

# A **Social** and **Governance** Taxonomy for Europe: Extending the EU ESG Framework to *Socially* Sustainable Activities and Sustainable *Governance*

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On February 28, 2022, the European “Platform on Sustainable Finance” expert group (the “**Platform**”) published its final report on a “**Social Taxonomy**”.

Regulation (EU) 2020/852 (the “**Taxonomy Regulation**”, or “**Environmental Taxonomy**”) established (back in 2020) an EU-wide framework to determine if a given economic activity may qualify as *environmentally* sustainable (or “green”). This framework is intended to provide businesses and investors with a common language to identify sustainable financial products, investments and debt exposures.

The European Commission will now consider how the Taxonomy framework can be extended to also cover **social** and **governance** sustainability objectives (the “S” and “G” of E-S-G). The Platform’s final report is expected to serve as the basis for a new regulatory proposal by the Commission to this effect.

This alert *memorandum* provides an overview of the Platform’s comprehensive recommendations on Europe’s upcoming Social and Governance Taxonomy, including as to companies’ **corporate governance** of sustainability aspects.

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## I. Background

Social sustainability objectives – essentially, workers’ and other human rights – are at the core of the European Union. This is reflected, for instance, in Article 3(3) of the Treaty on European Union, which provides that “*the Union shall [...] work for the sustainable development of Europe [...] aiming at full employment and social progress [...], combat social exclusion and discrimination, and shall promote social justice and [...] equality between women and men*”.<sup>1</sup> This is also at the basis of the Charter of Fundamental Rights of the European Union.<sup>2</sup>

In furtherance of these objectives, on February 28 of this year, the Platform presented to the Commission its report on a Social Taxonomy (the “**Report**”).<sup>3</sup> The Platform is an independent group of experts from industry, academia and the public sector. Its purpose is to advise the Commission in relation to the development of sustainable finance policies and, in particular, the EU Taxonomy.<sup>4</sup> On July 12, 2021, the Platform published a draft version of the Report.<sup>5</sup> The definitive version published this year takes into account the stakeholder feedback received since.

The Commission is now expected to publish a proposal for a Social Taxonomy Regulation in the course of 2022. While the recommendations in the Platform’s final report are not binding, they are likely to carry significant weight. Once the Commission’s regulatory proposal is published, it will be subject to review by the European Parliament and Council as part of the ordinary legislative procedure.

## II. Introduction

As mentioned, the purpose of a Social Taxonomy will be to lay down clear criteria which economic activities need to satisfy in order to qualify as socially sustainable. These criteria will be used in companies’ disclosures as well as in the marketing and labelling of financial products. The overarching purpose of this is to allow investors to easily identify which investments are socially sustainable, and so channel capital towards sustainable activities.

<sup>1</sup> The Treaty is available [here](#).

<sup>2</sup> The Charter is available [here](#).

<sup>3</sup> The Report is available [here](#).

## III. Elements of a Social Taxonomy

### a. Relation to the Environmental Taxonomy

The Platform recommends that, where possible, the Social Taxonomy should follow the model of the Environmental Taxonomy. This would avoid imposing unnecessary administrative burden on companies and investments, and facilitate market acceptance and understanding (given the market’s familiarity with the Environmental Taxonomy). It would also allow investors to easily determine if investments are (only) environmentally sustainable, (only) socially sustainable, or both.

In line with this view, the suggested structure of the Social Taxonomy contemplates: (i) a number of pre-set overarching social objectives; (ii) criteria for “substantially contributing” to those objectives; (iii) “do no significant harm” (“**DNSH**”) criteria; and (iv) a number of minimum safeguards that sustainable activities will have to comply with regardless of the objective that is pursued by the underlying activity or investment.

However, the proposed Social Taxonomy deviates from the Environmental Taxonomy in some ways – that is:

1. Structurally, by breaking down the social objectives into sub-objectives;
2. In terms of the approach that will have to be adopted in designing specific criteria for “substantial contribution” and DNSH.

The reason for these differences (especially the second point) lies in some fundamental differences between *environmental* and *social* sustainability:

1. While some economic activities are inherently harmful to the environment (and others are not), most activities tend to have some inherent social benefits, for instance by creating employment. A Social Taxonomy must therefore differentiate between “inherent” (“business-as-usual”) and “additional” social benefits of economic activities;

<sup>4</sup> The Taxonomy Regulation is accessible [here](#). To read out our analysis of the Environmental Taxonomy, access our related alert [here](#).

