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The Neglected Role of Social Factors: Towards an EU-wide Social Taxonomy

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Introduction

The international community has long recognized the need to reconcile economic development with environmental protection and the public interest. Since the Burtlandt Report of 1987, the concept of sustainability, understood as development that meets the needs of the present generation without compromising the ability of future generations to meet theirs, has permeated the choices of lawmakers in various initiatives that culminated in the 2015 approval by the United Nations of the 2030 Agenda for Sustainable Development, which sets 17 ambitious goals to be achieved by 2030. In the same year, the Paris Agreement was signed, which requires signatory states to commit to combating dangerous climate change and to keep the increase in global warming below 2°C compared to pre-industrial levels. Following these international initiatives, individual states began to adopt their own national plans to address these issues.

The European Union has emerged as a frontrunner in the fight against climate change and sustainable development. To achieve these goals, it presented the European Green Deal in 2019, which sets the goal of zero greenhouse gas emissions by 2050 and further intermediate targets in 2030 and 2040. To support this transition, the Commission has declared its intention to mobilize more than one trillion over the next ten years. The main problem is that this transition process requires an amount of investment that exceeds the funds of the EU budget and available public funds in general. The amount of missing funds is estimated at EUR 180 billion per year, which the EU has decided to turn to the financial system to fill. This role played by the financial system will also be crucial for investing in achieving the sustainable development goals set by the United Nations in the 2030 Agenda. In March 2018, the Commission therefore published an Action Plan to finance sustainable growth. These initiatives build on market dynamics and previous regulatory measures resulting from a growing awareness of sustainable finance. Indeed, in recent years, the consideration of ESG factors, i.e., environmental, social and governance, by companies, institutional investors and financial intermediaries has increased. These dynamics, on the other hand, are not sufficient to support a transition towards sustainable development as various obstacles stand in the way of developing the full potential of this area of finance. First and foremost is the lack of a precise and agreed definition of what constitutes sustainable investment.

Without such a definition, market participants as well as legislators are unable to make informed decisions based on a widely accepted standard. Investors, on the other hand, are

not in a position to assess whether their investment really pursues a sustainable goal because they lack the information necessary to make such an assessment. The European Union has therefore championed a regulatory framework that would incentivize sustainable finance starting with the disclosure by companies of more information about their non-financial performance.

In spite of this, the European Union as well as the international community, due to the need for swift action to tackle climate change, has mainly focused on only one of the pillars of sustainable development, namely the environmental side. The social side of ESG has always been the one least in the focus of legislators and commentators. This is mainly due to its inherent characteristic of being difficult to define. Many factors come into play in the definition of sustainable sociality, first and foremost the cultural aspect. Depending on different cultures, a certain social issue may be more or less felt by the community. In addition, social aspects are regulated at the national level and very often diverge from one another, e.g., in the area of labour law the minimum wage, which is provided for in some EU countries while in others it is not, which contributes to exacerbating the difficulty policy makers and scholars have in providing a precise definition of social sustainability.

The paper therefore aims to highlight the evolution of sustainable finance and how international initiatives have helped to expand the boundaries of this concept and how the role of social factors has always been neglected by policymakers and the European Union, which has addressed this issue as a feature rather than the main focus of its initiatives. The further aim of this paper is to highlight how the introduction of a Social Taxonomy is essential for the achievement of sustainable development and the attainment of the goals set by the UN 2030 Agenda.

The paper is therefore divided into 3 chapters. The first makes an analysis of the evolution of the concept of sustainable finance and the obstacles to its development. It then elaborates more on the concept of sustainability and sustainable development starting from the definition provided in the 1987 Burtlandt Report, as well as the various evolutionary stages of the concept of corporate social responsibility, which is central to understanding how companies have long wanted to incorporate sustainable factors into their business model. In the following paragraphs we will instead explain the central role played by international initiatives such as the Paris Agreement, also attempting to analyze the legal nature of the Agreement also following the recent withdrawal by the United States, and the United

Nations 2030 Agenda in the evolution of the role of sustainable finance. Finally, the first chapter ends with an analysis of the impact that Covid 19 has had in this area.

