ALERT MEMORANDUM

Beyond Just "**Green**": The EU Taxonomy Traffic Light – From **Red**, to **Amber**, to **Sustainable**

April 11, 2022

Regulation (EU) 2020/852 (the "**Taxonomy**") in 2020 established an EU-wide framework for classification of economic activity as environmentally sustainable (or "**green**"). This framework is intended to provide businesses and investors with a standardized understanding to identify sustainable financial products and investments. The ultimate purpose of the Taxonomy is to direct capital flows towards green activities, and to prevent greenwashing.

On March 29, 2022, the European "Platform on Sustainable Finance" expert group published its report on a future "**Extended Environmental Taxonomy**".

The report aims to support the European Commission, as it considers whether and how to extend the Taxonomy to cover activities that have an ambiguous impact on environmental sustainability ("**amber**"), and those that – at the opposite extreme – have a significantly detrimental impact on the environment ("**red**").

This alert *memorandum* provides an overview of the Platform's preparatory work, the likely structure of the Taxonomy's future "traffic light system", and its implications for firms.

If you have any questions concerning this memorandum, please reach out to the authors or to your regular firm contact, including

Clara Cibrario Assereto
+39 06 6952 2225
ccibrarioassereto@cgsh.com

Andreas Wildner
+44 20 7614 2248
awildner@cgsh.com

Maurits Dolmans
+44 20 7614 2343
mdolmans@cgsh.com

Andrew Bernstein
+ 33 1 40 74 68 60
abernstein@cgsh.com

Barthélemy Faye
+33 1 40 74 69 49
bfaye@cgsh.com

Helena K. Grannis
+1 212 225 2376
hgrannis@cgsh.com

Chris Macbeth
+ 971 2 412 1730
cmacbeth@cgsh.com

Francesca Odell
+1 212 225 2530
flodell@cgsh.com

Scott Senecal
+7 495 660 8520
ssenecal@cgsh.com

Sophie Smith
+44 7841 490 626
sosmith@cgsh.com

Denise Shiu
+86 10 5920 1080
dshiu@cgsh.com

Ferdisha Snagg
+44 20 7614 2251
fsnagg@cgsh.com

I. Context

The EU's Taxonomy framework (in force since 2021) so far covers only environmental sustainability objectives and environmentally sustainable activities.[1]

Article 26 of the Taxonomy (on follow-on regulatory initiatives), however, mandates the Commission to explore how to extend the Taxonomy beyond green activities, in two distinct ways:

(a) To include **social and governance sustainability** objectives; and

(b) As regards **environmental sustainability** objectives, to also address low-impact and **red** (*i.e.,* non-"green") activities.

We analysed the Platform's preparatory work on **social and governance sustainability** (item (a)) in a recent memorandum.[2] This alert addresses item (b), i.e., further work on **environmental sustainability**, and specifically the recent "Extended Environmental Taxonomy" report (the "**Report**").[3]

II. Limits of the Taxonomy's current architecture

The current Taxonomy labels certain activities as "green", without addressing the (neutral or negative) characteristics of activities that do not comply with its sustainability criteria. It also does not cover a wide variety of activities that are out of scope (*i.e.,* those defined by the Commission as "not Taxonomy *eligible*").

ACTIVITIES FALLING IN SCOPE OF THE TAXONOMY	ACTIVITIES OUT OF SCOPE
Taxonomy **aligned**	(*i.e.,* not Taxonomy **eligible**)
Non-**aligned**	

Only a small proportion of activities (estimated 1 to 5%) qualifies as "green" under the above approach.

Other activities might not qualify, in some instances, because the activity, while to some extent positive to the environment, fails to fully satisfy the Taxonomy's "green" criteria (*e.g.*, potentially nuclear energy and natural gas[4]). Other examples are activities not impactful enough to warrant inclusion (*e.g.*, professional services).[5] Others yet by nature harm the environment (*e.g.*, energy from coal or peat).

Stakeholders may interpret this exclusion as a negative signal – which might cause finance to dry up for these activities. However, access to finance by non-green activities may be important for a successful transition.

Worse: among all the activities that do not qualify under the Taxonomy, the system does not distinguish between those that harm the environment and those that just narrowly fail the sustainability test. Moreover, low-impact activities (even if individually insubstantial) may well collectively contribute to environmental goals.

