



# THE EU TAXONOMY REGULATION

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Practical Insights for Fund  
Management Companies

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**The EU Taxonomy Regulation applies, in part, from 1 January 2022. It introduces a common classification system for sustainable economic activities, or an “EU Taxonomy”. This paper outlines the reasons for the introduction of the Taxonomy Regulation, how it interacts with the other pieces of EU legislation forming part of the EU’s sustainable finance agenda, and what actions fund management companies need to take in order to comply with the Taxonomy Regulation.**

## What is the background to and context of the Taxonomy Regulation?

In 2015, the Paris Agreement was signed with the objective of limiting global warming to well below 2 degrees Celsius compared with pre-industrial levels.<sup>1</sup> To meet the EU's climate and energy targets for 2030, regulators have taken action to encourage investment towards sustainable projects and activities. The European Commission ("**Commission**") released its Action Plan for Financing Sustainable Growth in March 2018 ("**Action Plan**")<sup>2</sup>, with the objectives of: reorienting capital flows towards sustainable investment; mainstreaming sustainability into risk management; and fostering transparency and long-termism in financial and economic activity.

The Action Plan is aligned with the objectives of the European Green Deal, which was launched in December 2019, committing the EU to becoming climate neutral by 2050. Following the publication of the Action Plan, a number of legislative proposals were introduced to achieve the Action Plan's objectives: the Sustainable Finance Disclosure Regulation ("**SFDR**")<sup>3</sup>; the Low Carbon Benchmarks Regulation<sup>4</sup>; amendments to delegated acts under the UCITS Directive<sup>5</sup>, the Alternative Investment Fund Managers Directive ("**AIFMD**")<sup>6</sup>, the Markets in Financial Instruments Directive ("**MiFID II**")<sup>7</sup>, Solvency II<sup>8</sup> and the Insurance Distribution Directive<sup>9</sup>; and a proposal to establish a framework to facilitate sustainable investment known as an EU Taxonomy.<sup>10</sup>

In its Communication<sup>11</sup> on the European Green Deal, the Commission announced its intention to review the Non-Financial Reporting Directive ("**NFRD**") as part of the strategy to strengthen the foundations for sustainable investment. In April 2021, the Commission presented its proposal<sup>12</sup> for a Corporate Sustainability Reporting Directive ("**CSRD**"), which aims to revise and strengthen the existing rules introduced by the NFRD and to bring sustainability reporting on a par with financial reporting.

## What is the EU Taxonomy Regulation?

A critical tool to achieve the objectives of the Action Plan and the European Green Deal is a common language, underpinned by a clear definition of what economic activities can be classified as 'sustainable'. Consequently, the Action Plan called for the creation of a common classification system for sustainable economic activities, referred to as the EU Taxonomy.

The Taxonomy Regulation establishes this common classification system for determining whether an economic activity qualifies as being 'environmentally sustainable', using science-based criteria. The objective of the regulation is to make data available for investors to decide on their allocation of capital relative to their values. It will also allow companies to reliably use the EU Taxonomy to plan and finance their climate and environmental transition and enable financial institutions to design credible green financial products to accelerate capital allocation to green initiatives.

The Taxonomy Regulation entered into force on 12 July 2020 and a timeline of ensuing legislative developments is set out in Appendix 1.

## Who does the Taxonomy Regulation apply to?

The Taxonomy Regulation is an EU regulation, meaning that it will apply directly in the same manner to all EU member states, without the need for further transposing measures. The Taxonomy Regulation acts as golden thread throughout EU sustainable finance legislation, mandating disclosure from financial market participants ("**FMPs**") (which includes fund management companies), issuers and undertakings regarding the extent to which their business activities are aligned to the EU Taxonomy. There are three core user groups for the EU Taxonomy:

1. Entities within the scope of the definition of FMPs in the SFDR, including managers of Alternative Investment Funds ("**AIFs**") and/or Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), managing and/or offering financial products in the EU;

<sup>1</sup> [Paris Agreement](#) United Nations 2015

<sup>2</sup> See [COM/2018/097](#) 8 March 2018

<sup>3</sup> [Regulation \(EU\) 2019/2088](#)

<sup>4</sup> [Regulation \(EU\) 2019/2089](#)

<sup>5</sup> Commission Delegated Directive [\(EU\) 2021/1270](#)

<sup>6</sup> Commission Delegated Regulation [\(EU\) 2021/1255](#)

<sup>7</sup> Commission Delegated Regulation [\(EU\) 2021/1253](#) and Commission Delegated Directive [\(EU\) 2021/1269](#)

<sup>8</sup> Commission Delegated Regulation [\(EU\) 2021/1256](#)

<sup>9</sup> Commission Delegated Regulation [\(EU\) 2021/1257](#)

<sup>10</sup> Regulation [\(EU\) 2020/852](#)

<sup>11</sup> [Communication](#) on the European Green Deal 11 December 2019

<sup>12</sup> See [COM/2021/189](#) final 21 April 2021

2. Large undertakings that are already required to provide a non-financial statement under the NFRD (which will be replaced by the CSRD as of 2023); and
3. The EU and Member States, when setting public measures, standards or labels for green financial products or green (corporate) bonds.

It is envisaged that EU initiatives such as the EU Ecolabel, the EU Green Bond Standard, the Low Carbon Benchmarks Regulation and other EU sustainable finance initiatives will also align to the EU Taxonomy as they evolve.

### What are the key requirements under the Taxonomy Regulation?

As well as providing a classification system to identify environmentally sustainable economic activities, the Taxonomy Regulation imposes disclosure and reporting requirements on FMPs, issuers and undertakings within the scope of the NFRD (“**NFRD Investee Companies**”).

The Taxonomy Regulation amends the disclosure framework introduced under the SFDR to require FMPs to disclose in their pre-contractual disclosures and periodic reports: (a) information on the environmental objective(s) set out in the Taxonomy Regulation to which underlying investments contribute; and (b) how and to what extent underlying investments are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation. These disclosure requirements are discussed in more detail below in the specific context of fund management companies and funds.

The Taxonomy Regulation also requires undertakings subject to the NFRD to include in their non-financial statements information on how and to what extent the undertaking’s activities are associated with environmentally sustainable economic activities under the Taxonomy Regulation. The non-financial reporting requirements apply to non-financial undertakings and financial undertakings (which could include large asset managers but is unlikely to include fund management companies due to the employee number/balance sheet/turnover thresholds applied).<sup>13</sup>

### What are the environmental objectives under the Taxonomy Regulation?

Six environmental objectives are set out in Article 9 of the Taxonomy Regulation, as follows:

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

The Taxonomy Regulation applies with respect to the first two environmental objectives from 1 January 2022 and respect to the latter four environmental objectives from 1 January 2023.

### When is an economic activity deemed “environmentally sustainable”?

In order for an economic activity to be regarded as “environmentally sustainable”, it should demonstrate the following three characteristics:



## How do you measure “substantial contribution”?

The criteria for making a substantial contribution to one of the six environmental objectives mentioned above are listed in Articles 10 to 15 of the Taxonomy Regulation and will be further detailed in technical screening criteria (“TSC”) to be set out in delegated acts adopted under the Taxonomy Regulation.<sup>14</sup> The Commission considers that activities can make a substantial contribution when:

- they have a low impact on the environment and have the potential to replace high impact activities (e.g. renewable energy);
- they reduce impact from other activities (e.g. water treatment); or
- they make a positive environmental contribution (e.g. restoration of wetlands).

The Taxonomy Regulation also recognises two distinct types of activities that make a substantial contribution:

1. Transitional activities – in the context of the climate mitigation objective, these are activities for which low carbon alternatives are not yet available and that have greenhouse gas emission levels that correspond to the best performance in the industry or sector.
2. Enabling activities – these are activities that directly enable others to make a substantial contribution to an environmental objective.<sup>15</sup>

## How do you apply the Do No Significant Harm criteria?

The Do No Significant Harm (“DNSH”) criteria will also be defined by the TSC at an economic activity level. For example, in order for an economic activity to be aligned with the climate change mitigation objective, it needs to make a substantial contribution to that objective according to the defined criteria and meet the DNSH harm criteria for the other five environmental objectives. The purpose of this test is to ensure that an activity intended to make a positive contribution to

environmental sustainability does not have a negative impact in pursuit of its objective or do more harm than good. For example, a renewable energy plant might contribute to climate change mitigation, but if it is constructed in an area that requires clearing of forests which are home to an endangered species, the harm might outweigh the benefits.

It should also be noted that under the Taxonomy Disclosures Draft RTS, a dual assessment must be carried out by the fund management company to be satisfied that the DNSH test has been met by the relevant investment. In addition to complying with the relevant TSC for the economic activity carried out by the investee company, the management company must also take into account the indicators for adverse impacts set out in Table 1 in Annex I of the draft SFDR RTS published on 2 February 2021. For further details see the response below to the question “How can a fund management company satisfy itself that an EU Taxonomy-aligned investment satisfies the DNSH test imposed under the Taxonomy Regulation?”.

## What are the Minimum Safeguards?

The Minimum Safeguards are developed to ensure that economic activities also encompass the broader facets of ESG, including human rights. Although covering environmental and governance considerations also, the safeguards act as a precursor to addressing the ‘S’ of ESG pending development of a Social Taxonomy.<sup>16</sup> Undertakings complying with the disclosure requirements under Article 8 of the Taxonomy Regulation need to demonstrate that they avoid any negative impacts on the Minimum Safeguards identified in the Taxonomy Regulation. This means ensuring that the undertaking operates in line with the OECD Guidelines, UN Guiding Principles on Business and Human Rights and the International Labour Organisation’s (“ILO”) eight Core Labour Rights conventions. The application of these best practice standards and frameworks goes beyond the reported eligible activities. Undertakings complying with Article 8 of the Taxonomy Regulation will be expected to publicly

<sup>13</sup> At present, the NFRD applies to “large public interest entities” (“PIEs”) – that is, entities which have more than 500 employees; a balance sheet total of €20 million and/or net turnover of €40 million; and which are one of the following types of entities: (i) EU entities that have transferable securities admitted to trading on an EU regulated market; (ii) EU credit institutions; (iii) EU insurance undertakings; and (iv) EU entities that are designated by Member States as public-interest entities. The CSRD would extend the scope of the legislation from large PIEs to all large companies (whether listed or not) and all listed companies (except for listed micro-enterprises). “Large companies” for these purposes means companies exceeding two out of three of the following criteria: a balance sheet total of €20 million; net turnover of €40 million; and an average number of employees during the financial year of more than 250.

