REWARD VALUE

REWARD VALUE BACKGROUND NOTE SERIES

EU FRAMEWORK OF SUSTAINABLE FINANCE REGULATIONS OVERVIEW OF ARCHITECTURE

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Over the past few years, 'sustainability' has established itself as a critical factor for consideration in the world of business. However, this importance has also at once been diluted by the lack of substance with which one could possibly measure sustainability in a given context. It is with this in mind that the latest and upcoming regulations not only in the European Union ("EU") but also worldwide, are a welcome inception of change.

The development of an EU framework of sustainable finance regulations is also an important building block for improved executive remuneration.
Addressing climate and social inequalities is key for a sustainable future for generations to come. The EU regulations will stimulate the business and investment communities to make responsible and sustainable investment for the long-term future and therewith support the needed transition to a regenerative economy operating within the carrying capacity of nature and society. As it is important to stimulate businesses and investors by means of this EU framework of sustainable finance, it is also essential that executives are properly incentivised to lead the transition. Current executive pay structures are often too much focused on short-term financial gains instead of stimulating long-term sustainable value creation for stakeholders and shareholders. In order to effectively redesign executive remuneration, harmonized disclosures on sustainability, establishing transparency on sustainable progress is dearly needed. It allows businesses to set better goals on material ESG topics, it supports

the analysis of sustainable impact and gives shareholders and stakeholders insight in business progress and corporate leadership. As Reward Value, we believe executive remuneration, structured well, can function as a catalyst for change. It is therefore vital that transparency and harmonisation is reached and mandatory reporting obligations are given to the investment and business communities. We therefore welcome the EU developments and seek to effectively incorporate these regulations in modernized executive remuneration design.

This is the first of our Background Note series on the Sustainable Finance regulations in the EU; a set of publications aimed at clarifying the current legal developments in this domain. In this first edition, a brief overview of the architecture of such regulation will be provided. The following pieces will provide deep dives into each piece of legislation in the order of their release – namely, as currently foreseen, the EU Taxonomy – both environmental and social, the Sustainable Finance Disclosure Regulation ("SFDR"), the Corporate Sustainability Reporting Directive ("CSRD"), as well as other proposals in the corporate governance sphere. These deep dives will provide insight not only into the thinking behind and practical aspects of the regulations, but also in what way these reforms have contributed (or not) to the development of a better system of executive remuneration.

On 1 December 2019, the European Commission published the European Green Deal – an ambitious set of policy responses to the 2016 Paris Agreement, which brought together 194 countries and the collective European Union in a series of promises aimed at tackling climate change on a global scale. At the heart of the European Green Deal is the future of the economy. The climate goals of the European Union and its member states are only achievable in a paradigm where the choices, distribution and use of resources are more sustainable.[1]
An integral part of the Green Deal is the challenge of securing finance to support the transition towards an economy that would support efforts against climate change. According to a communication by the Commission to other EU institutions, 2016 levels of investment towards sustainable initiatives indicated a "gap of almost EUR 180 billion".[2] To this end, ten 'actions' were set out, divided into the categories of 'Reorienting capital flows towards a more sustainable economy'; 'Mainstreaming sustainability into risk management' and 'Fostering transparency and long-termism'. These ten actions are as follows:

1. Establishing a clear and detailed EU taxonomy, a classification system for sustainable activities
2. Creating an EU Green Bond Standard and labels for green financial products
3. Fostering investment in sustainable projects
4. Incorporating sustainability in financial advice
5. Developing sustainability benchmarks
6. Better integrating sustainability in ratings and market research
7. Clarifying asset managers' and institutional investors' duties regarding sustainability
8. Introducing a 'green supporting factor' in the EU prudential rules for banks and insurance companies
9. Strengthening sustainability disclosure and accounting rule-making

[1] European Commission (2019) "A European Green Deal" (available at https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en).
[2] European Commission (2018) "Action Plan: Financing Sustainable Growth" (available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN) p2.

10. Fostering sustainable corporate governance and attenuating short-termism in capital markets

Different economic actors are addressed by each of these actions. The goal is to engage each entity in the financial system, whether private or public, in the task of restructuring the role that sustainability plays in their sector, so that its adoption across the entire system can be better secured as a functional reality of our economy. In the context of the EU's goals regarding climate change and sustainability as a whole: these actions in practical terms 'put the money where its mouth is'.