The second chapter sets out to make an analysis of the main regulations at European level by first analyzing the European Sustainable Finance Action Plan and its points in order to redirect capital towards a more sustainable economy. Subsequently, an analysis of the main regulations on the disclosure of non-financial information will be carried out, subdividing the requirements according to the subjects on which these obligations are imposed, respectively for companies and financial market participants. With respect to the former requirements, an analysis will then be made of Directive 2014/95 and the recent proposals made by the Commission to broaden its scope. With reference to the latter, instead, we will analyze the Sustainable Finance Disclosure Regulation 2019/2088 and specifically how a line can be drawn between financial products that qualify as Article 8 and Article 9, also highlighting the critical issues encountered by market professionals. Furthermore, we will analyze the central role played by the Taxonomy Regulation 2020/852 in qualifying an investment as environmentally sustainable if it pursues one of the 6 objectives contained therein. In the following paragraphs, we will instead analyze the provisions on sustainable finance contained in the Shareholder Rights Directive 2017/828 and in the Commission's latest proposal for a Corporate Sustainability Due Diligence Directive. Lastly, we will analyze, in the light of the regulations previously analyzed, the role that social factors currently play within the European regulatory framework, trying to highlight the extent to which they have been merely a feature rather than the main focus of the regulator.

The third chapter will focus on the role of taxonomy as a tool to stimulate the movement of capital towards more sustainable investments and social investments in particular. We will try to better understand the rationale behind the introduction of such a tool and whether it is a necessary measure to provide a comprehensive definition of what can be socially sustainable. Finally, we will analyze the report of the Platform on Sustainable Finance published in February 2022 on the Social Taxonomy and look at its structure, its merits and the concerns behind its introduction.

I. History of Sustainable Finance

1.1 Concept of Sustainable Finance

In recent years, sustainable finance has been the focus of attention of various players in the financial market and has enjoyed incredible success. Proof of this can be seen in the financial weight that sustainable investments have been gaining in recent years. The exponential growth of green bond issuance in the last two years saw a record year in 2021 in which bonds with a total value of $489 billion were issued. These figures are accompanied by the increasing tendency of political and regulatory authorities to introduce new initiatives to foster and regulate this field that is gaining momentum. Initiatives such as the Network for Greening the Financial System have seen an increase in membership in just a few years to over 90 central banks and published various reports and recommendations. Contrary to various authors who argued that sustainable finance would lose ground in the event of a crisis, the post-pandemic experience from Covid 19 showed us that not only did sustainable funds perform better than that portfolio of non-sustainable assets, but in addition the European legislator created a connection between the provision of funds to cope with the economic shock caused by the pandemic and sustainable development[1]. These are the words of the European Commission President Ursula von der Leyen: "*The recovery plan turns the immense challenge we face into an opportunity, not only by supporting the recovery but also by investing in our future: the European Green Deal and digitalization will boost jobs and growth, the resilience of our societies and the health of our environment. This is Europe's moment. Our willingness to act must live up to the challenges we are all facing. With Next Generation EU we are providing an ambitious answer*.".

The growth of the market size of sustainable finance finds its key driver in the investor preferences. In fact, 45% of the millennials think that they would orient their investments towards sustainable finance and social responsibility is deemed an important factor in their decision process[2]. Furthermore 90% of women investors believe making a positive impact on society is important in their investment decisions[3].

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[1] DIMMELMEIER, "*Sustainable finance as a contested concept: tracing the evolution of five frames between 1998 and 2018*", Journal of Sustainable Finance & Investment (2021).

[2] FIDELITY CHARITABLE "*Using dollars for change: Insights into impact investing for 2022 and beyond*" (2021).

[3] UBS "*Values, money and the pursuit of more intentional lives*" (2022). Available at: https://www.ubs.com/us/en/wealth-management/insights/market-news/article.1565414.html?caasID=CAAS-FASocial.

Having shown how important sustainable finance is at this time in history, we cannot avoid questioning the meaning and history of the term 'sustainable finance'. Even though the label "sustainable finance" imposed itself all over the world, the meaning of the term remains contested. It is argued that sustainable finance is nothing more than a synonym of Socially Responsible Investment (SRI) or is merely a tool used by financial market participants to satisfy their own interests, thus leaving the term sustainable finance as a mere "empty signifier"[4]. Although the 2030 UN Agenda states that financial investment might boost sustainable development and although it contains an objective related to macroeconomic profiles, it does not give relevance to the financial system[5]. In the EU, the relevance given to the financial system to "green" the economy was justified by the lack of public funds which might be directed to a green transition. In 2018, the High-Level Expert Group on Sustainable Finance gave their definition of this notion by stating that "*sustainable finance is about two imperatives. The first is to improve the contribution of finance to sustainable and inclusive growth as well as the mitigation of climate change. The second is to strengthen financial stability by incorporating environmental, social and governance (ESG) factors into investment decision-making. Both imperatives are pressing, given the rising climate-related risks and degradation in the environment and other sustainability areas.*[6]*"*. Following this approach according to European Commission, sustainable finance is the process of including ESG factors in the investment decision and is aimed to support economic growth while reducing pressures on the environment and at the same time taking into account social and governance aspects.