<sup>14</sup> At the time of publication, the TSC with respect to the climate change mitigation and climate change adaptation have not been published in the Official Journal of the EU. The Commission published its proposed delegated act setting out the TSC (known as the “[Climate Delegated Act](#)”) on 6 July 2021. The Commission [webpage](#) has links to Annexes 1 to 11 of the delegated act.

disclose their policies and risk management programmes implementing the safeguards. This includes policies on human rights and anti-bribery and corruption.

### What is meant by EU Taxonomy “eligibility” versus “alignment”?

For each of the environmental objectives under the Taxonomy Regulation, the TSC to be adopted under the Taxonomy Regulation will identify relevant economic activities. If an economic activity is listed within the TSC, it is referred to as “**eligible**” under the EU Taxonomy. Being Taxonomy-eligible is an indication that a certain activity is capable of making a substantial contribution to one of the six environmental objectives. However, in order to be “**aligned**” to the EU Taxonomy, the activity must meet all of the criteria set out in the TSC, including the criteria to measure substantial contribution, the DNSH test and compliance with the minimum safeguards. The detailed criteria for each activity listed within the EU Taxonomy are accessible online via the EU Taxonomy Compass<sup>17</sup>, which was developed by the Commission to facilitate ease of access to the evolving legislative provisions and to support integration of criteria into business databases and IT systems.

It is intended that the economic activities listed under the EU Taxonomy will continually evolve to take account of new developments. At the time of publication of this paper, economic activities considered to contribute to climate change mitigation and/or adaptation objectives link to the following NACE<sup>18</sup> macro sectors:

- Forestry;
- Environmental protection and restoration activities;
- Manufacturing;
- Energy;
- Water supply, sewerage, waste management and remediation;
- Transport;
- Construction and real estate activities;
- Information and communication; and
- Market research, development and innovation.

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<sup>15</sup> See FAQ: [What is the EU Taxonomy and how will it work in practice](#) European Commission, 21 April 2021.

<sup>16</sup> See further below – [How might the Taxonomy be expanded in future?](#)

<sup>17</sup> See [EU Taxonomy Compass](#).

<sup>18</sup> NACE refers to the Statistical Classification of Economic Activities in the European Community and is the industry standard classification system used in the EU.

## Which fund management companies and funds fall within the scope of the disclosure obligations under the Taxonomy Regulation?

As noted above in the context of the key requirements introduced by the Taxonomy Regulation, the regulation amends the disclosure framework introduced under the SFDR to require FMPs to make certain disclosures in pre-contractual disclosures and periodic reports relating to the EU Taxonomy alignment of underlying investments.

In the funds context, the Taxonomy Regulation principally applies to managers of funds which

have been classified as “Article 8” funds under the SFDR (that is, funds which promote environmental characteristics) and to funds classified as “Article 9” funds under the SFDR (that is, funds which contribute to an environmental objective), as the regulation requires such funds to make certain EU Taxonomy-alignment disclosures.

The product categorisation under the SFDR (either Article 6, 8 or 9 SFDR) will determine the relevant article within the Taxonomy Regulation that an FMP needs to comply with (see table below).

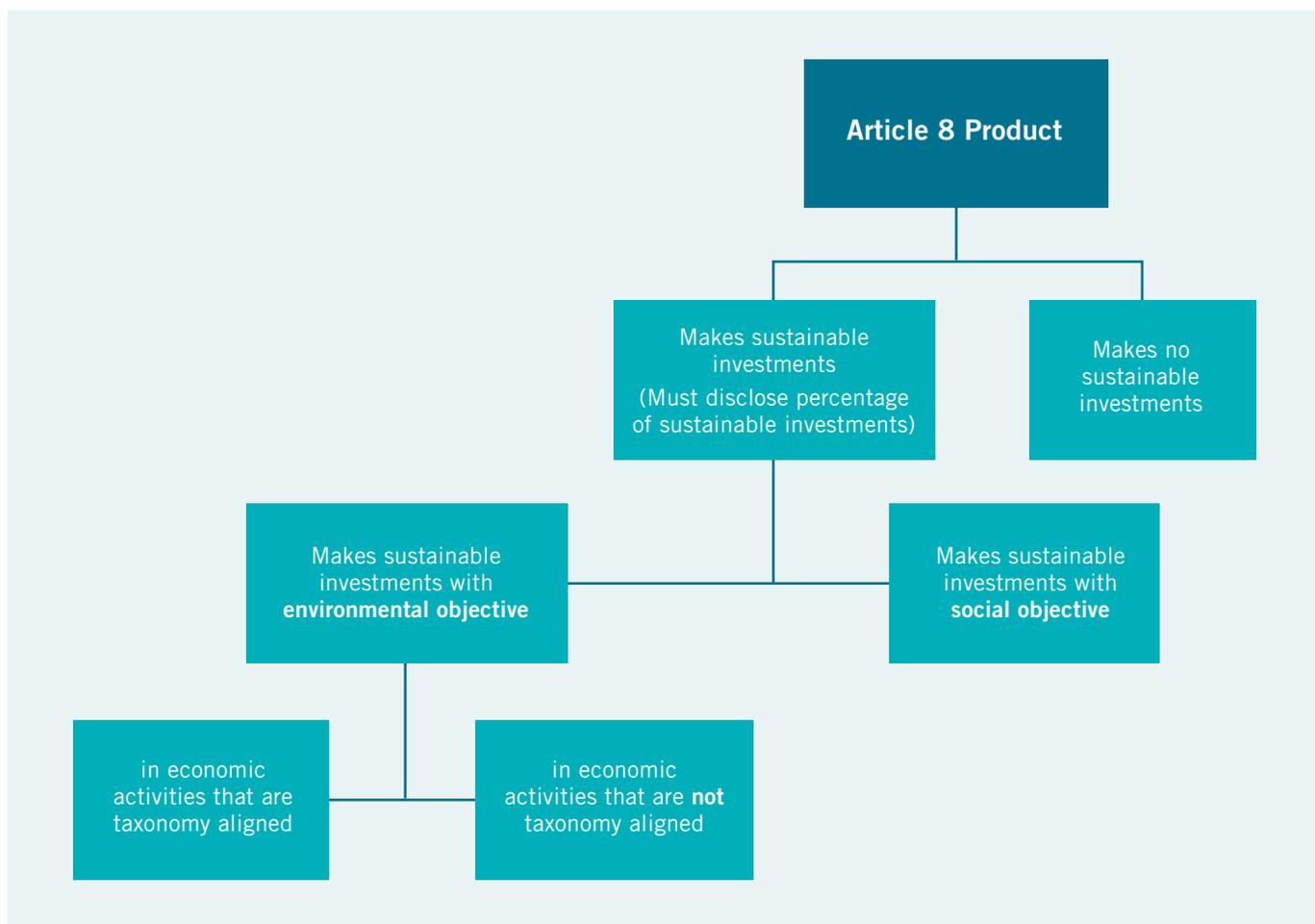
SFDR Product Categorisation		Relevant Taxonomy Regulation Article	
<b>Article 9</b>	Financial product that has sustainable investment as its objective.	<b>Article 5</b>	Pre-contractual disclosures and periodic reports to include information on the environmental objective(s) to which underlying investments contribute and a description of how and to what extent underlying investments are in environmentally sustainable economic activities.
<b>Article 8</b>	Financial product that promotes environmental or social characteristics.	<b>Article 6</b>	Pre-contractual disclosures and periodic reports to include information on the environmental objective(s) to which underlying investments contribute and a description of how and to what extent underlying investments are in environmentally sustainable economic activities.  Must include this statement:  <i>‘The “do no significant harm” principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities.</i>  <i>The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’.</i>
<b>Article 6</b>	Financial product that is not an Article 8 or an Article 9 product	<b>Article 7</b>	Must include this statement: <i>‘The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’.</i>

It is worth noting that under the final report<sup>19</sup> on draft regulatory technical standards (“RTS”) with regard to EU Taxonomy-related disclosures published by the European Supervisory Authorities (“ESAs”)<sup>20</sup> on 22 October 2021 (**Taxonomy Disclosures Draft RTS**), the ESAs have suggested that the detailed disclosure obligations imposed under Article 6 of the Taxonomy Regulation should only apply to Article 8 funds which:

- (i) promote environmental characteristics; and
- (ii) make “sustainable investments” with environmental objectives within the meaning of Article 2(17) of the SFDR.

