THE EU TAXONOMY FOR SUSTAINABLE INVESTMENTS – AGRICULTURE AND FORESTRY (SOFT COMMODITIES)

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THE TAXONOMY REGULATION AND ITS OBJECTIVES

Regulation (EU) 2020/852 of the European Parliament and EU Council (the 'Taxonomy Regulation')[1] came into force on 12 July 2020, although it will not start applying until 1 January 2022 at the earliest. It represents a key step towards the EU's objective of achieving a climate neutral union by 2050.

> "The taxonomy is likely to be a key tool in assessing any green supporting factors under banks' prudential rules (e.g. capital adequacy treatment)."

The Taxonomy Regulation provides uniform criteria for companies and investors to determine whether an economic activity is "environmentally sustainable". It is a classification system (known as a "taxonomy") which will help investors identify what is, or is not, sustainable. Its aims include[2]:

- To re-direct capital flows to sustainable investment and to companies engaged in or transitioning to more sustainable activities;
- To limit market fragmentation in the classification of green activities and investment projects, which will in turn facilitate cross-border sustainable investment in the EU;
- To increase transparency thereby enhancing investor confidence and awareness of the environmental impact of financial products/corporate bonds; and
- To create visibility and address concerns about "greenwashing" (that is, the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact, basic environmental standards have not been met).

Further, the taxonomy is likely to be a key tool in assessing any green supporting factors under banks' prudential rules (e.g. capital adequacy treatment). For example, the European Banking Authority has a mandate to assess the need for a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives, which will use the new EU taxonomy[3].

SCOPE OF THE TAXONOMY REGULATION

The Taxonomy Regulation applies to:

- measures adopted by Member States or by the EU that set out requirements for financial market participants ("FMPs") or issuers in respect of financial products (which includes investment funds, pensions and UCITS) or corporate bonds that are made available as environmentally sustainable, for example Green Bonds (FMPs include insurance undertakings, investment firms, pension providers and fund managers);
- FMPs that make available financial products; and
- undertakings which are subject to the obligation to publish a non-financial statement or a consolidated non-financial statement pursuant to the Non-Financial Reporting Directive (see below).

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THE DEFINITION OF "ENVIRONMENTALLY SUSTAINABLE" UNDER THE TAXONOMY

There are **four criteria** under the Taxonomy Regulation which an economic activity must meet in order to qualify as "environmentally sustainable[4]":

1.		2.		3.		4.
Contributes substantially to one or more of the six environmental objectives	+	**Does not significantly harm** any of the six environmental objectives	+	Complies with the **minimum safeguards** (set out in Article 18 of the Taxonomy Regulation)	+	Complies with the **Technical Screening Criteria ("TSC")** (see below)

As mentioned above, the Taxonomy Regulation sets out **six environmental objectives[5]:**

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control; and
6. protection and restoration of biodiversity and ecosystems.

Each of the objectives is defined in the Taxonomy Regulation.

TECHNICAL SCREENING CRITERIA: OVERVIEW

The **Technical Screening Criteria** (the "TSC") are uniform criteria which will be used to determine whether economic activities "contribute substantially" to each environmental objective, and therefore can be considered sustainable[6]. The TSC will also determine whether any of those economic activities cause significant harm to any of the other environmental objectives (in accordance with criteria (2) above). The TSC will therefore be used as a basis for establishing an actual list of environmentally sustainable activities and will be implemented pursuant to the Taxonomy Regulation through delegated acts which are to be adopted in two sequences[7].

"This first delegated act was expected to be adopted by 31 December 2020 with the intention that the taxonomy would apply from 1 January 2022."

The draft TSC covers the following 13 sectors:

1) Agriculture and forestry;
2) Environmental protection and restoration activities;
3) Manufacturing;
4) Energy;
5) Water supply, sewerage, waste management and remediation activities;
6) Transport (including maritime);
7) Construction and real estate;
8) Information and communication;
9) Professional scientific and technical activities;
10) Financial and insurance activities;
11) Education;
12) Human health and social work activities; and
13) Arts, entertainment and recreation.

Work has commenced on elaborating the TSC for the first two environmental objectives (*climate change mitigation and climate change adaptation*). This first delegated act was expected to be adopted by 31 December 2020 with the intention that the taxonomy would **apply from 1 January 2022**[8]**.** However, the regulation is still in draft form and will be adopted as soon as possible after the evaluation of the stakeholder feedback. The feedback period closed on 18 December 2020, so we expect more information from the EU on the timetable for implementation in due course.