Sustainable finance is inevitably oriented to the long term by implementing sustainable decisions in the current investment. The implementation of this approach with regard to all players in the financial system entails an evolution of decision-making processes that embrace the identification of objectives (creation of financial value in the short and long term) and the reorganization of production and consumption processes (no longer linear but circular, based on production factors that include natural and social capital in addition to financial capital). In the more advanced version of sustainable finance, a model is asserted

[4] ECCLES, "*Sustainable Investment, Dickens, Malthus and Marx*." Journal of Sustainable Finance & Investment, 3:4, 287-302, (2013).
[5] Resolution adopted by the UN General Assembly on 25 September 2015: "*Transforming our world: the 2030 Agenda for Sustainable Development*" in which under Goal 8 states "*Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all*".
[6] High Level Expert Group on Sustainable Finance, Final Report 2018.

in which ESG factors are no longer constraints on the maximization of objectives but themselves part of the objectives.

In order for economic actors to make decisions that are aligned with sustainable development objectives, it is crucial that the market incorporates all relevant information on the ESG performance and risks of production and financial activities into prices. In order for this to happen efficiently and consistently with the transition to a medium- to long-term time horizon, appropriate data, information, metrics and analysis models are required for measuring and representing the ESG characteristics of economic and financial activities. To this end, both information 'producers' (primarily companies) and information intermediaries (such as ESG score and rating providers) play a central role.

Sustainable finance has two subcategories[7]:

1) negative sustainable finance; and
2) positive sustainable finance.

The first subcategory includes all those investments with respect to their risk profiles in relation to the three ESG factors. A long-term risk detection is then carried out with respect to environmental social and governance facts and if it is found that this investment is high ESG risk then the financial participant divests or does not invest. For example, a common risk is high CO2 emissions, but such risks can also include respect for labor rights, strategies to improve diversity and inclusion, and respect for human rights.

Positive sustainable finance focuses on providing new funds and make a contribution to one or more of the 17 UN Sustainable Development Goals. Estimates tell us that there is currently a gap of $3 to $4 trillion in funds each year to achieve the goals set for sustainable development by 2030[8].

1.1.1 ESG ratings

As private interest in sustainability has increased, more and more private organizations[9] have started to provide metrics and scores on funds and companies on how they implement ESG

[7] NICHOLLS A., "*Sustainable Finance: a primer and recent developments*" (2021).
[8] *Ibid.*
[9] According to the latest ESMA's letter to the European Commission "*Outcome of ESMA Call for Evidence on Market Characteristics of ESG Rating and Data Providers in the EU*" of June 2022 the number of ESG ratings providers currently active in the EU is 59. According to this letter, the EU ESG ratings providers are small or medium sized enterprises, and the most common model of business is "investor-pays". The letter is available at https://www.esma.europa.eu/sites/default/files/library/esma80-416.

(i.e., Environmental, Social and Governance) factors. The main issue of the ESG ratings is that they do not have a legal binding definition. A definition was proposed by the European Supervisory Market Authority (ESMA) in a letter to the European Commission dated 28 January 2021[10], where, under Note 4, ESMA defines ESG ratings as "*an opinion regarding an entity, issuer, or debt security's impact on or exposure to ESG factors, alignment with international climatic agreements or sustainability characteristics issued using a defined ranking system of rating categories*". According to Christina Wong, ESG rating are instead defined as "*evaluations of a company based on a corporative assessment of their quality, standard or performance on environmental, social or governance issues"[11].*

The most common mechanism for assessing the incorporation of ESG factors into creditworthiness comprises several steps. The first is the selection by credit agencies of various indicators for specific sectors. Next, the credit agency starts collecting information and data from the issuer and evaluates this data by assigning it a score.

