation and formulate a delegated act, which under the Taxonomy Regulation is required by June 1, 2021. The delegated regulation in respect of SFDR disclosures is not expected to be finalized until late June 2021 or early July 2021 (despite a specified deadline of June 1, 2021).

In-scope entities need to consider carefully the relevant proposals and the data needed to calculate the relevant KPIs and put in place procedures for producing the proposed disclosure if required by the

Commission. Notwithstanding that the Commission has not yet finalized the technical screening criteria for the climate change mitigation and adaptation Taxonomy objectives, in-scope entities will need to comply with KPI reporting requirements in respect of those two objectives beginning January 1, 2022 (including in respect of the 2021 financial year). Reporting in relation to the other four environmental objectives will be mandatory beginning January 1, 2023.

Non-EU entities outside the scope of the Taxonomy Regulation and the SFDR may also come under pressure from investors or other stakeholders to voluntarily report on the EU KPIs in order to facilitate comparisons across jurisdictions.

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ENDNOTES

[1] 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.

[2] See our previous memo on the Taxonomy Regulation: Sustainable Finance Update: EU Taxonomy, Updated Equator Principles, New Actions by Securities Regulators and Other Recent Developments (April 30, 2020), Sullivan & Cromwell LLP.

[3] 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.

[4] See ESMA's proposals here: esma30-379-471_final_report_-advice_on_article_8_of_the_taxonomy regulation.pdf (europa.eu).

[5] See EIOPA proposals here: DocType (europa.eu).

[6] See EBA proposals here: EBA Opinion - Advice to EC on Disclosures under Article 8 Taxonomy Regulation.pdf (europa.eu) and Report - Advice to COM_Disclosure Article 8 Taxonomy.pdf (europa.eu).

[7] See the Consultation Paper here: JC 2021 22 - Joint consultation paper on taxonomy-related sustainability disclosures.pdf (europa.eu).

[8] 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.

[9] Specifically, the SFDR applies to financial market participants as defined in Article 2(1) SFDR and financial advisors as defined in Article 2(11) SFDR.

[10] Article 25 of the Taxonomy Regulation amended the SFDR to include additional empowerments in Articles 8(4), 9(5) and 11(5) of the SFDR for the development of further regulatory technical standards on taxonomy-related product disclosures, which will be set out in a delegated regulation developed jointly by the ESAs.

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