<sup>5</sup> The draft report was made available [here](#).

2. Unlike the Environmental Taxonomy, there are fewer scientific standards on which the criteria for a Social Taxonomy could be based. The Platform recommends that the Social Taxonomy should therefore be based on “*internationally agreed authoritative norms and principles*”;
3. Relatedly, developing quantifiable criteria for a Social Taxonomy may be more challenging in some instances (compared to measuring pollution or other environmental sustainability factors), which is why a combination of quantitative and qualitative criteria will likely need to be employed.

**b. Social objectives**

As with the Environmental Taxonomy, in order to be considered (socially) sustainable an economic activity will need to “substantially contribute” to one or more of the EU’s chosen social sustainability objectives.

The Platform proposes that the Taxonomy focus on **three high-level objectives** (centred around three groups of stakeholders, whose lives of are typically most affected):

1. Promoting decent work (focusing on **employee**-stakeholders)
2. Promoting adequate living standards and wellbeing for end-users/consumers (focusing on **end-users** as stakeholders)
3. Promoting inclusive and sustainable communities and societies (for any other **communities affected** at any point of the product’s value chain)

As mentioned, in contrast to the Environmental Taxonomy, the Platform proposes that these be broken down into sub-objectives. These must be designed so as to (i) not overlap with each other, but at the same time (ii) collectively cover all essential topics within the objective to which they refer.

The Platform Report contains the following indicative list of sub-objectives:

Objective	Sub-objectives
<b>Decent work</b>	Promoting <b>decent work</b>
	Promoting <b>equality and non-discrimination</b> at work
	Ensuring respect for the human rights and <b>workers’ rights</b> of affected workers in the value chain
<b>Adequate living standards and wellbeing for end-users</b>	Ensuring <b>healthy and safe products</b> and services
	Designing products to be <b>durable</b> and <b>repairable</b>
	Providing for cybersecurity and the protection of <b>personal data</b> and <b>privacy</b>
	Engaging in <b>responsible marketing</b> practices
	Ensuring access to quality <b>healthcare</b> products and services including care services
	Improving access to healthy and highly nutritious <b>food</b>
	Improving access to good-quality drinking <b>water</b>
	Improving access to good-quality <b>housing</b>
<b>Inclusive and sustainable communities and societies</b>	Improving access to <b>education</b> and lifelong learning
	Promoting <b>equality</b> and <b>inclusive growth</b>
	Supporting sustainable livelihoods and <b>land rights</b>
<b>Inclusive and sustainable communities and societies</b>	Ensuring respect for the human rights of affected communities by carrying out <b>risk-based due diligence</b>

“Substantial contribution” to an objective (and, therefore, whether an economic activity qualifies as “socially sustainable”) will be defined at sub-objective

level.

### c. Substantial contribution and sector prioritisation

The Platform envisages three different types of substantial contribution to a social sustainability objective:

- (i) Reducing the negative impact of economic activities
- (ii) Enhancing the inherent positive impact of certain economic activities
- (iii) Facilitating/promoting either (i) or (ii) above (“**enabling activities**”)

As with the Environmental Taxonomy, criteria for what qualifies as substantial contribution will be tailored to specific economic activities. This requires prioritisation of sectors. The Platform considers that any prioritisation of sectors (classified according to the NACE industrial classification system) should depend on the type of substantial contribution.

#### i. Reducing negative impact

The first category of substantial contribution relates to the embedding of social rights due diligence in businesses’ activities across their value chains. The Platform recognises that reducing the negative impact of business operations can bring “transformative social improvements” for those affected.

The Platform recommends to prioritise high-risk sectors, where negative impacts are easier to identify. Examples may include, in relation to health and safety for instance, mining, manufacturing, or construction.

The Platform notes the following challenges:

- (i) **‘Business as usual’**: minimum standards which form part of ‘business as usual’ should not be enough to qualify as substantial contribution. The Platform therefore recommends to require measures to be (i) credible, (ii) ‘best in class’ in terms of design and implementation, and (iii)

meaningful in terms of outcomes for stakeholders.