Taking the method of Vigeo-Eiris, one of the leading ESG credit rating agency, as an example, it is based on 38 criteria divided into 6 macro-areas[12]:

- Environment
- Human rights
- Human resources
- Community involvement
- Business Behavior
- Corporate Governance

The Vigeo-Eiris methodology is characterized by the choice of giving different weights to different sectors industries in making the same ESG choice. This serves to define a different effort made by one sector compared to another in pursuing ESG strategies. The rating takes integer values between 0 and 100.

[10] ESMA's letter to the European Commission on ESG ratings, available at: https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf
[11] WONG, "*Rate the Raters: 2018: Ratings Revisited*" (2018).
[12] Euronext ESG Providers Methodologies, available at: https://live.euronext.com/sites/default/files/documentation/index rules/Euronext%20ESG%20Providers%20Methodologies%2021-01b.pdf

The main flaw in this mechanism is that each credit rating agency interprets the data provided differently, which is why many clients interface with several credit rating agencies to get different ratings. What results is a complex rating that lacks transparency about which indicators are used and which algorithms. The validity of ESG ratings is also endangered by the different biases of (i) company size, (ii) geography, (iii) industry sector and (iv) the rating agency itself[13].

The first stems from the fact that the larger company has more economic and human resources at its disposal in assessing its impact on ESG factors than smaller companies, for which the assessment process becomes very complex and costly.

As for the second type of bias, it is well established that locating the company in a jurisdiction that imposes more disclosure requirements has a greater influence on the company's decision-making choices. In addition, the culture itself in that jurisdiction is a factor that influences ESG, for instance in those jurisdictions where voluntary adherence to ESG issues is much more widespread than in those countries where there is less awareness of these issues.

The industry sector bias arises from the fact that the rating agency fails to assess in a neutral manner several companies operating in different sectors, from which different risks arise and which have different structural characteristics among themselves.

The last bias, also known as the "rater effect" was first conceptualized by Berg F., Koelbel J., and Rigobon R. in 2020 According to the authors, the rater effect "*describes a bias, where performance in one category influences perceived performance in other categories*". The consequence of this divergence in the ESG ratings are important. Not only does it become very complicated for rating agencies to understand how companies perform in terms of ESG, but this divergence leads to a disincentive for companies to improve their ratings and thus increasingly embrace ESG factors in their policies. This could ultimately lead to a decrease in sustainable investments[14].

1.1.2 Challenges of the development of sustainable finance

[13] GYÖNYÖROVÁ, STACHOŇ & STAŠEK "*ESG ratings: Relevant information or misleading clue? Evidence from the S&P Global 1200*" Journal of Sustainable Finance & Investment, pp. 1–35, (2021).

[14] BERG, KOELBEL AND RIGOBON, "*Aggregate Confusion: The Divergence of ESG Ratings*." Review of Finance, (2020).

The main criticalities of the shift from the 'traditional' finance paradigm to sustainable finance are: (i) the absence of a shared taxonomy for the identification of sustainable financial activities, products and services; (ii) the publication of insufficient and/or non-comparable information by companies; (iii) the opacity of methodologies underlying ESG ratings and scoring, which are based on backward-looking analyses (i.e., a backward-looking approach regarding the analysis of all historical company information, in addition to the verification of the current condition) and do not always capture material issues for the stakeholders who use them; and (iv) the lack of a satisfactory dialogue between companies, investors and data providers[15].

A major obstacle to the development of sustainable finance is the lack of a shared taxonomy of sustainable activities and a standardized terminology. To date, it is indeed very difficult to understand which investments fall under the E, S and G factors, and this is particularly complicated in the second factor, the social factor. The latter represents the most general and undefined category of sustainability, and *de facto*, in the absence of a recognized taxonomy, everything that is sustainable but not related to the environment and governance is socially sustainable.

A second issue that has long concerned investors is the standardization of information. There is a lack of standardized agreements on non-financial reporting, and it is very difficult for the market to converge towards standardization on its own if it is not imposed on it. Although on 11 September 2020, the five international ESG organizations published a joint statement in which they commit to work together with key market players and propose the integration of existing ESG standards and generally accepted financial accounting principles as the basis for a coherent and comprehensive corporate reporting system[16]. Other initiatives to achieve standardization have since emerged from this statement, such as that of the IFRS Foundation, which in 2020 launched a public challenge and explored the idea of creating an International Sustainability Standards Board (ISSB) that would set standards in the non-financial sphere. The ISSB was then created on 3 November 2021 and in March 2022 it

[15] LINCIANO, CAFIERO, CIAVARELLA, DI STEFANO, LEVANTINI, MOLLO, NOCELLA, SANTAMARIA, TAVERNA "*Sustainable finance: Trends, issues and perspectives amid the evolution of the EU regulatory framework*" Finanza Sostenibile, Consob, 2021.