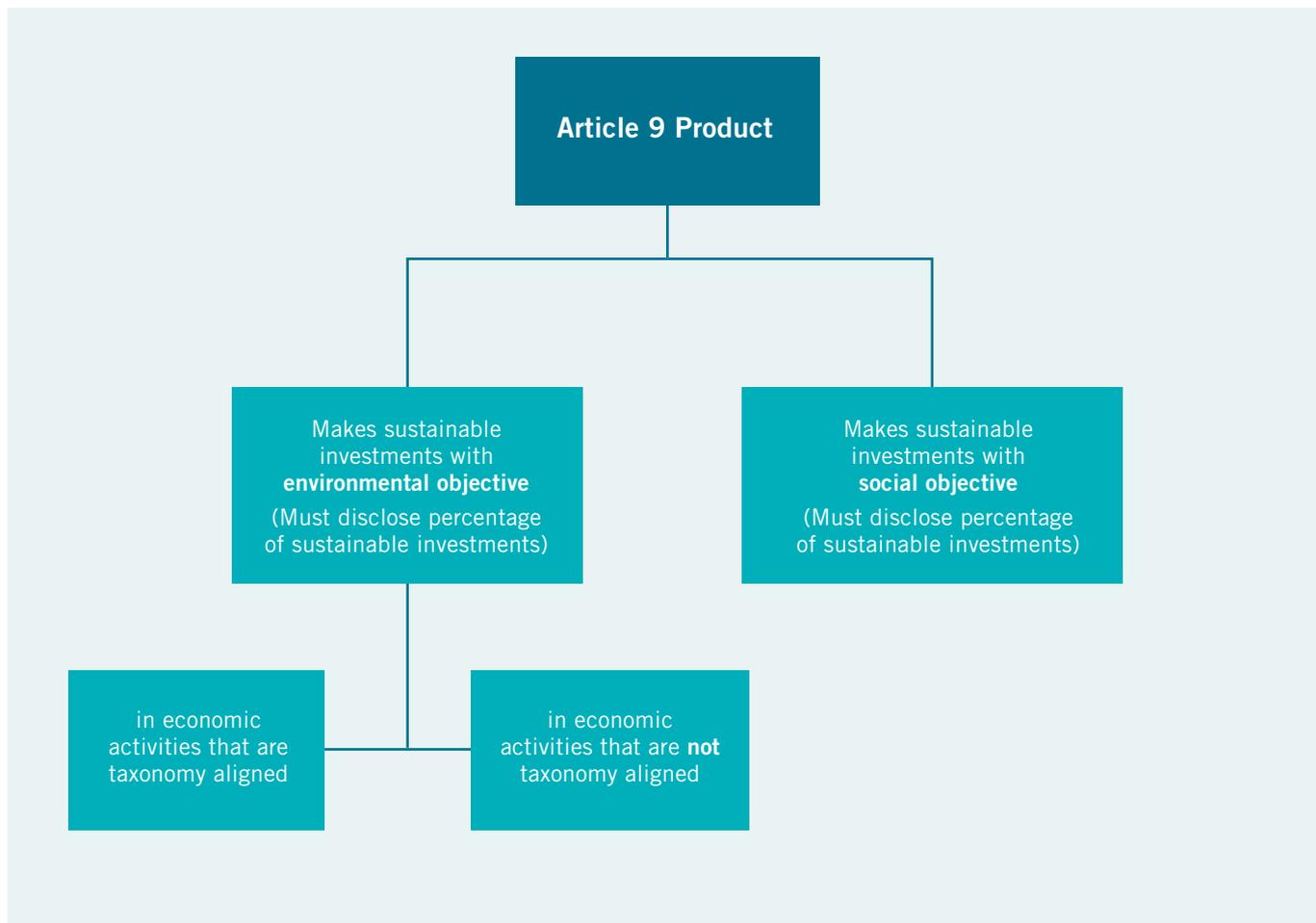
Therefore, to the extent that an Article 8 fund promotes environmental characteristics but does not commit to making “sustainable investments” with environmental objectives within the meaning of the SFDR, it would not appear to fall within the detailed EU Taxonomy-related disclosure obligations which generally apply to Article 8 funds that promote environmental characteristics.

Article 8 funds which promote social characteristics or Article 9 funds which pursue a social objective do not currently fall within the scope of the Taxonomy Regulation.



<sup>19</sup> [Final Report](#) on draft Regulatory Technical Standards with regard to the content and presentation of disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088 JC 2021 50 22 October 2021.

<sup>20</sup> The ESAs include the European Securities and Markets Authority (“ESMA”), the European Insurance and Occupational Pensions Authority (“EIOPA”) and the European Banking Authority (“EBA”).



## What do the disclosures framework under the Taxonomy Regulation look like?

The Taxonomy Regulation itself (typically referred to as “**Level 1 Taxonomy**”) sets out certain information that must be included in pre-contractual disclosures and periodic reporting for Article 8 funds and Article 9 funds that fall within the scope of detailed disclosure obligations under Article 5 and Article 6 of the Taxonomy Regulation (the “**In-Scope Funds**”).

More detailed disclosures, which will be required to follow a prescribed template and which must be incorporated into the prospectus/fund supplement and periodic reports of In-Scope Funds will be set out in the form of a Commission Delegated Regulation which will be based on the Taxonomy Disclosures Draft RTS. These disclosure obligations (typically referred to as “**Level 2 Taxonomy**”) are expected to be incorporated into the SFDR Level 2 disclosure requirements<sup>21</sup> to form a single Commission Delegated Regulation.

## What are the specific disclosure requirements imposed under the Taxonomy Regulation?

### Level 1 Taxonomy Disclosures

Level 1 Taxonomy obligations require that In-Scope Funds disclose:

- to which of the six environmental objectives set out in Article 9 of the Taxonomy Regulation the underlying investments in the fund contribute;
- a description of “how and to what extent” the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under Article 3 of the Taxonomy Regulation. This must include the percentage of the fund’s investments which are in EU Taxonomy-aligned activities, including the proportions of enabling and transition activities as defined by relevant TSC.

There is no specified template wording to be followed in order to comply with Level 1 Taxonomy disclosure requirements. Managers of In-Scope Funds will need to determine the best way to present this information, which will appear alongside the SFDR-related disclosures in the prospectus/fund supplement and in relevant periodic reports.

For In-scope Funds which have been classified as an “Article 8” fund under the SFDR, the following statement is to be disclosed alongside the EU Taxonomy-related and SFDR-related disclosures:

*‘The “do no significant harm” principle applies only to those investments underlying the financial product that take into account the EU criteria for environmentally sustainable economic activities.*

*‘The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities.’*

### Level 2 Taxonomy Disclosures

The ESAs have been tasked with developing RTS (which will take the form of a Commission Delegated Regulation once adopted by the Commission) to specify the detail of EU Taxonomy-related fund pre-contractual disclosures and periodic reporting under Level 2 Taxonomy. The EU Taxonomy-related disclosure requirements will follow a prescribed template and form part of an “annex” to the relevant prospectus/fund supplement and periodic reports which will contain all relevant SFDR and EU Taxonomy-related information. Details of the Level 2 mandatory disclosure templates are set down in the Taxonomy Disclosures Draft RTS published by the ESAs on 22 October 2021<sup>22</sup>.

## What are the applicable deadlines?

### Level 1 Taxonomy Disclosures

The prospectus and periodic disclosure obligations applicable to In-Scope Funds are due to apply from **1 January 2022** in respect of the environmental objectives of climate change mitigation and climate change adaptation. Our understanding is that any periodic report of an In-Scope Fund published in 2022 will be required to incorporate required Taxonomy-related disclosures, regardless of the reference period covered by such periodic reports.

From **1 January 2023**, the prospectus and periodic reports of In-Scope Funds which invest in economic activities that contribute to the remaining four environmental objectives (being (i) the sustainable use and protection of water and marine resources, (ii) the transition to a circular economy, (iii) pollution

<sup>21</sup> The SFDR Level 2 disclosure requirements were set out in the ESA’s [Final Report](#) on draft Regulatory Technical Standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a(3), Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088 JC 2021 03 2, February 2021.

<sup>22</sup> Final Report on draft Regulatory Technical Standards with regard to the content and presentation of disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088, JC 2021 50, 22 October 2021.

prevention and control and (iv) the protection and restoration of biodiversity and ecosystems) will be required to incorporate relevant disclosure obligations imposed under Article 5 and Article 6 of the Taxonomy Regulation as applicable.

## Level 2 Taxonomy Disclosures

Fund management companies with In-Scope Funds will be required to update their prospectuses to address the detailed disclosure obligations which will be set down in a Commission Delegated Regulation **from 1 January 2023** in respect of all six environmental objectives.<sup>23</sup>

## What should be the approach where there is insufficient data available to disclose quantitative information on EU Taxonomy alignment as at 1 January 2022?

There is a lack of clarity on how In-Scope Funds should meet the Level 1 Taxonomy alignment quantitative disclosure obligations as of 1 January 2022. This uncertainty stems from a number of issues:

- (i) The TSC for determining the conditions under which a specific economic activity qualifies as environmentally sustainable in the context of the environmental objectives of climate change mitigation and climate change adaptation remain in draft form and have not yet been published in the Official Journal of the EU. Additional supplementary TSC covering sectors including agriculture, natural gas and nuclear energy are expected to be proposed by the end of 2021 with the publication of same having been delayed due to political negotiation. Without the TSC being finalised, it is not possible to ascertain conclusively that an investment constitutes an “environmentally sustainable investment” within the meaning of the Taxonomy Regulation;
- (ii) The detailed methodology to be used to calculate the degree of In-Scope Funds’ EU Taxonomy alignment was only published on 22 October 2021 in the form of the Taxonomy Disclosures Draft RTS. The Commission now has three months to consider whether they will endorse the Taxonomy Disclosures Draft RTS, which means that an element of uncertainty remains as to the finalised calculation methodology to be used;

- (iii) There will continue to be a sparsity of EU Taxonomy-related data being published by NFRD Investee Companies. This is due to the fact that, under the draft Delegated Act published pursuant to Article 8 of the Taxonomy Regulation (the “**Article 8 Taxonomy Regulation Delegated Act**”), financial and non-financial undertakings which constitute NFRD Investee Companies only need to disclose on EU Taxonomy eligibility (rather than EU Taxonomy alignment) of their business activities for reports published in 2022 covering the reporting period 2021, with the requirement to publish EU Taxonomy-alignment disclosures only being phased in for non-financial NFRD Investee Companies from 1 January 2023 and from 1 January 2024 for financial undertaking NFRD Investee Companies. Fund management companies with In-Scope Funds are also experiencing difficulties in obtaining appropriate data on the EU Taxonomy alignment of investments which are issued by investee companies which do not fall within the scope of the NFRD (i.e. EU SME investee companies and non-EU investee companies).