For the four other environmental objectives (*water; circular economy; pollution control and biodiversity)*, the taxonomy is intended to be established by the end of 2021 so that the taxonomy can start to apply to those objectives from **1 January 2023**[9]**.** This gives those affected by the Taxonomy Regulation a year to familiarise themselves with the TSC and to prepare for their application[10].

"THE DRAFT TSC NOTES THE OPPORTUNITIES FOR SIGNIFICANT CLIMATE CHANGE MITIGATION IN THE AGRICULTURE SECTOR".

The annexes to the delegated acts are where the TSC are set out in detail, together with very technical industry specific tests for various sectors and economic activities. Investors will need to use these annexes when determining whether or not the economic activity is sustainable.

The Technical Expert Group (the "TEG") was set up by the Commission to provide technical input and establish the TSC for each environmental objective. The TEG has now been replaced by the Platform on Sustainable Finance (the **"**Platform"), comprising of a broad range of experts from both the public and private sectors, who will be responsible for establishing and updating the TSC going forward[11]. The Platform will therefore develop the TSC for the remaining four environmental objectives.

The Commission will review the TSC, based on the advice it receives from the Platform in line with scientific and technological developments, and where appropriate amend the delegated acts[12]. This means that, in the case of tightening criteria for certain economic activities, it is possible that some activities that were previously considered taxonomy-aligned would lose their eligibility[13]. It is also envisaged that the scope of the taxonomy is extended beyond environmentally sustainable economic activities so that it covers other sustainability objectives, including **social objectives**[14], and criteria for a **"brown" taxonomy**[15]**.**

TECHNICAL SCREENING CRITERIA: AGRICULTURE AND FORESTRY (SOFT COMMODITIES)

AGRICULTURE

The draft TSC recognises that the agriculture sector (defined in the draft TSC as "the management of the natural environment, plants and animals to produce and process food, fuel and other products") plays a central role in climate change, sustainable development and food security and notes the opportunities for significant climate change mitigation in this area.

"The agriculture sector can "act as both a source and a sink for greenhouse gas emissions". As such, it recognises that to achieve net negative emissions in every instance of agricultural activity may not be possible."

The following agriculture-related economic activities are expressly referred to in the draft TSC:

- growing of non-perennials: including cereals, rice, leguminous crops and oil seeds, vegetables, melons, roots and tubers, sugar cane and fibre crops;
- growing of perennials: including grapes, tropical and sub-tropical fruits, citrus fruits, stone fruits, other tree and bush fruits and nuts, oleaginous fruits, beverage crops, spices, aromatics and drug and pharmaceutical crops, grass leys; and
- animal production: including dairy and other cattle and buffaloes, sheep, goats, pigs and poultry and the management of their waste (manure) and related grassland or pasture.

Substantial contribution to climate change mitigation

The draft TSC highlights that the agriculture sector can "act as both a source and a sink for greenhouse gas ("GHG") emissions[16]". As such, it recognises that to achieve net negative emissions in every instance of agricultural activity may not be possible – the draft TSC does not require this, but alternatively requires that the following three criteria are all met for agricultural activities to be recognised as delivering substantial contributions to climate change mitigation:

- reduced emissions from ongoing land and animal management;
- increased removals of carbon from the atmosphere and storage in above and below ground biomass through ongoing land and animal management, up to the limit of saturation levels; and
- the agricultural activity is not being carried out on land that was previously deemed to be 'of high carbon stock'.

Interestingly, the draft TSC also recognises the capability for agricultural production to enable mitigation in other areas – specifically through the supply of biomass and use thereof in textiles, bio-based materials for industry, construction, packaging and bioenergy.

Impact

The Taxonomy Regulation could have a wide-ranging impact on the agricultural sector – the draft TSC envisages the following specific impacts:

- restoration of natural habitats by removing land from agricultural production;
- a general switch from high emitting activities to low emitting activities (by, for example, increasing production of legumes to replace reliance on beef, lamb and dairy products); and

- increased awareness of water and energy use which could lead to the use of renewable energy throughout agricultural processes and the modernisation of irrigation and water pumping systems.