- (ii) **Difficulties in sector-prioritisation**: some topics or sub-objectives are sector agnostic, meaning that it is challenging to determine which sectors are especially relevant to the sub-objective. Examples of this include collective bargaining and workforce diversity aspects. The Platform recommends formulating generic DNSH criteria where this is the case. These would be linked to an activity (not to the entity), and they would have the same wording for all activities identified in the Social Taxonomy.

- (iii) **Zero-tolerance issues**: some issues, such as child labour or forced labour (on which, see also Section IV below), are generally subject to “*zero-tolerance in law and ... sometimes subject to import bans and exclusion criteria*”. It may be difficult to formulate substantial-contribution criteria for objectives like “avoiding and addressing” these issues. The Platform recommends that experts be consulted to “*better understand if and how these objectives could be reasonably framed in substantial-contribution criteria*”.

#### ii. Enhancing positive impact

The second substantial contribution category relates to the provision of certain economic goods, services or infrastructure that are essential for ensuring adequate living standards. Examples of this are food and water, housing, healthcare, education, transport and telecommunications.

In terms of sector prioritisation, the Platform recognises that not all economic activities relating to such goods or services should equally qualify as socially sustainable. Capital flows should be directed towards situations in which basic human needs/infrastructure are (i) not met at all, (ii) not accessible to certain groups, or (iii) at risk of not being met in the future. The Platform suggests that such situations can be identified by applying the “**AAAQ Concept**” (Availability, Accessibility, Acceptability, Quality), which it describes as a way “*to address all possible obstacles to the fulfilment of social, economic and cultural rights and to find ways to overcome these obstacles*”.<sup>6</sup>

<sup>6</sup> Report, page 41.

### iii. Enabling activities

The third category of substantial contribution relates to activities which enable improved social performance in other activities. The Platform cites as examples social audits, stakeholder dialogues, mediation services or complaint mechanism, and testing aimed at detecting harmful substances in consumer products.

The selection of sectors for enabling activities will reflect the one that applies to the other substantial contribution categories.

### d. DNSH

The Platform recommends that DNSH criteria be formulated at the level of each sub-objective. The effect of this would be that, even where an activity substantially contributes to a relevant sub-objective, it will not qualify as socially sustainable if it violates any of the DNSH criteria that refer to *other* sub-objectives.

The Platform mentions potential challenges with this approach:

- (i) **Practical difficulties of granularity:** formulating DNSH criteria at the sub-objective level will require assessing an activity for both its substantial contribution (to one sub-objective) and DNSH (to other sub-objectives), under the same headline objective. It might occur that an activity assessed for substantial contribution to one sub-objective also needs to demonstrate DNSH for the very same sub-objective.
- (ii) **Impossibility of linking turnover or expenditure to sustainability objectives:** where turnover or expenditure cannot meaningfully be linked to one or more sub-objectives (for purpose of Taxonomy-related disclosures, such as the ones that are set under Article 8 of the current Taxonomy Regulation), minimum-safeguards should apply instead. Sub-objectives like freedom of association and taxation could present this challenge, for instance. The Platform notes, however, that the aim should be to have formulate DNSH criteria wherever possible, since these are typically more precise and tailored than the general minimum safeguards discussed under Paragraph (f) below.

### e. Metrics

Screening criteria should include both qualitative and quantitative metrics:

- (A) **Quantitative metrics:** where quantitative metrics can be meaningfully applied, they may provide clear outcome-oriented performance benchmarks. Examples of good data availability in this respect include safe and healthy working conditions, anti-discrimination, freedom of association, employment generation, staff wages.
- (B) **Qualitative metrics:** where no quantitative data is available, qualitative indicators may still be used. These might focus on policies and procedures in place in a company.

On a general level, the Platform considers that indicators for a Social Taxonomy should: be derived from internationally recognised standards, function as a good proxy for the objective they address, be specific and precise, have a clear direction, be available at a reasonable cost, be all set at a similar level of detail, and avoid creating wrong incentives.