For all these reasons, the Report considers the Taxonomy's overall binary ("green"/"non-green") approach to be insufficiently differentiated.

III. The Platform's recommendations

The Platform recommends introducing new categories into the Taxonomy and graduating its approach, so as to cover potentially the entire economy. To facilitate understanding of this new structure the Report recommends using a traffic light colour scheme, which could be easily and universally understood:

Substantial environmental harm (*must decommission*)	Substantial environmental harm (*may transition*)
Intermediate performance	
Substantial contribution to environmental sustainability	
Low environmental impact activities	

[1] The Taxonomy is accessible here. To read our overarching analysis of the Regulation, access our related alert here.

[2] The Platform's report on the extension of the Taxonomy to social and governance sustainability objectives (of February 28, 2022) is available here. To read our analysis, access our related alert here.

[3] The "Extended Environmental Taxonomy" report of March 29, 2022 is available here.

[4] See the Platform's response to the Commissions' proposal to include nuclear and gas related activities in the Taxonomy Climate Delegated Act, which can be accessed here. To read our analysis of the proposal, access our related alert here.

[5] The Platform estimates that more than a third of the EU's economy is made up of low-environmental-impact industries (such as financial or legal services and education).

The new categories in this scheme are the following:

(i) **Red - activities that significantly harm the environment and that should be abandoned**: This category would include energy generation from solid fossil fuels, for instance (although the Platform recommends that other categories be identified, too). The decommissioning of all activities falling under this category should in turn qualify as environmentally sustainable (so as to facilitate finance for the decommissioning).

(ii) **Red - activities that significantly harm the environment that may transition to greater sustainability:** activities in this category would urgently need to improve so as to stop significant harm to the environment. Improvements should be acknowledged even where the result falls short of substantially contributing to environmental sustainability.

(iii) **Amber – intermediate performance**: this would cover activities that significantly impact the environment but that do not significantly harm, nor substantially contribute to, environmental sustainability objectives.

(iv) **Green - sustainable activities** (fulfilling all environmental sustainability requirements under the Taxonomy).

(v) **Unclassified - low environmental impact activities:** this category would include activities which do not have the potential to contribute substantially, nor significantly harm, environmental sustainability. Among other things, introducing a grey category would make it easier for companies to show their low environmental impact to investors. Even ESG-focused investors may in fact want to diversify their green portfolio, by adding low-environmental risk assets. This category would also allow for classification of individual investments as green, even where the activity itself cannot qualify as such.

Altogether, the Platform expects that the recommended extension of the Taxonomy framework would:

(a) Enhance transparency and allow for more nuanced decision-making, thereby focussing on all necessary transitions throughout the economy; and

(b) Help to effectively create a ladder, to help economic actors to see, and incentivise actors to take, the appropriate path forward.

The Platform also acknowledges certain trade-offs: greater complexity, cost of additional reporting obligation, and possibly reputational risk (attributable to the added attention to "**red**" activities). Overall however, the Platform considers that, with careful implementation, advantages would outweigh the potential drawbacks.

IV. Next Steps

The Platform considers that implementation of its recommendations may start immediately, in the form of voluntary reporting. This would apply in particular to activities for which the Taxonomy's "Climate Delegated Act" [6] lays down both substantial-contribution and do-no-significant-harm (DNSH) criteria. [7] The Commission is invited to publish guidance on such voluntary reporting, especially in relation to intermediate performance ("**amber**") and low impact ("**unclassified**") activities.

Next steps may include the identification of further significantly harmful activities that cannot transition. It will also be necessary to consider the interaction between the Taxonomy and other parts of the EU's sustainable finance architecture, such as the Corporate Sustainability Reporting Directive.[8]

It will now be up to the Commission to consider the Platform's Report, and to decide whether and how to expand the Taxonomy. It is expected that this will be addressed in the course of 2022. While not binding, the Platform's recommendations are expected to strongly influence the future development of this framework.

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[6] *I.e.*, Commission Delegated Regulation (EU) 2021/2139, which can be accessed here.

[7] Please consult our alert on the Taxonomy (reference under footnote 1 above) for further guidance on certain technical terms (such as "substantial contribution" and "DNSH") utilised throughout this alert.

[8] The Commission's proposal can be accessed here. To read our analysis of the proposal, access our related alert here.