Syntax

Breaking Down the Basics: EU Taxonomy

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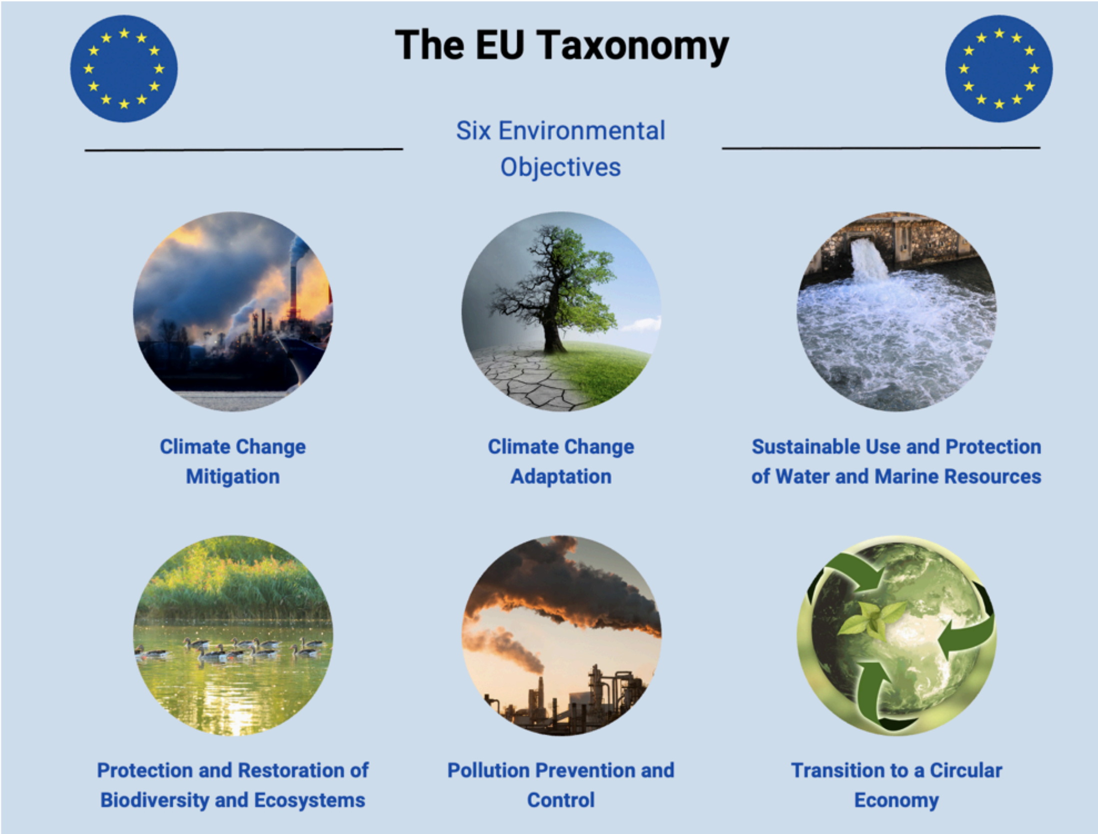
EU Taxonomy

Breaking Down the Basics

What is the EU Taxonomy?

In July 2020, the European Union (EU) began development on the EU Taxonomy, the first-of-its-kind sustainable business classification system that aims to standardize for the investment community what qualifies as an investment in a sustainable business.[1] The EU Taxonomy is a key component of the Sustainable Financial Disclosure Regulation (SFDR), which aims to govern sustainability labeling for financial products and services marketed in the EU. The EU Taxonomy will serve as a common language and reliable benchmark for measuring the sustainability of investments. Additionally, to be labeled as an "Article 9" investment product, the most stringent categorization under SFDR, an investment manager must demonstrate a product's alignment with the EU Taxonomy.[2]


The EU Taxonomy
Six Environmental Objectives
Climate Change Mitigation
Climate Change Adaptation
Sustainable Use and Protection of Water and Marine Resources
Protection and Restoration of Biodiversity and Ecosystems
Pollution Prevention and Control
Transition to a Circular Economy

Who does the EU Taxonomy apply to?