## What approach is being taken by fund management companies of In-Scope Funds as regards Level 1 Taxonomy Disclosures?

As a result of the issues outlined above, it may be that, as at 1 January 2022, fund management companies with In-Scope Funds conclude that, in the absence of reliable and comparable investee company EU Taxonomy alignment reporting and a methodology which has been agreed by the Commission for doing so, it will not be possible for them to disclose any quantitative information on EU Taxonomy alignment of these funds. These fund management companies may seek to address the quantitative disclosure obligations as at 1 January 2022 by issuing qualitative, principle-based pre-contractual disclosures for their funds in the form of an explanation to investors that there is insufficient data available for them to be able to assess investments using the TSC and they are therefore not currently in a position to perform the calculation necessary to make the quantitative disclosures. Having been approached by industry on the use of such an explanation, the

<sup>23</sup> The original intention had been that the Level 2 Taxonomy disclosures would apply from 1 January 2022 with respect to the first two climate-related environmental objectives. On 8 July 2021, the Commission delayed the application date to 1 July 2022. On 25 November 2021, the application date was further delayed to 1 January 2023. The Taxonomy Disclosures Draft RTS specify that the RTS will apply with respect to the latter four environmental objectives from 1 January 2023, so it would now appear, subject to further communications from the Commission, that the Level 2 Taxonomy will apply with respect to all six environmental objectives from 1 January 2023.

Central Bank has simply confirmed that the manager of In-Scope Funds must confirm to the Central Bank in writing that the relevant disclosures comply with the provisions of the Taxonomy Regulation.

An alternative option for fund management companies with In-Scope Funds may be to disclose 0% EU Taxonomy alignment or to disclose another percentage of EU Taxonomy alignment based on estimated data. If a fund management company decides to disclose a commitment of 0% to EU Taxonomy alignment, it may want to consider including appropriate qualitative disclosures alongside this figure to explain why it is only committing to 0% taxonomy alignment at this juncture.

In the absence of reliable and comparable investee company reporting and a finalised calculation methodology, it may be that fund management companies are not in a position to disclose estimated quantitative information on EU Taxonomy alignment in a uniform and comparable manner. It will certainly be extremely challenging for fund management companies to obtain accurate and comparable estimated data on EU Taxonomy alignment at short notice in light of the delay in the Commission adopting the Taxonomy Disclosures Draft RTS and the delay in finalising the TSC applicable to climate change mitigation and climate change adaptation.

In each case, fund management companies with In-Scope Funds should keep the disclosures under review and ensure that such disclosures are updated to include the requisite quantitative information once sufficient reliable, timely and verifiable data becomes available.

## What type of disclosures could be made to explain a low level of EU Taxonomy alignment (e.g. in respect of investment in economic activities not yet covered by the framework)?

Fund management companies may wish to include some additional wording to explain the low level of EU Taxonomy alignment, for example explaining to investors that the TSC currently cover only two of the six environmental objectives and, even within these two objectives, there may be scope for further expansion of the economic activities included in the EU Taxonomy framework.

## Is it possible to rely on estimates in order to calculate the level of EU Taxonomy alignment within a portfolio?

This is not entirely clear.

A recital to the Taxonomy Regulation itself refers to FMPs being able to make “*complementary assessments and estimates on the basis of information from other sources*” only in “*exceptional cases*” and specifically relates to non-NFRD Investee Companies.

However, Recital 6 to the Taxonomy Disclosures Draft RTS provides that, where an NFRD Investee Company does not yet disclose its EU Taxonomy-aligned activities, third party data providers may be relied upon.

Recital 6 goes on to provide that for those undertakings which do not constitute NFRD Investee Company (i.e. those entities which do not fall within the scope of Article 8 of the Taxonomy Regulation which includes non-EU issuers and EU SMEs), public reporting of data should be prioritised. This should be followed by “*privately obtained data, either directly from investee companies or from third parties, in each case provided the information is equivalent to the disclosures made in accordance with that Article*”.

Obtaining data from investee companies or Data Vendors which is “*equivalent*” to the information which will need to be reported by NFRD Investee Companies represents a significant challenge for FMPs. Fund management companies will need to satisfy themselves that the data being reported by third party data providers (where this information is not based on publicly reported data published by the relevant undertaking) is “*equivalent*” to that which must be reported under Article 8 of the Taxonomy Regulation.

To the extent that quantitative data on the EU Taxonomy alignment of a portfolio is being disclosed in fund documentation, appropriate disclosure regarding the reliance on equivalent information (whether such equivalent information is provided by third parties or based on information directly obtained from NFRD Investee Companies) should be provided to investors in the pre-contractual disclosures and annual reports of all In-Scope Funds.

Fund management companies should engage as early as possible with Data Vendors in order to give themselves adequate time to carry out due diligence and where

applicable, to allow data feeds provided by such data providers to be integrated into their systems.

## What EU Taxonomy-related disclosures could fund management companies with Article 8 funds and Article 9 funds falling outside of the scope of Article 5, 6 and 7 of the Taxonomy Regulation consider making?

Article 8 funds that do not commit to investing in sustainable investments with environmental objectives or which promote social (but not environmental) characteristics, and Article 9 funds which contribute to a social (but not an environmental) objective, will not fall within the scope of Article 5, 6 or 7 of the Taxonomy Regulation. Managers of such funds may voluntarily decide to include in the fund prospectus a form of disclaimer similar to that mandated for use by Article 6 funds pursuant to Article 7 of the Taxonomy Regulation, or in the case of funds promoting social characteristics or social objectives, an explanation that social objectives are not yet covered by the EU Taxonomy framework.

## Does the website of the manager need to be updated to include any Taxonomy-related information?

Yes. The website of any fund management company with In-Scope Funds must be updated to include the EU Taxonomy-related information which is incorporated into the prospectus of each In-Scope Fund.

## If the pre-contractual disclosures specify an EU Taxonomy-aligned environmental objective that the fund targets, does this need to be reflected within fund objectives or is it sufficient if it is generally aligned with existing fund objectives?

There is nothing in the text of the Level 1 Taxonomy or in the Taxonomy Disclosures Draft RTS which provides that the investment objective of any Article 9 fund must specifically reference the relevant environmental objective in the investment objective itself, nor have the ESAs or the Central Bank of Ireland (“**Central Bank**”) published any guidance on this specific point. In the absence of such guidance from relevant authorities, it would seem reasonable that an Article 9 fund could be considered to contribute to an environmental objective under the Taxonomy Regulation without being required to include specific reference to that environmental objective in the fund’s investment objective. By way of

example, an Article 9 fund’s investment objective may reference the broader UN Sustainable Development Goals, while its investment policy goes on to identify the specific Taxonomy environmental objective(s) the fund is contributing to.

## Will shareholder approval or shareholder notification be required in respect of the updates being made to the prospectus/fund supplement to include EU Taxonomy-related information?

It is not expected the initial disclosure of the proportion of EU Taxonomy-aligned investments within an In-scope Fund in pre-contractual disclosures would require shareholder approval or advance shareholder notification. If, however, this disclosure would give rise to a change in the way the fund is managed, the usual rules around whether investor approval/notification is required would need to be considered, including whether this amounts to a material change to the investment policy of the relevant fund.

## If the EU Taxonomy alignment of a portfolio falls below the minimum level of EU Taxonomy alignment disclosed in the prospectus/fund supplement, is there an obligation to sell non-aligned securities and replace with aligned securities in the same way as a breach of a statutory investment restriction?

The ESAs suggest in their final report containing the Taxonomy Disclosures Draft RTS that the proportion of EU Taxonomy-aligned investments detailed in pre-contractual disclosures are intended to be “commitments” and have described such pre-contractual disclosures as “binding” in a letter to the Commission dated 22 October 2021 . If considered a “commitment” rather than a regulatory investment restriction, this would mean that such disclosures should not be considered subject to the obligation to remedy the situation as a priority objective taking due account of the interests of investors.

Fund management companies bear significant commercial/reputational risk associated with falling below the expected level of EU Taxonomy alignment disclosed in the pre-contractual disclosures as, in such circumstances, they would also be required under the Taxonomy Regulation to disclose underperformance

of the stated proportions in the periodic reports for the relevant fund. Therefore, it is recommended that a conservative estimate of the level of EU Taxonomy-alignment of the portfolio is included in the pre-contractual disclosures. In addition, fund management companies may also wish to engage with their depositary on how they intend treating the EU Taxonomy-related figures disclosed in the pre-contractual documents.

## Which asset classes/instruments can be considered for inclusion in the numerator when calculating the EU Taxonomy-alignment of a portfolio?

Under the Taxonomy Disclosures Draft RTS, the ESAs have suggested that when calculating the market value of EU Taxonomy-aligned investments of an In-Scope Fund, the market value of the following investments can be included in the numerator:

- (i) The market value of the proportion of debt securities or equities of investee companies which are associated with EU Taxonomy-aligned economic activities;
- (ii) The market value of the proportion of green bonds (other than those green bonds which satisfy the EU Green Bond Standard) which are used exclusively on EU Taxonomy-aligned economic activities;
- (iii) The market value of EU green bonds issued under EU legislation on environmentally sustainable bonds;<sup>24</sup>
- (iv) The market value of investment in real estate assets which qualify as EU Taxonomy aligned economic activities;
- (v) The market value of investment in infrastructure assets which qualify as EU Taxonomy-aligned economic activities;
- (vi) The market value of the proportion of underlying exposures of securitisation positions in EU Taxonomy-aligned economic activities; and
- (vii) The market value of the proportion of financial products falling within the scope of Article 5 or Article 6 of the Taxonomy Regulation representing the EU Taxonomy alignment of investments.

## What KPI must be used when calculating the EU Taxonomy alignment of an investee company?

In the Taxonomy Disclosures Draft RTS, the ESAs have proposed that, for pre-contractual disclosures, the EU Taxonomy-alignment of investments in non-financial investee companies should be calculated using one Taxonomy key performance indicator (“KPI”) per financial product, which is turnover by default. However, the Taxonomy Disclosures Draft RTS permit the use of either capital expenditure (“Capex”) or operational expenditure (“Opex”) when justified by the features of the relevant fund. For the disclosures contained in the periodic reports, all three Taxonomy KPIs (i.e. turnover, Capex and Opex) must be used.

## When calculating the level of EU Taxonomy alignment within a portfolio, is there a specific date with reference to which the calculation should be performed?