FORESTRY

The Taxonomy Regulation defines "forest" in line with the definition of the UN Food and Agriculture Organization[17] – "land spanning more than 0.5 hectares with trees higher than 5 meters and a canopy cover of more than 10%, or trees able to reach these thresholds in situ. It does not include land that is predominantly under agricultural or urban land use[18]". There is therefore a distinction between forestry and agriculture in the taxonomy, and the taxonomy makes clear that plantation forests[19] are specifically excluded.

The draft TSC selects the following activities which are thought to represent interventions at different stages of a forest's economic life-cycle:

> "Large parts of the EU bioeconomy risk being considered as unsustainable for taxonomy purposes, even though their primary purpose is to produce, process and add value to renewable resources."
>
> The European Bioeconomy Alliance

- afforestation: the establishment of forest through planting and/or deliberate seeding on land that, until then, was under a different land use, implies a transformation of land use from non-forest to forest;
- reforestation (UN Forestry and Agriculture Organisation ("FAO") Global Forest Resources Assessment ("FRA") 2020 Definition): the re-establishment of forest through planting and/or deliberate seeding on land classified as forest;
- restoration/rehabilitation: any intentional activity that initiates or accelerates the recovery of an ecosystem from a degraded state;
- existing forest management: management of land that is reported as forest, in accordance with the Sustainable Forest Management ("SFM") principles[20]; and
- conservation forests: defined as those in which the 'primary designated management objective' is that of conservation[21].

Substantial contribution to climate change mitigation

The draft TSC sets out three criteria that are required to be met to demonstrate sustainable and substantial mitigation:

- compliance with Sustainable Forest Management requirements[22] – these are mandatory but allow for flexibility as to differing regional/international approaches. The annex to the Taxonomy Regulation sets out a non-exhaustive list of activities that would meet these requirements;
- the establishment of a verified GHG balance baseline, based on growth-yield curves in order to demonstrate that the forest carbon sink continues to increase and GHG emissions from the forest sectors decrease; and
- the demonstration of permanence and steady progress with (a) and (b) above reported through a forest management plan at ten-year intervals[23].

Impact

The Taxonomy Regulation could have a wide-ranging impact on the forestry sector. The European Bioeconomy Alliance's view is that "large parts of the EU bioeconomy risk being considered as unsustainable for taxonomy purposes, even though their primary purpose is to produce, process and add value to renewable resources as feedstock for making innovative, value-added everyday products and materials[24]".

The forestry sector in the EU plays and will continue to play a vital role in tackling climate change and contributing to the EU meeting its climate action target to cut emissions by 55% by 2030. The Confederation of European Forest Owners notes that the forestry sector "provides three main climate benefits: CO2 sequestration in resilient, growing forests; carbon storage before and after harvesting; and a renewable and climate-friendly raw material that substitutes energy-intensive materials and fossil fuels[25]…" However, on review, the draft TSC places greater emphasis on the forestry sector improving carbon sinks in forests rather than focussing on the carbon cycle benefits that forestry may have.

> "Another important point to note is that that companies within the scope of the NFRD will have to disclose even if there are no specific criteria (yet) available to their activities/sector."

DISCLOSURE OBLIGATIONS

The Taxonomy Regulation is closely linked with the Disclosure Regulation (defined below) and the Non-Financial Reporting Directive (the "NFRD") and introduces new disclosure obligations for a range of entities. We set out what this will mean for both reporting companies and FMPs below.

REPORTING COMPANIES

Article 8 of the Taxonomy Regulation requires financial and non-financial organisations covered by the NFRD to include information in their non-financial information statements on how, and to what extent, their business activities (turnover, CapEx and OpEx) align with the Taxonomy Regulation[26]. They will have to start disclosing against the first two climate objectives (*climate change mitigation and climate change adaptation*) in the course of 2022 (covering the financial year 2021) and all six environmental objectives in the course of 2023 (covering the financial year 2022[27]).

Currently the NFRD applies only to EU-incorporated large public interest entities (PIEs), which can include organisations in the financial and non-financial sectors with securities traded on a regulated market, in each case if they have more than 500 employees. However, the Commission has announced a review of the NFRD and one issue being considered is whether it is amended to include all listed companies (including SMEs) and/or set the bar precisely at SMEs level (i.e. above 250 employees)[28].If the scope of the NFRD was extended, this would in turn have a knock-on effect on which organisations need to comply with the disclosure requirements in Article 8 of the Taxonomy Regulation.