Of these ten actions, several are already in motion – for example, (4) – 'Incorporating sustainability in financial advice' and (7) – 'Clarifying asset managers' and institutional investors' duties regarding sustainability'; both these actions can be said to have been at least partially addressed by the introduction of the Sustainable Finance Disclosure Regulation (hereinafter 'SFDR'), which came into effect on March 10, 2021.[3] The Green Bond is another project already in motion. This will, however, not form part of the discussion in this background note. Others, such as (1) – 'Establishing a clear and detailed EU taxonomy, a classification system for sustainable activities', are a work in progress, with some parts already published and active.[4] Others, still, like (9) – 'Strengthening sustainability disclosure and accounting rule-making' and to a lesser extent, (10) – 'Fostering sustainable corporate governance and attenuating short-termism in capital markets' are the subject of the recent draft proposal of the Corporate Sustainability Reporting Directive (hereinafter 'CSRD').[5]

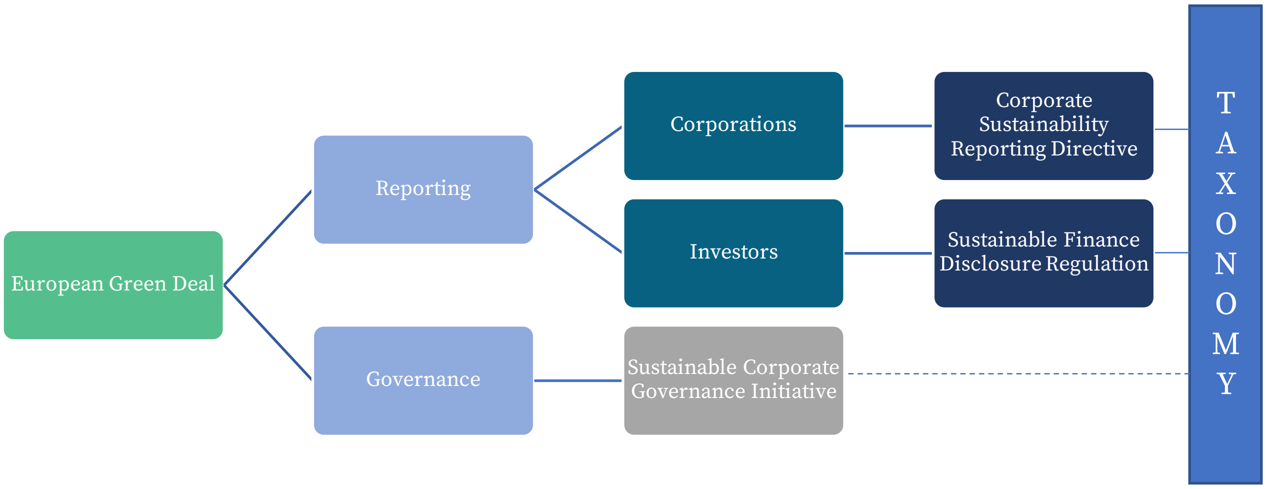
ARCHITECTURE

These three pieces of legislation and their subordinate Acts, some already effective, some waiting in the wings, will not exist in isolation but rather form part of an interactive framework, the architecture of which shall be discussed presently.

[3] Regulation (EU) 2019/2088 of 27 November 2018 on sustainability-related disclosures in the financial services sector, Art 20.

[4] European Commission (2020) "EU Taxonomy for Sustainable Activities" (available at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en) ; European Commission Platform on Sustainable Finance (2021) "EU Taxonomy and Platform" (available at https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/finance-events-210226-presentation-social-taxonomy_en.pdf).

[5] Proposal for a Directive (EU) amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) 537/2014 as regards sustainability reporting.



The participation of corporate society, financial institutions, and investors, plays an important role in ensuring that economic activity is not only truly sustainable, but that the financing of sustainable activities is prioritised over that of traditional, pollutive or socially harmful initiatives.

EU Taxonomy

The goal of the EU taxonomy to provide a classification system for what qualifies as sustainable, is therefore a key element in this equation. By engaging experts in the formulation of a common language to inform sustainability efforts, corporate actors and stakeholders can be held to a more reliable standard, thereby "creat[ing] security for investors, protect[ing] private investors from greenwashing, help[ing] companies to plan the transition, mitigat[ing] market fragmentation and eventually help[ing] shift investments where they are most needed".[6]

In this context, the Taxonomy Regulation, and its five Delegated Acts – one of which has been published thus far, act as a kind of dictionary which can be referred to by consumers, corporate actors, and investors.