Unlike the position taken for Principal Adverse Indicators (“PAI”) reporting under Article 4 of the SFDR, the Taxonomy Disclosures Draft RTS do not set down any specific requirements around the date with reference to which the calculation should be performed. It would therefore seem to be open to each fund management company to decide whether to use a snapshot of the portfolio at a specific point in time or to use a weighted average approach over a period of time in order to perform their EU Taxonomy-related calculations. Fund management companies may want to consider explaining the approach taken in the disclosures included in the fund prospectus/periodic reports.

## How can a fund management company satisfy itself that an EU Taxonomy-aligned investment satisfies the DNSH test imposed under the Taxonomy Regulation?

Under the Taxonomy Disclosures Draft RTS, a dual assessment must be carried out by the fund management company to be satisfied that the DNSH test has been met by the relevant investment.

Firstly, the relevant investment must meet the DNSH TSC set down in the relevant Commission Delegated Regulation for the economic activity carried out by the investee company. In addition to this, the management

<sup>24</sup> This legislative initiative is often referred to as the EU Green Bond Standard.

company must also take into account the indicators for adverse impacts set down in Table 1 in Annex I of the draft SFDR RTS published on 2 February 2021. The second test introduces a significant element of subjectivity and, according to the ESAs in their letter to the Commission dated 22 October 2021 will “*result in a significant increase of the requirements on investments in taxonomy-aligned economic activities compared to other sustainable investments*”. There are concerns amongst industry that the application of this two-step test may result in a reduced investible universe for In-Scope Funds. Fund management companies are also considering how they will create a governance framework for the assessment to be carried out by them when determining whether an investment complies with the DNSH criteria set down in Table 1 in Annex I of the draft SFDR RTS.

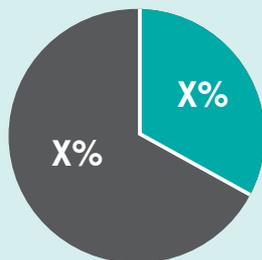
## When calculating the level of EU Taxonomy-alignment of an individual portfolio, can exposure to sovereign bonds be considered?

In the Taxonomy Disclosures Draft RTS, the ESAs suggest that In-Scope Funds must carry out (and disclose) two separate calculations when determining the EU Taxonomy-alignment of the relevant portfolio. The first calculation must include all investments, including those in sovereign exposures. The second calculation must include all investments excluding sovereign exposures, in recognition of the fact that there is currently no appropriate calculation methodology to assess the EU Taxonomy alignment of sovereign exposures. Sovereign exposures are defined as any “*exposure to central governments, central banks and supranational issuers*” for this purpose.<sup>25</sup>

The two graphs below show in green the minimum percentage of investments that are aligned with the EU Taxonomy. As there is no appropriate methodology to determine the Taxonomy-alignment of sovereign bonds\*, the first graph shows the Taxonomy-alignment in relation to all the investments of the financial product including sovereign bonds, while the second graph shows the Taxonomy-alignment only in relation to the investments of the financial product other than sovereign bonds.

### 1 Taxonomy-alignment of investments including sovereign bonds\*

- Taxonomy-aligned
- Other Investments



### 2 Taxonomy-alignment of investments excluding sovereign bonds\*

- Taxonomy-aligned
- Other Investments



Extract from Annex II to Taxonomy Disclosures Draft RTS

\*For the purpose of these graphs, 'sovereign bonds' consist of all sovereign exposures

<sup>25</sup> The second calculation (which excludes sovereign exposures) is consistent with the approach taken for financial undertakings falling within the scope of Article 8 of the Taxonomy Regulation, where the Article 8 Taxonomy Regulation Delegated Act confirms that it is not currently possible for financial undertakings to take into account exposure to sovereign bonds in either the numerator or the denominator of the relevant KPI.

## Can exposure to non-EU entities be considered when calculating the level of EU Taxonomy-alignment of an individual portfolio?

The Taxonomy Disclosures Draft RTS do not preclude exposures to non-EU issuers from being considered EU Taxonomy-aligned activities.

It is worth noting that in the Article 8 Taxonomy Regulation Delegated Act, the Commission provides that, for the purposes of disclosing how and to what extent their activities are associated with environmentally sustainable economic activities, financial NFRD Investee Companies cannot classify exposures to non-EU issuers as being EU Taxonomy-aligned (and therefore cannot be included in the numerator) while such exposures must be included in the denominator of such calculations (i.e. the figure used to calculate total assets of the institution).

## When performing EU Taxonomy calculations for an In-Scope Fund, is it possible to distinguish between investments in: (i) economic activities within scope of the current EU Taxonomy which do not meet the relevant TSC applicable to the economic activity of the underlying undertaking; and (ii) economic activities which are not covered yet by the EU Taxonomy framework?

Under the Taxonomy Disclosures Draft RTS, there is no distinction drawn between the above categories of investments. In both cases, such investments cannot be considered to constitute an “environmentally sustainable investment” within the meaning of Article 3 of the Taxonomy Regulation.

This differs from the approach taken by the Commission in the Article 8 Taxonomy Regulation Delegated Act which introduces, for the first phase of reporting obligations applicable to in-scope financial undertakings, the concept of “EU Taxonomy Eligible Activities”<sup>26</sup>. Under this approach, NFRD Investee Companies must provide information on the proportion of EU Taxonomy-eligible activities in relation to total activities for the period from 1 January 2022 to 31 December 2022.

In a letter to the European Commission dated 22 October 2021<sup>27</sup>, the ESAs advised that they did not believe that the approach of providing “EU Taxonomy-eligible disclosures” instead of EU Taxonomy-aligned disclosures was appropriate “*for financial products marketed to investors on the basis of Taxonomy-aligned investments due to concerns about the potential investor detriment arising from the cliff effects of switching back to EU Taxonomy-aligned investment disclosures at a certain point in time*”.

## Should fund management companies be getting their EU Taxonomy statement reviewed by a third party?

At this stage, there is no requirement for EU Taxonomy-related fund disclosures to be assured by an auditor or reviewed by a third-party. However, under Level 2 Taxonomy, fund management firms will be required to disclose in EU Taxonomy-related pre-contractual disclosures and periodic reporting whether the statement will be subject to an assurance provided by an auditor or a review by a third party and, if so, the name of that auditor or third party. Whilst fund management companies may choose to obtain assurance over these statements for commercial reasons, this will be a matter for each individual fund management company to decide on.

## Are there any specific distribution considerations which should be borne by fund management companies of In-Scope Funds?

From 2 August 2022, EU distributors which offer the services of portfolio management and/or investment advice to their clients will be required to obtain information about their client’s “sustainability preferences” as part of their suitability assessment. This will include establishing whether, and if so, to what extent, the relevant fund being offered to the client should include one or more of the following:

- (i) A minimum proportion of investment in “environmentally sustainable investments” within the meaning of the Taxonomy Regulation;
- (ii) A minimum proportion of investment in “sustainable investments” within the meaning of the SFDR; or

<sup>26</sup> “EU Taxonomy Eligible Activities” are described by the Commission as referring to the share of economic activities that are described in the relevant Commission’s delegated acts, but that do not yet meet the relevant TSC.

<sup>27</sup> Accessible on the [Irish Funds Members’ Portal](#).

(iii) A consideration of the PAI of investment decisions on sustainability factors (where the client determines the relevant qualitative or quantitative elements to be satisfied in such circumstances).

Therefore, to the extent that a client of an in-scope EU distributor indicates that it only wants to invest in a fund which has committed to invest a specific proportion in EU Taxonomy-aligned investments, the EU distributor cannot offer any fund which does not commit to investment in EU Taxonomy-aligned investments. This is notwithstanding the fact that the relevant fund is not required to meet any minimum investment proportions in order to be classified as a fund which either promotes environmental characteristics under Article 8 of the SFDR or which contributes to an environmental objective under Article 9 of the SFDR. This is a consideration which needs to be borne in mind by fund management companies when considering their distribution strategy and portfolio allocation for Article 8 funds and Article 9 funds going forward.

## What steps should fund managers take to implement the Taxonomy Regulation?

Whilst the approach taken by each firm will be specific to that firm, there are some common insights emerging from practitioners engaged in the implementation of the Taxonomy Regulation. The following step plan sets out common themes across the industry:

### Step 1: Governance

Each firm will need to identify internal responsibilities for interpretation and implementation (both initial and ongoing) of the Taxonomy Regulation. Firms should ensure that management are aware of the regulatory requirements and that appropriate oversight and resources are allocated. An early view on whether internal resources are available to gather data from companies directly or whether to use external data providers is likely to help inform the process. Expectations should be managed regarding the challenges of reaching EU Taxonomy alignment for financial products at this stage, given the lack of data and the current low levels of alignment within the real economy.

### Step 2: Scope

The function responsible for interpretation of the evolving Taxonomy Regulation should familiarise itself with the requirements and assess the scope of its application to the firm's financial products.

### Step 3: Methodology

The firm must develop its approach to assessing EU Taxonomy alignment for financial products falling within scope. The first step is likely to be an assessment of the data already accessible, and the extent to which this can be used to assess EU Taxonomy alignment. Where there are gaps, targeted data acquisition will be required, either through third-party providers, proprietary analysis or engagement with investee companies on disclosure. Given the granularity of the TSC, particularly in relation to the DNSH requirement, assessment of EU Taxonomy alignment will require appropriate expertise and detailed analysis at the level of individual investee companies.

### Step 4: Implementation

Create or leverage existing infrastructure to establish the required processes. In particular, the Taxonomy Regulation has implications for product disclosures, ongoing investment analysis and periodic reporting. Taxonomy Regulation obligations will be an ongoing requirement, and consideration should be given as to how these will be integrated into 'business as usual' activity in order to reduce the ongoing costs and resources required.

## What are the implications of non-compliance?

The Central Bank is tasked with monitoring the compliance of Irish-regulated UCITS management companies and AIF managers ("AIFMs") with the disclosure obligations set down under the Taxonomy Regulation.