Large companies falling under the Non-Financial Reporting Directive (NFRD)[3]

- The NFDR applies to large companies (more than 500 employees, a total balance sheet of over €20 million or total net revenue of over €40 million).
- The NFRD will be replaced by the Corporate Sustainability Reporting Directive (CSRD) in 2024. The CSRD expands the coverage of companies from the current 11,700 to 50,000 and adds additional requirements to materiality consideration, third-party auditing and assurance, and disclosure requirements.[4]

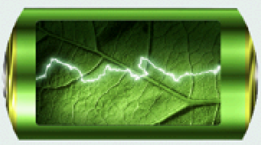
Financial market participants (both inside and outside of the EU) that offer and distribute financial products in the EU, including:

- Occupational Pension Providers and pan-European Personal Pension Product (PEPP)[5] providers
- Insurance companies offering insurance-based investment products (IBIPs)
- Alternative investment fund managers
- UCITS funds
- Corporate or investment banking portfolios containing financial instruments (as defined by MiFID II)[6]

EU member states setting measures for green financial products or green bonds

Main Uses

Renewable Energy



Energy Efficiency

Clean Transportation

Responsible Resources Management

Following the introduction of the EU Taxonomy, several other supplementary regulations were released to provide further guidance around reporting requirements, specifically in relation to the technical screening criteria.

1. Climate Delegated Act of 2021[7]

a. On June 4, 2021, the European Parliament established the "technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives."

b. In June 2023, the European Parliament included additional activities to the Climate Mitigation and Climate Adaptation objectives, including activities focused on manufacturing and transportation sectors.

2. **Environmental Delegated Act of 2022**[8]

a. Formally discloses the remaining eligible activities that can make a substantial contribution to the remaining environmental objectives.

3. Complementary Climate Delegated Act of 2022[9]

a. The latest addition to the regulation came into effect in 2023 and includes clauses around the inclusion of nuclear and fossil gas activities within eligible activities.

Taxonomy Eligibility vs. Taxonomy Alignment

To be eligible for consideration for EU Taxonomy alignment, a company has to derive revenue from one of 195 listed business activities that potentially contribute to either climate mitigation or climate adaptation. In the coming months and years, this list of activities will expand to include activities relevant to water, circular economy, pollution prevention, and biodiversity.

Deriving revenue from one of these 195 activities does not make a company aligned with the EU Taxonomy, it only makes it eligible for alignment. To be considered aligned with the EU Taxonomy, a company has to adhere to several criteria that enable a common measurement for sustainability contributions that the economic activity must meet or not negatively impact. These include:

1. **Substantial Contribution**: activities must make a significant contribution to the environmental objective and adhere to the Technical Screening Criteria (TSC). These criteria specify what operational benchmarks the sustainable investment has to meet to qualify as sustainable. For example, a company that generates geothermal power, a lower but not zero emission power source, cannot exceed a certain carbon emissions threshold per gigawatt hour.

2. **Do No Significant Harm (DNSH)**: ensures the business activity does not significantly contribute towards harming any one of the other key environmental objectives of the taxonomy. For example, if a company that builds and operates rail infrastructure does not follow particular waste recycling practices, its business would be deemed to cause significant harm to the goal of promoting a circular economy and therefore unaligned with the taxonomy.

3. **Comply with the Minimum Safeguards:** ensures the company complies with the following international standards:
a. OECD Guidelines for Multinational Enterprises
b. UN Guiding Principles on Business and Human Rights, including the International Labour Organization's ("ILO") declaration on Fundamental Rights and Principles at Work, the eight ILO core conventions, and the International Bill of Human Rights.