The two latter categories are currently the only parties under pressure – and indeed in most cases, under obligation, to make use of this tool, due to the recently adopted SFDR, and pre-existing NFRD. In time, the NFRD will be replaced by the CSRD, thereby also expanding its scope of compliance. Two important guiding principles for the Sustainable Finance project were coined during the formulation of the Taxonomy, namely those of 'substantial contribution' and 'do no significant harm'. In addition to and above all other criteria that may be imposed on a certain economic activity, it can only ever be classified as 'sustainable' if it makes a substantial contribution to the prescribed environmental objectives, as well as doing no significant harm to any of the remaining objectives.[7] The duality of this requirement –

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[6] European Commission (2020) "EU Taxonomy for Sustainable Activities".

[7] European Commission (2019) "Spotlight on Taxonomy" (available at https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-spotlight_en.pdf) page 1-3.

herein named the 'double materiality' element, in that the economy activity must both significantly contribute to one or more of the objectives while doing no significant harm to any others, is an important innovation in sustainability regulation.
Another important development in this field is that of the Social Taxonomy, which, like its environmental counterpart, is created with the aim of creating a common language around which economic activities contribute to the social objectives. Various of these objectives have already been identified, such as better working conditions, more sustainable living communities, and access to healthcare and housing, to name only but a few.

SFDR

Under the SFDR, which came into effect on 10 March 2021, investors and other so-called 'financial market participants' (a category defined under the Regulation itself) are obliged to enhance transparency regarding their investment processes and products, irrespective of whether the entity is expressly focused on ESG or not.
The regulation is split into Level 1 and 2, the former already being in place from March of this year, and the latter only from 1 July 2022.
Level 1 focuses primarily on the entity of the financial market participant itself – for example, its process of identifying sustainability risks, the impact of those risks on investment decisions of the entity, as well as – and perhaps most importantly for our purposes: the alignment of remuneration policies with sustainability risks and objectives.
Level 2 of the SFDR goes into further detail on the entity, and also prescribes disclosures relating to the product line. In terms hereof, investment products are split into three categories:

1. Article 8 (those that promote social or environmental characteristics);
2. Article 9 (those that have social or environmental objectives); and
3. 'other'.[8] While this 'other' category is not specifically set out in an article of the regulation, the financial market participant is obliged to make disclosures on the sustainability factors and risks of products irrespective of their orientation towards sustainability. Thus, where a product falls neither into Article 8 or 9, it will still be in the ambit of the SFDR.

This identification is to be carried out in reference to the Taxonomy's classification of sustainable activities, as well as in compliance with the two criteria of 'substantial contribution' and 'doing no significant harm' as discussed above. Each disclosure on a product level and especially those in terms of Article 8 and 9, will therefore need to show their alignment with the Taxonomy.
The above disclosures are to be made in several forms at different stages of the investment process. For example, entity-level disclosures should be made available on the website of the financial market participant, while product-level disclosures are to be made on the website as well as in pre-contractual information. Article 8 and 9 disclosures, by contrast, are to be made on the website, in pre-contractual information as well as in periodic reports.
Aside from highlighting which investments are more sustainable, financial market participants will also be obliged to disclose where financial products might actively cause harm, or risk causing harm, to environmental or social objectives.[9] These are called the

[8] 2019/2088, Art. 8; Art 9.
[9] 2019/2088, Art.6

'adverse impacts' of the financial market participant, the most severe of which are named 'principle adverse impacts' and are set out in the Regulatory Technical Standards. In making these and the many other disclosures necessary under the SFDR, financial market participants will have to make extensive use of not only the Taxonomy and its Delegated Acts, but also the Regulatory Technical Standards of the SFDR, which provide additional guidance on how information to be disclosed should be measured and formulated. A detailed analysis of the SFDR will follow in a separate background note.

CSRD

The CSRD, by contrast, aims to improve the sustainability of the actual business behind the investments described above by obliging corporate entities to disclose key information about the way that their businesses are run. Not only are corporates obliged to disclose on how various phenomena (environmental, societal or other) may impact on their business, but also how their business impacts on these phenomena in turn. This element is called double materiality, and is a crucial innovation in the sustainability legislation. In this, it is an overhaul of the Non-Financial Reporting Directive (hereinafter 'NFRD'), which was viewed by EU institutions as being stunted in its ability to enact the kind of urgent change that is needed across the corporate sector, due to the insufficiency, omissions, and ease of avoidance in the former reporting rules.[10] The centrepiece of these considerations is the drive towards the adoption of universal standards in order to enable better comparability and assurance by auditors, as well as to put sustainability on the same footing as financial information.
In this revamped Directive, while much of the objectives remain the same (reporting on various categories of non-financial information of the enterprise relevant to sustainability), various of the rules have changed. This includes:

- [The extension of] the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises)
- [The requirement of] the audit (assurance) of reported information
- [The introduction of] more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards
- [The requirement of] companies to digitally 'tag' the reported information, so it is machine readable and feeds into the European single access point envisaged in the capital markets union action plan".[11]

Compliance with these obligations will once again rely on heavy reference to the Taxonomy and its Delegated Acts. An additional relevant publication will be the revised reporting standards for sustainability. The CSRD and the SFDR will work hand-in-hand, as demonstrated by the European Commission's plan to integrate the sustainability reporting standards imposed on enterprises with the indicators of measurement under the SFDR Regulatory Technical Standards.[12] The institutional investors will naturally rely on the accuracy and coherency of information disclosed by corporate entities in order to fulfil their own obligations under the SFDR. The sequence of these Directives therefore poses a

[10] European Commission (2021) "Questions and Answers: Corporate Sustainability Reporting Directive proposal" (available at https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_1806)
[11] European Commission (2021) "Corporate Sustainability Reporting" (available at https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en)
[12] European Commission (2021) "Questions and Answers: Corporate Sustainability Reporting Directive"

temporary hurdle, in that information symmetries between market participants may be skewed until both the SFRD and the CSRD are active and in place, possibly causing disclosures made under the former to lack in quality or rigour in the interim.

Sustainable Corporate Governance

With several pieces of legislation enacted, and many more on the way, there is still much to be done in the Sustainable Finance project – and one key area remains relatively out of the spotlight. There have been some developments on corporate governance: for example, the Commission's Sustainable Corporate Governance initiative (our response to which can be found here). The proposal for a directive covering the topics discussed herein is due to be released in the fourth quarter of 2021.

Despite these advancements, much of the internal focus and external coverage of current sustainability efforts is on that of its environmental dimension. This is similarly noticeable in the detail offered under point (10) of the action plan – 'Fostering sustainable corporate governance and attenuating short-termism in capital markets'. While most points of the action plan are well-developed, with clear objectives and activities to be carried out, (10) is comparably short, vague and empty of any real commitment beyond research projects and publications.

While the need to tackle climate change and other related environmental issues is an urgent one, and – as aforementioned - redirecting capital towards these efforts is necessary, there can be no evolution towards a 'green' economy if it is not carried out in joint participation with all stakeholders – the People. The fact that the EU is cognisant of this reality is reflected in the creation of the Just Transition Mechanism, a fund intended to mitigate the socio-economic side-effects of the 'greening' of our economies.[13] However, the tackling of socio-economic issues goes beyond the distribution of funds.

The work of the Commission is supportive of a future economy which is regenerative and long-term oriented. As aforementioned, corporates form an integral part of these economic outcomes. Therefore, more must be done to change the way that corporations interact with their stakeholders, as well as the way that risk is distributed throughout these enterprises so that when the economic transition comes, it truly leaves no one behind. Reforms in corporate governance are therefore vital in order to support these other legislative changes.

Our Mission

Reward Value is a not-for-profit foundation seeking to modernise the way in which executive remuneration is measured and distributed in an effort to reform corporate purpose and its externalities. Our mission goes to the heart of the sustainability issue, in appreciation of the fact that we collectively must treat our planet differently than we do now. In practice, our work focuses on the finance and governance perspective that forms part of this change. In this effort, we aim to remain active in the discussions underpinning legal developments in this field, supporting the work of the Commission in recognition of the need for standardisation of sustainability practices and joining our voice to the call for an extension of this standardisation and regulation in corporate governance.

[13] European Commission (2021) "The Just Transition Mechanism: making sure no one is left behind" (available at https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal/finance-and-green-deal/just-transition-mechanism_en)

REWARD VALUE

To transform the economy, it is necessary to have transparency from entities, regulation and market incentives. At Reward Value, we believe that executive remuneration is a catalyst for change. The realisation of the goals set out in the European Green Deal is reliant on the taking up of responsibility of market participants. Recognition of the role of enterprises must not be limited to the entity itself, but its leaders as well. While reporting stimulates participation in the shift towards sustainability, these efforts can be accelerated by incentivising those who carry the most weight in their organisations. Executive remuneration is a powerful tool that should be used to stimulate performance in a holistic way. The reconfiguration of incentives will empower executives to make decisions on their activities which are better not only for their longevity as a business, but for the people and environment that surround them. Changes in the way that executive performance is measured and rewarded, when paired with enhanced corporate reporting and clarity on directors' duties, make a powerful combination that is key to unlocking the regenerative and long-term oriented economy which our planet and people so desperately need.