Failure on the part of an Irish regulated AIFM or UCITS management company to comply with the disclosure obligations set down in the Taxonomy Regulation may lead to the Central Bank invoking its administrative sanctions regime against any such entity. Under this regime, the Central Bank has a range of powers, including the ability to impose a fine for failure to comply with applicable disclosure obligations.

## How does the Taxonomy Regulation interact with the SFDR?

As noted above, the Taxonomy Regulation amends the SFDR by requiring specific disclosures for Article 6, Article 8 and Article 9 SFDR products relating to EU Taxonomy alignment. The product categorisation under the SFDR (Article 6, 8 or 9) will determine the relevant article of the Taxonomy Regulation with which the FMP must comply.

It is worth noting that “sustainable investments” as defined under Article 2(17) of the SFDR represent a broader range of investments than “environmentally sustainable economic investments” under the Taxonomy Regulation. The SFDR defines a sustainable investment as an investment in an economic activity that contributes to an environmental or social objective, provided that the investment does not significantly harm any environmental or social objective and that the investee companies follow good governance practices. The recitals to the Taxonomy Regulation note that the definition of “sustainable investment” in the SFDR includes investments in economic activities that contribute to an environmental objective, which, amongst others, should include investments in economic activities that contribute to an environmental objective with the meaning of the Taxonomy Regulation. The Taxonomy Regulation seeks to distinguish Taxonomy-aligned investments from the broader category of sustainable investments by referring to “environmentally sustainable investments”.

Due to the wider definition of “sustainable investment” in the SFDR and the fact that EU Taxonomy-aligned investments are a sub-set of sustainable investments, it would be possible to have an Article 9 SFDR that has 0% Taxonomy-alignment, for example where the fund has a social objective only, or where its investments contribute to other environmental objectives not set out in the Taxonomy Regulation, including, in the first year of application of the regulation, the latter four environmental objectives set out in the Taxonomy Regulation.

## How does the Taxonomy Regulation interact with the CSRD?

The NFRD currently sets out rules regarding the disclosure of non-financial information by large public-interest companies, in particular requiring them to publish information related to environmental and social matters. The NFRD only applies to a limited set of large companies but, on 21 April 2021,<sup>28</sup> the Commission adopted its proposal<sup>29</sup> for the CSRD, which will replace the NFRD and extend the scope of the reporting obligations to all large companies and all companies (including SMEs) listed on regulated markets (except listed micro-enterprises).<sup>30</sup> The CSRD aims to provide greater transparency and more comparable and standardised information on how companies perform from a sustainability perspective. The reporting standards to be developed under the CSRD will specifically include the ESG reporting metrics in respect of the SFDR and the Taxonomy Regulation. These reporting standards are currently being developed and it is expected that a first set of standards will be adopted by October 2022. This information is essential for funds and asset managers seeking to integrate ESG considerations into their investment decisions and to comply with their obligations under the EU sustainable finance regime.

Under the proposal, the changes will impact on the 2023 reporting period and companies in scope will be required to provide the broad range of new reporting requirements by 1 January 2024. Companies will be subject to an annual reporting requirement under the CSRD thereafter.

It is envisaged that the CSRD reporting requirements will support compliance with both SFDR and the Taxonomy Regulation because it will require companies to report the information that FMPs (as investors in those companies) need to reference when fulfilling their reporting duties under both disclosure regulations. Specifically, Article 8 of the Taxonomy Regulation requires NFRD Investee Companies, including those who will be brought within its scope by the CSRD, to report on the extent to which their economic activities qualify as environmentally sustainable under the Taxonomy Regulation.

<sup>28</sup> See Commission [press release](#) dated 21 April 2021.

<sup>29</sup> See [COM\(2021\) 189 final](#), 21 April 2021.

<sup>30</sup> It is estimated that the number of entities affected by this extension of scope will increase roughly fivefold from the current NFRD scope of 11,000 companies to 50,000 companies in the EU.

Financial and non-financial undertakings which constitute NFRD Investee Companies only need to disclose on EU Taxonomy eligibility (rather than EU Taxonomy alignment) of their business activities for reports published in 2022 covering the reporting

period 2021, with the requirement to publish EU Taxonomy-alignment disclosures only being phased in for non-financial NFRD Investee Companies from 1 January 2023 and from 1 January 2024 for financial undertaking NFRD Investee Companies.

## Does data availability present a significant challenge?

In October 2021, Irish Funds conducted a survey of current Taxonomy KPI solutions on the market from Data Vendors to assess their level of readiness to meet upcoming regulatory deadlines, as set out in Appendix 1.

Irish Funds reached out to eleven Data Vendors, both established and emerging, and provided them with a sample of seven securities issued by investee companies and two sovereign bonds (together known as the “Sample Portfolio”). Irish Funds analysed the data provided and assigned a Red Amber Green (**RAG**) rating on the basis for coverage.

The outcome of this exercise raises significant concerns relating to data availability. Only three Data Vendors responded to the research request and in each instance incomplete data was provided. This poor result indicated that currently there is limited data available to support a comparative analysis on the basis of both the coverage

universe and vendor options. All Taxonomy KPIs were rated Red given the lack of response and low quality of data provided by the Data Vendors. It is important to note that the data analysed refers to vendor data available up to October 2021. Overall, all vendors appear to be struggling with assessing the eligibility of activities due to the lack of relevant reporting. It is clear that the general readiness of the data around EU Taxonomy reporting is limited, although data quality is expected to improve in the first 1-2 years of the Taxonomy Regulation’s application as more and higher quality data becomes available.

The table below sets out the questions Irish Funds presented to the Data Vendors with the aim of comprehending Data Vendors’ methodology on data gathering and assessment. It should be borne in mind that at the time we issued these questions to the Data Vendors, the ESAs had not yet clarified that the PAI indicators should additionally be applied to the DNSH test for EU Taxonomy alignment.

	Question	Response from Data Vendors
<b>EU Taxonomy eligibility</b>	Are Data Vendors building bespoke systems geared to the EU Taxonomy scope or repurposing existing tools that may have a different scope? If the latter, what is the difference in scope and sectors that may differ between the EU Taxonomy and the tool?	Data Vendors are taking the initiative by designing new bespoke tools geared solely towards EU Taxonomy regulatory reporting. Providers are focused on being flexible and providing a responsive breakdown of the different types of ESG datasets based on clients’ ESG needs, giving clients the ability to integrate their reporting based on their obligations and type of funds.
<b>EU Taxonomy alignment</b>	What is the Data Vendor’s approach to assessing EU Taxonomy alignment in the absence of any reported data? Are estimates purely for turnover or do they also cover Capex, green bonds, etc?	<p>Currently, the absence of complete data is a challenge for Data Vendors. As companies are not reporting granular breakdowns of their EU Taxonomy-aligned activities, some Data Vendors must rely excessively on estimates for their universe coverage, testing specific TSC. Other Data Vendors may not use any estimates, leading to a very small coverage universe.</p> <p>The common action taken by Data Vendors is using their processes to estimate values based on already published data and proxies. As revenue is mainly reported in one business category, Data Vendors appear to be leveraging their estimation using revenues, CapEx, Opex and the collection of documents to correlate and break down financial figures to a specific activity aligned to ESG objectives.</p> <p>Data Vendors provided the following example of this approach - for a company not bifurcating revenue by segment, in part or in whole, relevant business segments are identified. Next, any other activities in that segment(s) are identified and considered in order to calculate an estimated percentage of revenues attributable to the segment, noting that these estimations come with a confidence level across Data Vendors. Data Vendors then estimate the percentage revenue for that company using a combination of modelling and peer assessment.</p>

	Question	Response from Data Vendors
<b>DNSH</b>	What is the Data Vendor's approach to assessing DNSH? Is it based on ESG research or ESG controversies or more tailored to the EU Taxonomy DNSH? Does the Data Vendor give a clear pass/fail or leave it to the user to determine?	<p>Data Vendors' approach to evaluating DNSH includes both proprietary data points specifically tailored to the EU Taxonomy and a controversy-based framework in search of adverse impact based on the nature and scale of the harmful activity.</p> <p>With limited guidance provided in relation to proxies, Data Vendors are interpreting what future proxies could be that are not captured in the current list of proxies. For example, Data Vendors propose to integrate ESG raw data metrics on lawsuits and grievances as a proxy to identify companies that are potentially falling short of the EU Taxonomy's DNSH criteria.</p> <p>Accompanied with a pass/fail assessment, clients will be able to identify entities that meet EU Taxonomy DNSH and those who do not, thus a significant value add for clients in excluding companies with significant controversies relating to environmental issues.</p>
<b>Minimum Safeguards</b>	What is the Data Vendor's approach to assessing Minimum Safeguards?	Data Vendors are generating specific signals for clients to identify entities that meet or do not meet the Minimum Safeguard assessment. The overall approach amongst Data Vendors to assess Minimum Safeguards includes both entity- and activity-level use of existing screens for Global Compact and social standards compliance such as ILO, United Nations Guiding Principles, United Nations Global Compact, and the Organisation for Economic Co-operation and Development Guidelines. However, even in this case, there are significant differences in the lists of Global Compact violators. This is a known issue in the investment management industry.
<b>Usability and reporting</b>	Does the Data Vendor allow for portfolio reporting in addition to asset-level information? Can the Data Vendor provide portfolio reporting, breaking down the data by transition/enabling?	Usability and accessibility are applicable to both portfolio-level and asset-level reporting with granular breakdowns of results per objective (Climate Change Mitigation / Adaptation) and per activity type (green, enabling, transition) at an aggregated level.

## How reliable are data solutions?

Driven by both investor demand and the need for compliance with regulations, the increased need for ESG data is being addressed by a range of providers from established players to innovative start-ups. Whilst the use of this data can support sustainable investment, poor quality data can lead to unintentional or intentional greenwashing, misallocation of capital and reputational damage. Currently there are no specific regulations that apply to the provision of ESG- or sustainability-related data, as it is not considered to constitute investment advice or recommendations but rather guidance<sup>31</sup>.

In a market that is a currently unregulated, juxtaposed to regulation on accounting standards like the International Financial Reporting Standards or IFRS, this has led to concerns from stakeholders about quality, transparency and potential conflicts of interests with increasing calls for regulatory oversight.