### f. Minimum safeguards

Similarly to the Environmental Taxonomy, in order to qualify as socially sustainable, activities will finally have to be carried out in compliance with certain minimum safeguards. The Platform is working in parallel on a report on the functioning of Article 18 (concerning minimum safeguards) in the Environmental Taxonomy. A comprehensive consideration of minimum safeguards in the Social Taxonomy will follow the publication of that report. However, the Platform's Report already provides some provisional considerations:

- (i) **Minimum environmental safeguards:** if the DNSH criteria of the Environmental Taxonomy cannot be meaningfully applied to the Social Taxonomy, then environmental minimum safeguards would need to be included. This is necessary in order to ensure that no incentive is created to invest in activities which harm the environment. One suggestion for environmental minimum safeguards would be the environmental part of the OECD Guidelines.<sup>7</sup>

<sup>7</sup> OECD Guidelines for Multinational Enterprises, accessible [here](#).

- (ii) **Minimum social safeguards:** as mentioned under Paragraph (d) above, in relation to sub-objectives for which it is impossible to lay down valid DNSH criteria, minimum social safeguards identical to those that apply in the Environmental Taxonomy should be used.
- (iii) **Policies and outcomes:** the Platform notes that it is important to ensure that minimum safeguards are not only incorporated in companies' internal policies, but also implemented in practice. However, it is not clear that the minimum-safeguards provision in the Environmental Taxonomy is currently applied in that way. One approach to address this might be to interpret minimum safeguards as requiring the prioritisation of salient indicators and the development of standardised reporting templates in line with the future Corporate Sustainability Reporting Directive.<sup>8</sup> The Platform recommends that further work be done to clarify the operation of the minimum safeguards in the Environmental Taxonomy. This work will then need to be taken into account when designing minimum safeguards for the Social Taxonomy.

#### IV. Forced labour and product bans

The Commission has reiterated on multiple occasions its “zero-tolerance” position on forced and child labour.

This is reflected in various initiatives promoting decent work, such as:

- The April 2021 proposal for a **Corporate Sustainability Reporting Directive** (setting out detailed reporting requirements relating among other things also to labour rights).
- The February 2022 proposal for a **Corporate Sustainability Due Diligence Directive**<sup>9</sup> (setting out due diligence obligation for certain large companies to identify, prevent, mitigate and account for actual and potential adverse impacts on human rights, including labour rights, throughout

their value chains); and

The Report aligns with this stance in the following ways:

1. **Sub-objectives:** one of the suggested Social Taxonomy objectives is “promoting decent work.” The Platform suggests that this may include “*taking immediate and effective measures to end forced labour and exploitation of work, with specific reference to workers with a migration background.*”<sup>10</sup>
2. **Substantial contribution:** the Platform recognised that it may be challenging to formulate meaningful criteria for substantial contribution to the objective of “*avoiding and addressing [...] child labour or forced labour*” (since these issues are generally subject to zero-tolerance). The Platform therefore suggests “*that experts be consulted to better understand if and how these objectives could be reasonably framed in substantial-contribution criteria.*”<sup>11</sup>
3. **DNSH:** the Platform recommends mirroring the Environmental Taxonomy structure in that activities should not qualify as Taxonomy-aligned where they do significant harm to any of the objectives and sub-objectives. In that context, the Platform noted as an example that “*an economic activity that makes a substantial contribution to living wages (thus promoting the decent-work objective) should not [...] use child or forced labour in supply chains.*”<sup>12</sup>

On February 23, 2022, the Commission also issued a “**Communication on Decent Work**”.<sup>13</sup> The document mentions an initiative (informally announced already in September 2021, by President Von der Leyen) to ban products made through forced labour from the European single market. The Commission states that this legislative proposal will build on international standards and will apply to both domestic and imported products.

The Report does not mention any such product ban. This is perhaps unsurprising given that the aim of a

<sup>8</sup> The proposal is available [here](#). To read our analysis of the proposal, access our related alert [here](#).

<sup>9</sup> The proposal is available [here](#).

<sup>10</sup> Platform’s final report, page 36.

<sup>11</sup> Platform’s final report, page 45.

<sup>12</sup> Platform’s final report, page 44.

<sup>13</sup> See Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on decent work worldwide for a global just transition and a sustainable recovery (the Commission’s “**Communication on Decent Work**”), accessible [here](#).