The taxonomy regulations specify the exact requirements for each business activity across the three areas listed previously. Each business activity has a different set of requirements.

EU Taxonomy Environmental Objectives

When finalized, the EU Taxonomy will have lists of eligible activities and alignment requirements across six environmental objectives. Since its inception, only the criteria for two objectives, Climate Change Adaptation and Climate Change Mitigation, had been completed. In June 2023, the technical screening criteria for the remaining environmental objectives was released.[10]

1. Climate Change Mitigation (Effective January 2022)

2. Climate Change Adaptation (Effective January 2022)

3. Sustainable Use and Protection of Water Resources (Expected Reporting January 2025)

4. Transition to a Circular Economy (Expected Reporting January 2025)

5. Pollution Prevention and Control (Expected Reporting January 2025)

6. Protection and Restoration of Biodiversity and Ecosystems (Expected Reporting January 2025)

Are Companies Reporting Alignment to the EU Taxonomy?

While the regulations lack some clarity around this topic, it is expected that issuing companies will begin to report their alignment to the EU Taxonomy in their annual filings. Some companies have already begun reporting for their year 2021 and 2022 annual filings. Companies reporting against the Taxonomy are required to include a description of their Taxonomy-aligned activities with the percentage of alignment; turnover, CAPEX, and OPEX percentages.

To showcase an example of how some companies are reporting today, below is an excerpt of Schneider Electric's, a French multinational energy company, self-reported alignment from its 2022 Sustainability Report.

Schneider Electric – Sample Sustainability Report

Economic Activities	Code(s)	Absolute Turnover	Proportion of Turnover	Substantial Contribution Criteria					
				Climate Change mitigation	Climate Change adaptation	Water and marine resources	Circular Economy	Pollution	Biodiversity and ecosystems
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
		Million Euros	Percent	Percent	Percent	Percent	Percent	Percent	Percent
A. TAXONOMY-ELIGIBLE ACTIVITIES									
A.1. Environmentally sustainable activities (Taxonomy-aligned)									
Manufacture of renewable energy technologies	3.1	64	0%	0%					
Manufacture of energy equipment for buildings	3.5	589	2%	2%					
Manufacture of other low carbon technologies	3.6	235	1%	1%					
Transmission and distribution of electricity	4.9	4,227	12%	12%					
Infrastructure for rail transport	6.14	53	0%	0%					
Infrastructure enabling low-carbon road transport and public transport	6.15	182	1%	1%		not applicable in FY2022			
Infrastructure enabling low carbon water transport	6.16	50	0%	0%					
Low carbon airport infrastructure	6.17	30	0%	0%					
Installation, maintenance and repair of instruments and devices for measuring, regulation and controlling energy performance of buildings	7.5	459	1%	1%					
Professional services related to energy performance buildings	9.3	1,044	3%	3%					

Not all companies, however, are reporting their taxonomy alignment. In the absence of company-reported data, an investor claiming Article 9 compliance should make a "best effort" to attain taxonomy alignment for all fund assets.[11] This could include analyzing the data themselves or purchasing it from a data provider. Even when taxonomy alignment data is reported by a company, investors may want to use a data provider to validate the reported data and aggregate it into an easily digestible format for analysis and reporting.

What Challenges Does the EU Taxonomy Present for Investors?

1. Mapping of NACE Codes and Unsatisfactory Classification

a. In 1970, Europe launched its first statistical classification of economic activities, known as NACE Codes. These NACE Codes were geared towards identifying a company's primary business line based on it's economic activity. Currently the EU taxonomy has mapped out all the eligible activities based on NACE Codes, but has cautioned that the NACE codes are to be "understood as indicative and should not prevail over the specific definition of the economic activity provided in its description."[12]

b. Relying on NACE Codes that depict companies based solely on primary business lines leads to an overarching issue around economic classification as a whole. Notably, most businesses are engaged in several activities and therefore, require additional analysis when interpreting their alignment with the EU Taxonomy.