Progress toward the regulation of ESG data has been evolving for some time and continues to gather support across the market. As part of the Action Plan, a study<sup>32</sup> was commissioned on sustainability ratings and research. Published in January 2021, the study included a review of methodologies and independence

<sup>31</sup> [Study on sustainability-related ratings, data and research](#) European Commission, November 2020.

<sup>32</sup> [Study on sustainability-related ratings, data and research](#) European Commission, November 2020.

of ESG data providers. It highlighted some common stakeholder concerns, and how regulation might address them. Specific concerns included:

- Lack of transparency around calculation methodologies, data sources and weighting, hampering comparability and understanding of ratings;
- Reliability of data, and level of engagement with a company to ensure accuracy;
- Estimation standards and methodologies;
- Clear and consistent terminology;
- Whether published ratings and products are consistent with internal methodologies;
- Potential conflicts of interest where a provider may supply a range of services in addition to ESG ratings including provision of second party opinions, insight into how ESG products are developed and advice on how to improve ESG ratings.

In July 2021, the Commission issued an update to its sustainable finance action plan, “Strategy for Financing the Transition to a Sustainable Economy”<sup>33</sup>, which included a proposal for a public consultation on ESG rating regulation. This follows on from a position paper by the French and Dutch Regulators (AMF/AFM)<sup>34</sup> on the topic, the Commission Study on Sustainability-Related Ratings, Data and Research<sup>35</sup> mentioned above and a letter from ESMA to the Commission<sup>36</sup> calling for legislative action on ESG ratings. Many themes discussed in these papers were echoed in a recent IOSCO review<sup>37</sup> that considered potential regulatory requirements for the ESG data industry.

Common elements addressed in the various papers included:

- **Framework:** The call for a fit-for-purpose mandatory regulatory framework, which is adaptable to the size of various players in the market and does not inhibit innovation. This could include a certification system, a supervisory body (with a proposal for ESMA to fill this role) and a legal definition for ESG ratings that captures the spectrum of products available.

- **Transparency:** Transparent methodologies including assessment criteria, data sources and overall objectives of the rating, together with any limitations users should be aware of, with a view to enhancing comparability between ESG ratings. Developing consistent terminology, mindful of existing regulation (e.g. Taxonomy Regulation) was also recommended.
- **Accountability:** Engagement with companies to ensure accurate and timely information, consideration of materiality and risk of bias.
- **Level Field:** Development of codes of conduct, internal controls and governance to ensure consistent quality services and appropriate management of conflicts of interests, including disclosure of relevant policies.
- A recommendation that providers offering services to European companies should operate through a legal entity registered and supervised within the EU.

## What are the assurance options to address data reliability concerns?

From 2023, the CSRD will introduce a requirement for limited assurance<sup>38</sup> to be provided on reported sustainability information with the longer-term objective of moving towards reasonable assurance<sup>39</sup> in line with financial reporting. In the interim, challenges regarding data accuracy and reliability abound, which can be mitigated by assurance of Taxonomy KPIs reported.

Assurance should comply with International Standard on Assurance Engagements (“**ISAE**”) 3000 (revised), issued by the International Audit and Assurance Standards Board (“**IAASB**”). This standard can be applied for assurance of internal controls, sustainability and compliance with laws and regulations, providing sufficient flexibility to determine the scope, including the extent of controls testing and choosing appropriate testing methods.

Acute challenges are expected in the early stages of reporting against the Taxonomy Regulation.

<sup>33</sup> [Strategy for Financing the transition to a sustainable economy](#) European Commission, 6 July 2021.

<sup>34</sup> [Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related services](#) AMF / AFM, 15 December 2020.

<sup>35</sup> [Study on sustainability-related ratings, data and research](#) European Commission, November 2020.

<sup>36</sup> ESMA Letter to Commissioner Mairead McGuinness, 28 January 2021.

<sup>37</sup> [Environmental, Social and Governance \(ESG\) Ratings and Data Products Providers Final Report](#) IOSCO, November 2021.

<sup>38</sup> Limited assurance engagements offer a moderate or low level of assurance regarding material misstatement, involve substantive testing and result in a negatively worded assurance conclusion, for example, “Nothing came to our attention to indicate...”.

<sup>39</sup> Reasonable assurance engagements offer a higher level of assurance regarding material misstatement, although not absolute assurance, involve substantive procedures along with testing of controls and result in a positively worded assurance conclusion.

Consequently, in the near-term, limited assurance options are likely to focus on substantive testing<sup>40</sup> of the Taxonomy KPIs reported, examining supporting documentation for completeness, validity and accuracy.

In the medium- to long-term, as data processing of companies increases in sophistication and reliability, the focus is likely to shift towards reasonable assurance,

involving testing of the control environment.

By assuring the control environment, assurance providers will evaluate the suitability of the design, existence and effectiveness of controls and the weight of substantive testing will decrease, becoming restricted to samples.

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<sup>40</sup> Substantive testing is an audit procedure that examines the financial statements and supporting documentation to see if they contain errors. These tests are needed as evidence to support the assertion that the financial records of an entity are complete, valid, and accurate.

## How might the EU Taxonomy be expanded in future?

In its recent update<sup>41</sup> to the sustainable finance action plan, the Commission made a number of commitments in relation to the future of the EU Taxonomy, including:

- a. Adoption of a second Taxonomy Regulation Delegated Act covering the remaining four environmental objectives (relating to water, biodiversity, pollution prevention and circular economy) in the first half of 2022;
- b. Potential extension of the EU Taxonomy "beyond green" to include significantly harmful ("SH") activities and no significant impact ("NSI") activities (both relating to environmental sustainability) within the overall EU sustainable finance framework; and
- c. Development of a Social Taxonomy including both vertical and horizontal dimensions. The vertical dimension focuses on products and services for basic human needs and basic infrastructure. The horizontal dimension takes into account impacts on different groups of stakeholders affected by economic activities (workers, consumers and communities). Sustainable corporate governance is regarded as setting the bar for environmental and social sustainability in economic entities. In this area, the focus is on topics including bribery, taxation and lobbying.

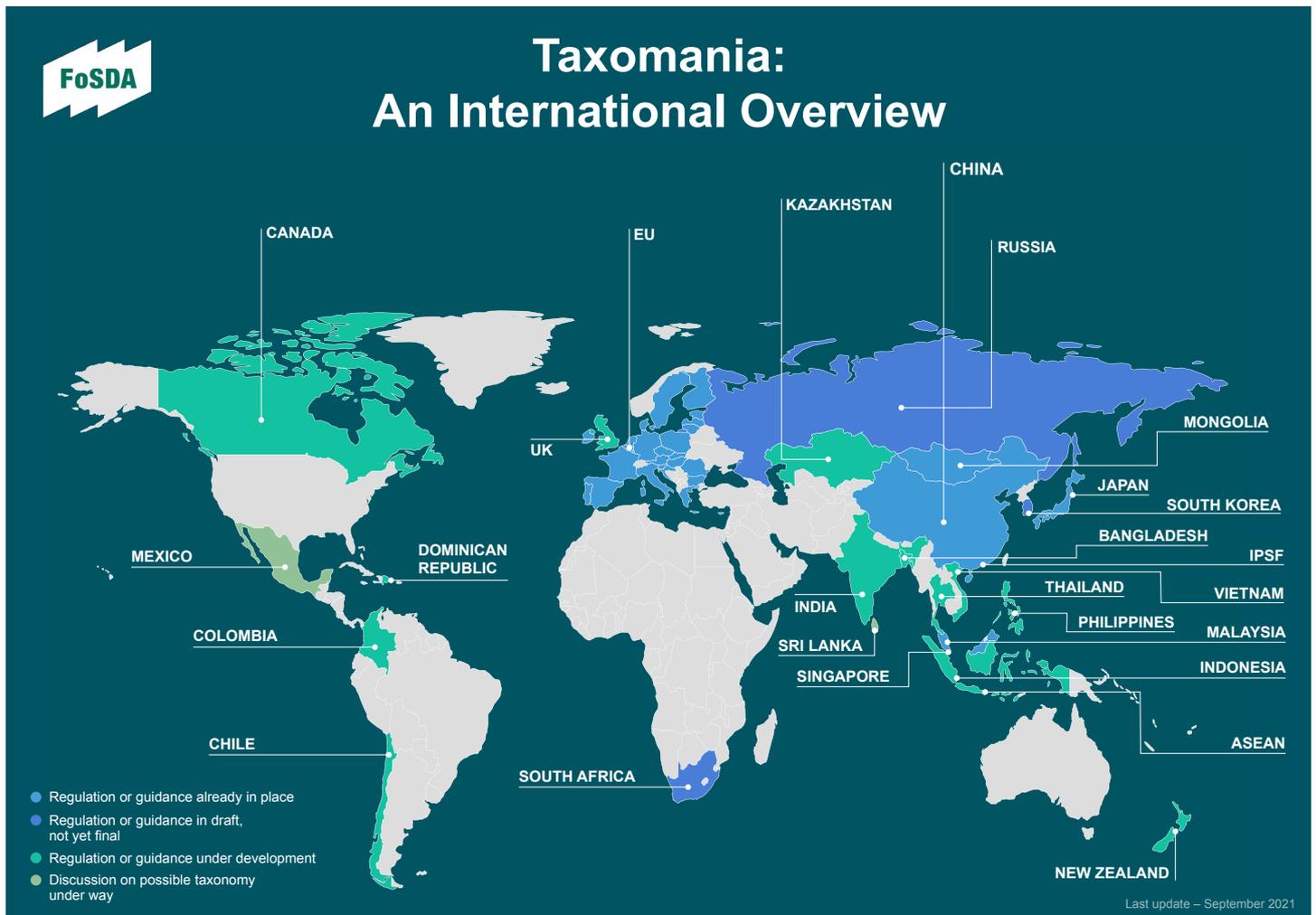
The EU Platform on Sustainable Finance ("PSF") is a permanent expert group of the Commission, established under Article 20 of the Taxonomy Regulation. It incorporates a balanced representation of sustainability experts from EU organisations, the financial industry, the corporate and public sector, as well as academia and civil society. Its role is to advise the Commission on tasks and topics related to implementation and further development of the EU Taxonomy.