Another important point to note is that that companies within the scope of the NFRD will have to disclose even if there are no specific criteria (yet) available to their activities/sector[29]. The content and presentation of the information to be disclosed under Article 8 will be further specified by the Commission by 1 June 2021 through a delegated act[30].

FINANCIAL MARKET PARTICIPANTS

Articles 5-7 of the Taxonomy Regulation introduce new disclosure requirements for entities covered by EU Regulation 2019/2088 (the "Disclosure Regulation"), which includes insurance undertakings, investment firms, pension providers and fund managers[31]. Such entities will need to disclose how and to what extent their portfolios align with taxonomy objectives. More specifically:

1. **Sustainable products (as defined by Disclosure Regulation):** entities will need to set out the percentage of their portfolio that is EU Taxonomy-aligned[32];
2. **Products with ESG characteristics (as defined by Disclosure Regulation):** as above, entities must set out the percentage of their portfolio that is EU Taxonomy-aligned; and include a statement that the "do no significant harm principle" only applies for the investments underlying the product that consider the EU taxonomy[33]; and
3. **Mandatory statement products with no ESG characteristics:** the following statement must be included in their disclosures: the "product does not consider the EU Taxonomy[34]".

These disclosures will need to be made in a company's pre-contractual documents, websites and periodic reports[35]. The first set of disclosures against the taxonomy, covering activities that substantially contribute to climate change mitigation and adaption, need to be made from 1 January 2022. Disclosures in relation to all six environmental objectives will need to be made from 1 January 2023[36].

EXTRA TERRITORIAL EFFECT

The disclosure obligations for FMPs in the Taxonomy Regulation (as set out above) apply to anyone offering financial products in the EU regardless of where the manufacturer of such products is based. In addition, the disclosure obligations pursuant to Article 8 of the Taxonomy Regulation (as set out above) apply to entities subject to the NFRD and to all their activities regardless of their location[37].

Furthermore, the TEG has suggested that investors in third countries could use the taxonomy criteria to benchmark or compare the environmental performance of local economic activities in those countries. In cases where a locally relevant threshold has been used to assess the environmental performance of an economic activity, it is also suggested by the TEG that companies and investors may wish to provide an additional second disclosure setting out the details and rationale for variation from the TEG standard[38].

> "How the roadmap will align with any UK taxonomy and implementation of the EU taxonomy has yet to be seen and will no doubt impact on, and add complexity to, the disclosure which FMPs are required to make."

The UK's approach with respect to taxonomy-related disclosures post-Brexit is not yet clear. In June 2020, it was confirmed that the UK would retain the taxonomy framework, including the six environmental objectives. However, as the details are to be set out in the future delegated acts which are not yet finalised, the UK government could not confirm at that stage the extent to which UK law will align with EU law here. In November 2020, the UK announced that a UK taxonomy will take the metrics and thresholds in the EU taxonomy as its basis and then a new UK Green Technical Advisory Group, an equivalent to the TEG, will be established to review these metrics "to ensure they are right for the UK market[39]". In addition, the UK has published a roadmap towards mandatory climate-related disclosures across the UK economy aligned with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD)[40]. How the roadmap will align with any UK taxonomy and implementation of the EU taxonomy has yet to be seen and will no doubt impact on, and add complexity to, the disclosure which FMPs are required to make.

VERIFICATION AND ASSESSMENT OF TAXONOMY ALIGNMENT

The Taxonomy Regulation does not explicitly require any formal verification of whether activities comply with the TSC. However, as set out above, compliance with the taxonomy disclosure obligations will be monitored. In addition, as good practice, FMPs are encouraged to seek external assurance on their taxonomy-related disclosures.

> "It is clear that the Commission intends the Taxonomy Regulation to become a benchmark for measuring sustainable investment in a number of ways."

Disclosures made under the NFRD do not, as a baseline, require verification (although this may vary based on the transposition by Member States). However, this may be subject to change depending on the outcome of the currently on-going review of the NFRD[41].