[16] The five ESG international organizations are: CDP, the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB). See "*Joint Statement: Working Together Towards Comprehensive Corporate Reporting*" 2020, available at: https://www.integratedreporting.org/news/joint-statement-working-together-towards-comprehensive-corporate-reporting/

published the Exposure Draft IFRS Sustainability Disclosure Standard[17], whose comments are expected by 29 July 2022. To sum up the proposals contained in the draft, they would require entities to provide material information on sustainability-linked risks and opportunities to which it is exposed, at the same time when the financial statements are disclosed, and this information will be useful to better understand the way in which the entity operates "*covering governance, strategy, risk management and metrics and targets*"[18]. The entity is required also to provide all the material information on the possible links between the information provided. Finally, an entity which wants to be deemed as IFRS Sustainability Disclosure Standards compliant, shall be compliant with all the requirements contained in it.

A further obstacle to the development of sustainable finance is investors' perception of a trade-off between ESG performance and financial return. Studies on the subject show, however, that the implementation of sustainable strategies can lead to a decrease in risk in the long run and thus meet the objectives of sustainable development and financial performance[19].

In addition on the subject of financial performance, there has been much debate about the breach of fiduciary duties of asset managers towards investment beneficiaries in the case of the above-mentioned trade-off between the pursuit of sustainable investment and financial performance. In this matter, the Freshfield Report commissioned by the United Nations and published in 2005 was a turning point[20]. According to this report, the integration of ESG factors is compatible with the fiduciary duties of asset managers in at least three circumstances:

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[17] Exposure Draft IFRS Sustainability Disclosure Standard, *"[Draft] IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information*", (2022). Available at: https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financial-information.pdf. For a summary of the General Requirements see the document available at the following link: https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/snapshot-exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financial-information-and-exposure-draft-s2-general-sustainability-related-disclosures.pdf

[18] *Ibid.*

[19] SASSEN, HINZE, HARDECK, "*Impact of ESG factors on firm risk in Europe*" Zeitschrift Für Betriebswirtschaft, vol. 86, no. 8, pp. 867–904, (2016).

[20] FRESHFIELDS BRUCKHAUS DERINGER, "*A legal framework for the integration of environmental, social and governance issues into institutional investment*" (2005). Available at: https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

(i) if there are two alternative investments and the sustainable investment is the tie-breaker;

(ii) if ESG factors are relevant on financial performance;

(iii) if such factors are relevant even if they result in losses in terms of financial performance.

Later in 2021, another report, entitled "Fiduciary Duty in the 21st Century", concluded the debate by stating that the failure to take ESG factors into account results in a breach of fiduciary duties if these factors affect long-term investment returns.[21]

[21] PRI, UNEP FI, UNEP INQUIRY AND UN GLOBAL COMPACT, "*Fiduciary Duty in the 21st Century*", 2021. Available at: https://www.unpri.org/download?ac=1378

1.2 The origins of sustainability from the concept of "Sustainable Development to "Corporate Social Responsibility"

In 1987 the World Commission on Environment and Development published a report that first defined the concept of sustainable development. The Brundtland Report, also known as "Our Common Future", defines sustainable development as "*…development that meets the needs of the present without compromising the ability of the future generations to meet their own*"[22]. This definition creates a linkage between the notion of development, until then conceived by economists only as the growth per capita income (i.e., GDP), and the environment. In addition, it links the needs of the current generation and the future generations, by implying that the exploitation of natural resources, necessary for production processes and ultimately for the satisfaction of human needs, must not be conducted in a manner that negatively impacts future generations[23]. This notion has had several positive effects on public opinion and lead to a growth of awareness of ecology and economy.