Following a consultation period throughout summer 2021, the PSF is scheduled to submit final reports to the Commission in autumn 2021 providing advice on b) and c) above. The advice will feed into the Commission's report on the potential extension of the EU Taxonomy framework, which is to be adopted by the end of 2021 under Article 26(2a) and (2b) of the Taxonomy Regulation.

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<sup>41</sup> [Strategy for Financing the transition to a sustainable economy](#) European Commission, 6 July 2021.

How does the EU Taxonomy Regulation interact with international taxonomies?



Source: Future of Sustainable Data Alliance, as at September 2021

The EU is not unique in developing a taxonomy to classify environmentally sustainable economic activities. In fact, over 30 different jurisdictions and associations have or are in the process of developing their own taxonomies.

Whilst many taxonomies around the world are based upon common principles similar to the EU Taxonomy (noting that the UK and Singapore are using the EU Taxonomy as a basis of their own frameworks), the scope and targets of each can vary. Taxonomies generally focus on issues specifically relevant for their regulatory jurisdictions. For example, the taxonomy used by Mexico is primarily focused on biodiversity whilst Canada and Australia have focussed on carbon transition due to their economic reliance on mining and other carbon intensive industries. It is also worth noting that many

international taxonomies are focused on the green bond market and therefore do not necessarily apply to funds or corporates.

Under the aegis of the International Platform on Sustainable Finance (“IPSF”), the EU and China are working on the Common Ground Taxonomy (“CGT”), with the hope of building convergence between international taxonomies. Given the evolving nature of the growth of taxonomies around the world, it is difficult at the time of publication of this paper to accurately assess the precise level of impact on the funds industry, but three considerations are explored below:

- a. The impact the growth of international taxonomies will have on the availability of data for assets in other jurisdictions;

- b. The potential for conflicts to arise where funds are distributed cross-border; and
- c. Managing the concerns of greenwashing as taxonomies are expected to diverge across jurisdictions.

## Does the growth of international taxonomies impact data availability for non-EU assets?

Whilst NFRD Investee Companies will be required to report on the level of EU Taxonomy-alignment of their activities, assessment of alignment for non-EU assets will continue to be problematic given the lack of equivalent data and frameworks in other jurisdictions. This is particularly problematic given that analysis carried out by ESMA shows that a quarter of EU funds have no exposure to NFRD Investee Companies and around half of EU funds have less than 20% exposure to these entities.<sup>42</sup>

In addition to the lack of mandatory reporting obligation, there are a number of design features of the EU Taxonomy that make it challenging to assess non-EU investments:

- The use of NACE codes to classify economic activities, which is a statistical classification system used exclusively in Europe;
- Many of the significant contribution thresholds have been based on EU frameworks;
- Many of the DNSH criteria are also based on EU regulations, for example many of the pollution criteria reference the EU Registration, Evaluation, Authorisation and Restriction of Chemicals (“REACH”) Directive

Without an agreed framework for assessing and determining equivalent rules in other jurisdictions, it is likely to remain challenging for firms to determine the level of Taxonomy alignment for non-EU investments.

In recognition of this issue of data gaps, the Commission in the Article 8 Taxonomy Regulation Delegated Act has proposed that financial NFRD Investee Companies should only include in their Taxonomy KPI calculation investments in NFRD Investee Companies, although the regulation provides that exposures to and investments in companies which are not NFRD Investee Companies but which provide equivalent information voluntarily, may be included in the numerators of KPIs of financial

undertakings from 2025 onwards. Conversely, in the Taxonomy Disclosures Draft RTS, the ESAs have not limited the scope of reporting in this way and have instead urged FMPs, in assessing investments in investee companies that are not NFRD Investee Companies, to prioritise public reporting of data, followed by privately obtained data, either directly from investee companies or from third parties, in order to comply with their disclosure obligations.

Many market participants agree that it is likely too early to tell whether the development of taxonomies in other jurisdictions might help alleviate some of the challenges in obtaining data in relation to non-EU assets. As noted above, many taxonomies currently under development in other jurisdictions have a narrower scope that is focused primarily on the green bond market and therefore are unlikely to deliver the requisite data for other asset classes. In addition, there is currently no equivalence foreseen under the EU Taxonomy that would enable other jurisdictions’ taxonomies to be considered equivalent under the Taxonomy Regulation and thus allow EU firms to rely on compliance with third country taxonomies for the purposes of reporting under the EU framework. However, with the work of the IPSF on developing a CGT, there is perhaps hope that this will pave the way for some form of equivalence to develop in the future.

## Does the growth of international taxonomies impact on the cross border distribution of funds?

As noted above, many of the taxonomies developed to date in other parts of the world are primarily focused on the green bond market and therefore should not create any conflicts with the EU framework. However, to the extent that taxonomies in other jurisdictions do include fund disclosure requirements, potential conflicts may be introduced to the extent that international taxonomies are tailored to local interests. For example, although the UK is taking the EU Taxonomy as the starting point for its taxonomy, the extent to which the TSC that establish the sectors and thresholds for taxonomy eligibility and alignment are suitable for the UK are under review and could result in the UK adopting divergent standards to those of the EU. Such fragmentation of standards could introduce complexities for funds distributing across borders since the requirements of the taxonomy

<sup>42</sup> See ESMA [Final Report Advice on Article 8 of the Taxonomy Regulation](#) 26 February 2021 pages 98-99

in the fund's domicile country may differ from that in which the product is distributed. For example, an Irish UCITS subject to the Taxonomy Regulation would be required to report its alignment under the EU Taxonomy within its pre-contractual disclosures. However, were this fund to be distributed in the UK, such disclosures may not be deemed equivalent under the UK Taxonomy and could require the fund to also disclose under the UK Taxonomy.

As set out above, there is the hope that regulators will start to consider how equivalence might work in this space. There are already examples of regulators considering ESG-related disclosures made under the SFDR to be equivalent to national rules, as is the case in Hong Kong, which could be replicated for taxonomy disclosures, along with the emergence of a CGT that is globally accepted.

### Do diverging international taxonomies increase the risk of greenwashing?

The lack of globally applicable data and definitions could create challenges for the industry when it comes to addressing concerns around greenwashing, since definitions of what can be considered green is likely to vary across different taxonomies, both in terms of which sectors are in scope, i.e. are eligible, as well as the setting of any thresholds. For example, the Chinese taxonomy included until recently "clean coal" in its list of eligible investments which would clearly not be considered green in the EU. Such divergences of approach could undermine the ultimate objective of the EU Taxonomy to ensure high standards when it comes to what is considered environmentally sustainable.

To address this challenge, the CGT currently being developed by the IPSF adopts the "highest common denominator" principle, ensuring that only those sectors and activities that are considered green under both the Chinese and the EU frameworks are included. Whilst this has the benefit of addressing any greenwashing concerns, it is likely to reduce the coverage of eligible investments.

The EU's ambition in seeking to be a global leader in setting standards for sustainable finance, including the introduction of the EU Taxonomy, is commendable. The scale of the project and political disagreement as to which economic activities ought to be included in the EU Taxonomy led to a delay in the adoption of the Taxonomy Regulation, creating misalignment between the application dates of the Taxonomy Regulation and other initiatives under the Action Plan including the SFDR. The fact that the CSRD, an essential cornerstone in the framework in ensuring data availability to assist

with compliance by FMPs, will not apply until 2023 represents a further disruption to the timeline and a significant implementation challenge.

The prospect of diverging international taxonomies may also create issues for fund management companies. In order to meet the many challenges presented by this ambitious project, Irish Funds will continue to engage at a domestic, EU and international level to arrive at pragmatic solutions and advance the sustainable finance agenda.

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# Appendix 1: Taxonomy Regulation Timeline

Mar  
2018

European Commission Action Plan: Financing Sustainable Growth – including commissioning of a study on sustainability ratings and research

12 Jul  
2020

TR entered into force

Jan  
2021

European Commission Study on Sustainability-Related Ratings, Data and Research

ESMA Letter to EC on ESG Ratings, calling for legislative action on ESG ratings and assessment tools

31 Dec  
2021

By this date, the Commission shall publish a report describing the provisions that would be required to extend the scope of the TR beyond environmentally sustainable economic activities including covering other sustainability objectives such as social objectives

Also the date by which the Commission shall establish the technical screening criteria in respect of the following environmental objectives ('non-climate objectives): (a) sustainable use and protection of water and marine resources (b) transition to a circular economy (c) pollution prevention and control and (d) protection and restoration of biodiversity and ecosystems

1 Jun  
2022

Deadline for the ESAs to submit the draft regulatory technical standards in respect of the non-climate environmental objectives

1 Jan  
2023

Articles 5 and 6 of the TR shall apply in respect of the four non-climate environmental objectives

As of this date and up to end of 2023 (for the reporting period 2022), financial undertakings shall disclose qualitative information and proportion in their total assets of exposures to Taxonomy non-eligible and eligible economic activities. Non-financial undertakings shall start disclosing KPIs

The Level 2 RTS under the SFDR and the Taxonomy Regulation will apply

Taxonomy Regulation ('TR') published in the Official Journal

22 Jun  
2020

AMF, AFM Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related services

Dec  
2020

European Commission Strategy for Financing the Transition to a Sustainable Economy – including plan for public consultation on ESG ratings, and potential follow up actions

Jul  
2021

Articles 5, 6 and 7 of the TR shall apply in respect of the first two environmental objectives: climate mitigation and climate adaptation

Article 8 of the TR also applies. As of this date and up to end of 2022 (for the reporting period 2021), non-financial undertakings shall disclose qualitative information and information on proportion of taxonomy-eligible activities

1 Jan  
2022

By this date and subsequently every three years after, the Commission shall publish a report on the application of the TR

13 Jul  
2022

As of this date and up to end of 2024 (for the reporting period 2023), financial undertakings shall start disclosing KPIs

1 Jan  
2024



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