Social Taxonomy would be to channel investment to certain activities through appropriate disclosure and labelling (rather than prohibiting certain products or activities). It appears, however, that in the context of the DNSH criteria the Platform suggests a strict approach to the use of forced labour, such that an economic activity that involves forced labour at any point in the supply chain would be (if not altogether banned) certainly not able to qualify as Taxonomy-aligned.

## V. Sustainable Governance, and corporate governance requirements related to ESG

The Report recommends that the Taxonomy should include **reporting requirements** for companies on certain corporate governance aspects related to sustainability.

Governance structures are seen as key to the aims of the Taxonomy, given that they provide a company with the internal framework for addressing social and environmental impacts.

Because governance is linked to the undertaking (entity-level) rather than its activities, the obvious place to include governance-related obligations within the Taxonomy would be within minimum safeguards.

The Report considers two key objectives related to sustainable governance:

1. **Sustainable Governance** (G) objectives, to complement the EU's Environmental (E) and Social (S) Taxonomy
2. Strengthening companies' requirements related to the **corporate governance** of ESG

In the Platform's view, each of these can be broken down into various sub-objectives.

### a. Sustainable Governance objectives

The Platform considers five governance (G) topics as relevant to sustainability:

- (i) **Anti-bribery and anti-corruption:** companies should be required to demonstrate and disclose their commitment to anti-bribery and anti-corruption measures. This may include appropriate

risk-assessment systems (especially in the context of interaction with public officials), routine anti-corruption training and whistle-blowing procedures.

- (ii) **Responsible lobbying and political engagement:** while recognising the important role it can play, the Platform suggests that lobbying must be conducted in a responsible manner. This may include refraining from active lobbying during elections and ensuring transparency over payments and collaboration with politicians. The Platform therefore recommends that the Social Taxonomy require companies to disclose their policies and procedures on direct and indirect lobbying, any payments for lobbying, and their involvement with tax-exempt organisations that write or endorse model legislation.
- (iii) **Transparent and non-aggressive tax planning:** the Platform notes the significant role that (corporate) taxes play in providing sources of government revenue (and so investment in public infrastructure and services), and reducing inequality (through redistribution of wealth). According to the Platform, the Social Taxonomy should aim to promote transparency over companies' approaches to tax and tax compliance. Specifically, the Platform recommends that companies should be required to disclose whether (or the extent to which) the company's board is directly responsible for tax compliance, how the company seeks to comply with the letter and spirit of the applicable tax laws, and what measures the company has in place to prevent tax avoidance practices.
- (iv) **Diversity of board members:** the Platform considers that requirements analogous to the ones falling under the decent-work objective be adopted in relation to board composition, diversity and non-discrimination based on factors such as gender and race.
- (v) **Employee representation on corporate boards:** the Platform considers employee representation to be essential to social dialogue within companies. Accordingly, it recommends that worker representatives should be given the chance to take part in the work and meetings of corporate boards.

## b. Corporate governance of ESG

The Platform considers that two sustainability-related aspects should be emphasised as part of companies' corporate governance:

- (i) **Sustainability competencies in boards:** risk management is a key task of any board of directors. This includes risks to the company's business and competitive position ("outside-in") and risks caused by the company ("inside-out"). Some of these risks may be social or environmental. To manage these risks, appropriate skills are needed. The Platform recommends that companies be required to publish a skills matrix stating how many board members have the sustainability skills that are relevant to the company's business.
- (ii) **Transparency and incentives on sustainability targets:** the Platform considers (in the same way as what the Commission implicitly signalled, as part of its recent Corporate Sustainability Due Diligence Directive proposal) that executive pay should be linked to the ESG objectives set by a company. This could affect long-term incentive plans (possibly combined with adequate claw-back or *malus* measures).

## VI. Next Steps

It is now up to the European Commission to consider the Platform's Report and decide how to progress the development of a Taxonomy related to social and governance (S-G) objectives. The Platform anticipates that next steps should involve clarifying minimum safeguards, conducting an impact assessment, ascertaining a rationale for prioritising objectives and sub-objectives and then defining substantial contribution and DNSH criteria for the chosen sectors and activities.

Although (as mentioned) the Report does not bind the Commission, it is expected that many of the principles here outlined will be key elements of the architecture of future EU rules on sustainability, and the integration of sustainability in companies' corporate governance – adding an "S" and "G" to the Taxonomy's ESG.

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