Nevertheless, the notion of sustainable development, as defined in the Brundtland Report, has been criticized for its anthropocentric approach, as it focuses on the economic and social aspect of human beings at the cost of natural resources, without taking other living beings into account[24]. Indeed, the key indicators used for measuring sustainable development were more economically and socially oriented and by taking this approach they were hampering the achievement of sustainable development. This is due to the fact that the perception of the objective of sustainable development is different depending on the interests of the group: for those who focus on the environment, sustainable development means protect the ecosystem's stability, whereas for those who focus on the social aspect means meeting the needs of humans. Lastly, for those who focus on the economy, sustainable development means to maintain the steadiness of economy. Robinson in 2004 argued that Brundtland Report's definition fostered delusions, because in order to achieve the objective of reducing poverty the Brundtland Commission proposed to increase world gross industrial activity by "5-10 fold", and by doing so, the author argues, that the report was not taking into account the equal

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[22] WCED 1987, "*Our Common Future: A Report from the United Nations World Commission on Environment and Development*", available online at: http://www.un-documents.net/our-common-future.pdf.

[23] MONTANI, "*The Ecocentric Approach to Sustainable Development. Ecology, Economics and Politics*." Federalista, XLIX, no. 1, pp. 25–60, (2007).

[24] SOPHIA, KHORSHED AND NARELLE, "*Reinterpreting the Definition of Sustainable Development for a More Ecocentric Reorientation*" Sustainable Development (Bradford, West Yorkshire, England), vol. 22, no. 2, pp. 134–144, (2014).

threat that the over-development, required to meet the need of the poor, posed to the environment[25]. The definition was also largely criticized because of its vagueness. Michael Jacobs noted that this striking characteristic of sustainable development "*allows business and "development" interests (and their government supporters) to claim that they are in favour of sustainable development when actually they are the perpetrators of unsustainabilty*"[26].The term sustainable development can, indeed, means several different things, but vague as it was in the 1987 report, it did not enable the policy makers to enact efficient legislation. It was argued by some authors that the proposed definition was intentionally left too vague in order to gain widespread acceptance with it, and its vagueness allowed to focus on economic development rather than to tackle environmental issues[27].

Notwithstanding, the first conception of sustainable development was often related to the issue of environmental protection[28], which is why its definition was taken up in the Rio Declaration[29] on Environment and Development, in which, under principle 3, it is stated that "*The right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations*.". This concept has served as the foundation for the drafting of important international treaties, including the Paris Agreement and the United Nations 2030 Agenda, both signed in 2015, and has established itself as a principle of international law.

It is therefore clear that the pillars of sustainable development are economy, environment, and society. Economic sustainability is the steadiness and the soundness of the economic system as a whole and its capacity to support a defined level of economic growth without negatively impact social, environmental, and cultural aspects of a community. Social sustainability, to

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[25] ROBINSON, "*Squaring the Circle? Some Thoughts on the Idea of Sustainable Development*" Ecological Economics, vol. 48, no. 4, pp. 369–384, (2004).

[26] JACOBS, "*Sustainable development: a contested concept*" in Andrew Dobson (ed.) Fairness and Futurity: Essays on Environmental Sustainability and Social Justice (Oxford, 1999; online edn, Oxford Academic,1 Nov. 2003).

[27] GIDDINGS, HOPWOOD AND O'BRIEN "*Environment, economy and society: fitting them together into sustainable development*", Sustainable Development (Bradford, West Yorkshire, England*)*, vol. 10, no. 4, pp. 187–196, (2002).

[28] Consob Paper on Sustainable Finance no. 1/2021, "*Sustainable finance: Trends, issues and perspectives amid the evolution of the EU regulatory framework*".

[29] The definition of sustainable development will be later taken up by the Convention on Biological Diversity of 1993, Convention on Climate Changes of 1994, as well as by the following Conferences of the United Nations in particular the Johannesburg Conference on Environment and Development of 2002.

use Stephen McKenzie's definition, is a positive condition within communities, and a process within communities that can achieve that condition[30].

The definition of environmental sustainability has always been a contentious issue and the result is that the concept is often interpreted based on one's own political and philosophical ideals rather than relying on a scientific definition[31]. Attempts to find a scientific definition have been made in the past such as John Morelli's, who defines it as "*a condition of balance, resilience, and interconnectedness that allows human society to satisfy its needs while neither exceeding the capacity of its supporting ecosystems to continue to regenerate the services necessary to meet those needs nor by our actions diminishing biological diversity*"[32]. It is often questioned the relevance of finding a clear definition of environmental sustainability, however, if we assume that the ultimate goal of sustainable development is to satisfy the needs of the present generation without negatively impacting future generations, it is self-evident that policymakers need clarity in what they have to counteract and they need a basis from which they can efficiently implement those measures necessary to achieve the goal of sustainable development. Later on, another definition[33] has been proposed[34], which defines environmental sustainability as "*The avoidance, to the maximum practicable extent, of irreversible and irretrievable commitment of resources*.".