2. **Potentially Changing Regulations and Puzzling Timelines**

a. Recognizing the rapidly changing nature of regulations, the EU released a proposal for amendments to be made to the SFDR in April 2023.[13] With respect to the EU Taxonomy, the regulation has been released in a piecemeal way, with delegated acts, annexes, and additional documentations serving as supplementary guidelines around interpreting the regulation. In conjunction with disparate information being shared, timelines around mandatory reporting are equally as difficult to interpret.

3. **Limited In-House ESG Resources and Guidance Around Economic Activities Interpretation**

a. ESG reporting is not new but many companies that have historically been subject to voluntary disclosures now find themselves scrambling to prepare for soon-to-be mandatory disclosure regulations globally. Companies that are undergoing this transition often face similar challenges, such as a lag in resource allocation, budgeting, and expertise, which create a compounding problem around advancing firmwide ESG initiatives. With a constantly evolving ESG landscape, staying up-to-date with the latest policy trends, frameworks, and regulations can be a daunting task for companies.

b. The EU Taxonomy, a first-of-its-kind sustainable economic classification system, notoriously warrants a substantial degree of complexity. Investors should heavily rely on the TSC to determine alignment, as well as the TSC guidance document that provides supplemental information around qualifying activities.

What is the Syntax Data Advantage as it relates to the EU Taxonomy?

Syntax's Affinity® Platform uses its product-line level data to capture granular company exposure to specific business activities that companies embark on. By leveraging product-line level data, Syntax can drill down further than the provided NACE codes to intimately identify all economic activities possibly eligible for the EU Taxonomy. At Syntax, our goal is to provide investors clarity and transparency around every aspect of ESG investing. To find out how the Affinity Platform, our data tools and custom investment solutions can help your organization meet its ESG goals, connect with us at contact@syntaxdata.com.

1. https://finance.ec.europa.eu/system/files/2022-03/sustainable-finance-taxonomy-nace-alternate-classification-mapping_en.xlsx

2. https://www.esma.europa.eu/press-news/esma-news/esas-propose-amendments-extend-and-simplify-sustainability-disclosures

3. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0095

4. https://www.europarl.europa.eu/news/en/- press-room/20221107IPR49611/sustainable-economy-parliament-adopts-new-reporting-rules-for-multinationals

5. https://www.eiopa.europa.eu/browse/regulation-and-policy/pan-european-personal-pension-product-pepp_en

6. https://www.esma.europa.eu/publications-and-data/interactive-single-rulebook/mi d-ii

7. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R2139

8. https://ec.europa.eu/info/law/better-regula-tion/have -your-say/initiatives/13237-Sustainable -investment-EU-environmental-taxonomy_en

9. https:// nance.ec.europa.eu/publications/eu-taxonomy-complementary-climate-delegated-act-accelerate-decarbonisation_en

10. https://ec.europa.eu/info/law/better-regulation/have -your-say/initiatives/13237-Sustainable -investment-EU-environmental-taxonomy_en

11. https://www.esma.europa.eu/sites/default/files/library/jc_2021_50_-_final_report_on_taxonomy-related_product_disclosure_rts.pdf

About Syntax

Syntax LLC is a financial data and technology company that codifies business models. Syntax operates through three segments: Company Data, Wealth Technology, and Financial Indices. Using its patented FIS® technology inspired by systems sciences, the Company Data segment offers the most comprehensive, granular, and accurate product line revenue data available on the market. The Wealth Technology segment then uses this abundance of data to facilitate the instantaneous creation and ongoing management of direct indexing solutions and rules-based equity portfolios through a fully automated platform. The Financial Indices segment enables Syntax to deliver customized and proprietary indices, including core global benchmarks and micro- and macro-thematic, smart beta, defined outcome, and target volatility indices. These indices are foundational for a range of financial products, such as ETFs, UITs, and structured products. Learn more at www.syntaxdata.com.

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