CONCLUSION

The Taxonomy Regulation is likely to have a significant impact on reporting obligations for FMPs and a broad range of other companies, although understanding the level of additional work required will depend on the detailed criteria set out in the TSC. It is clear that the Commission intends the Taxonomy Regulation to become a benchmark for measuring sustainable investment in a number of ways. We therefore suggest that FMPs and other entities follow its evolution closely, and in particular:

- identify any disclosure and data requirements and establish reporting procedures;
- consider the impact of the Taxonomy Regulation on investment and access to financing, particularly as this may enable investors to better target "green" investments; and
- consider their existing compliance with the criteria, and whether/how to take it into account in their future financing decisions.

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This is part of a series of articles on the EU Taxonomy. Follow the links to see our guidance on how it affects the transport, real estate, energy and mining & minerals sectors.

[1] For the text of the Taxonomy Regulation as published in the Official Journal, click here.

[2] Taxonomy Regulation, Recitals 6-14.

[3] Frequently asked questions about the work of the European Commission and the Tecnical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard (the "**TEG FAQs**"), p.8. For the text of the TEG FAQs, click here.

[4] Taxonomy Regulation, Article 3.

[5] Taxonomy Regulation, Article 9.

[6] See requirements as set out in the Taxonomy Regulation, Article 19.

[7] Taxonomy Regulation, Recital 54.

[8] Taxonomy Regulation, Articles 10(6) and 11(6).

[9] Taxonomy Regulation, Articles 12(5), 13(5), 14(5) and 15(5).

[10] Taxonomy Regulation, Recital 57.

[11] Taxonomy Regulation, Article 20 and TEG FAQs, p. 6.

[12] Taxonomy Regulation, Article 19(5).

[13] TEG FAQs, p.7

[14] Taxonomy Regulation, Recital 59.

[15] TEG FAQs, p. 8.

[16] Technical Annex to the TEG final report on the EU Taxonomy (the "**TEG Final Report")**, page 103. For the text of the TEG Final Report, click here.

[17] FAO FRA 2020.

[18] UN FAO (2019) Global forest resource assessment 2020: terms and definitions FRA. Forest resources assessment working paper 188.

[19] Plantations are defined by the FAO as "Planted Forest that is intensively managed and meet ALL the following criteria at planting and stand maturity: one or two species, even age class, and regular spacing. 1. Specifically includes: short rotation plantation for wood, fibre and energy; 2 Specifically excludes: forest planted for protection or ecosystem restoration; 3. Specifically excludes: Forest established through planting or seeding which at stand maturity resembles or will resemble naturally regenerating forest."

[20] SFM is further defined by Forest Europe as: 'sustainable forest management' means using forests and forest land in a way, and at a rate, that maintains their biodiversity, productivity, regeneration capacity, vitality and their potential to fulfil, now and in future, relevant ecological, economic and social functions, at local, national, and global levels, and that does not cause damage to other ecosystems – see https://foresteurope.org/wp-content/uploads/2016/10/MC_lisbon_resolutionL2_with_annexes.pdf#page=18.

[21] Technical Annex to the TEG Final Report, page 42.

[22] See note 20.

[23] Technical Annex to the TEG Final Report, page 45.

[24] 20201203_EUBA_Letter on taxonomy to member states_Final.pdf (cepf-eu.org).

[25] Statement | The role of forest management in the upcoming taxonomy regulation for sustainable investments | CEPF (cepf-eu.org.

[26] Taxonomy Regulation, Article 8(1) and (2).

[27] Taxonomy Regulation, Article 27(2).

[28] TEG FAQs, p. 16.

[29] TEG FAQs, p.13.

[30] Taxonomy Regulation, Article 8(4).

[31] Disclosure Regulation, Article 2(1). For the text of the Disclosure Regulation as published in the Official Journal, click here.

[32] Taxonomy Regulation, Article 5.

[33] Taxonomy Regulation, Article 6.

[34] Taxonomy Regulation, Article 7.

[35] The TEG Final Report on the EU Taxonomy (the "**TEG Final Report**"), paragraph 3.3.1. For the text of the TEG Final Report, click here.

[36] Taxonomy Regulation, Article 27(2).

[37] TEG FAQs, p. 10.

[38] TEG FAQs, p.18.

[39] Chancellor sets out ambition for future of UK financial services – GOV.UK (www.gov.uk).

[40] FINAL_TCFD_ROADMAP.pdf (publishing.service.gov.uk).

[41] TEG Final Report, paragraph 3.2.8 and TEG FAQs, p.11

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