Scholars studied the relationships between the three pillars of sustainable development and their interconnectedness, and the most common model is often figured as three interconnected

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[30] MCKENZIE, "*Social Sustainability: Towards Some Definitions*.", Hawke Research Institute Working Paper Series No. 27, p. 23, (2004). The author also supplemented his definition of Social Sustainability with a list of corresponding principles, including: (i) equity of access to key services; (ii) equity between generations; (iii) a system of cultural relations in which the positive aspects of disparate cultures are valued and protected; (iv) the widespread political participation of citizens, particularly at a local level; (v) a system for transmitting awareness of social sustainability from one generation to the next; (vi) a sense of community responsibility for maintaining that system of transmission; (vii) mechanisms for a community to collectively identify its strengths and needs; (viii) mechanisms for a community to fulfil its own needs where possible through community action; (ix) mechanisms for political advocacy to meet needs that cannot be met by community action.

[31] See ROBINSON (3).

[32] MORELLI, "*Environmental Sustainability: A Definition for Environmental Professionals*" *ournal of Environmental Sustainability*: Vol. 1: Iss. 1, Article 2, (2011), in which the author took the definition given by the Burtlandt Report and transposed it into the environmental sphere.

[33] FULTON, CLARKE & ALBAN "*Environmental sustainability: finding working definition*", Environmental Law Reporter, vol. 47, no. 6, p. 3, (2017).

[34] The authors drew inspiration from the U.S. National Environmental Policy Act adopted in 1970. NEPA's consideration 102 stipulates that "to the fullest extent possible…the policies, regulations, and public laws of the United States shall be interpreted and administered in accordance with the policies set forth in NEPA," such as the nation's commitment to "enhance the quality of renewable resources and approach the maximum attainable recycling of depletable resources" and in order to do so "every recommendation or report on proposals for legislation and other major Federal actions significantly affecting the quality of the human environment" should include a statement on its environmental impacts and "any irreversible and irretrievable commitments of resources which would be involved in the proposed action should it be implemented".

rings (Figure 1) whereby sustainable development is understood as the balance between the three different areas.

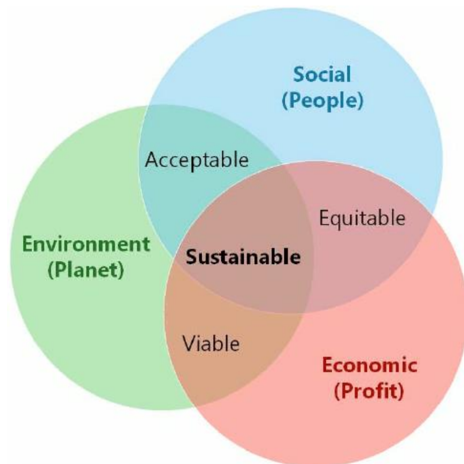

Figure 1. Three-ring view of sustainable development

However, as pointed out by Giddings, this model shows criticalities[35]. In fact, if the three pillars are figuratively and conceptually separated, it only fuels that difference of interests belonging to different groups, to the point where the sacrifice of one of these areas at the expense of the others is justified.

Giddings argued that sustainable development is structured in a multilevel way and proposed a new model of thinking in which the economic is dependent on society and the latter is dependent on environment. By reversing the common model, according to which the three areas could be depicted as three interconnected rings, the author created a new figurative and conceptual model in which economy, society and environment are depicted as three concentric rings that affects each other. On this view is author Lozano[36] who proposes a definition of sustainable development that connects all three pillars because is understood to be "*a change process, in which the societies improve their quality of life, reaching dynamic equilibrium between the economic and social aspects, while protecting, caring for and improving the natural environment. This integration and equilibrium among these three aspects must be taught and transferred from this generation to the next and the next*''. In this definition, sustainable development is a dynamic concept which evolves throughout the years; however, it seems that its main focus is on the first two pillars rather than the environment

[35] See GIDDINGS, HOPWOOD AND O'BRIEN (5).
[36] LOZANO-ROS, "*Sustainable development in higher education. Incorporation, assessment and reporting of sustainable development in higher education institutions*." MSc Thesis, In Environmental Management Policy. Lund University, Lund, Sweden, (2003).

which is deemed as a side effect of the main goal, i.e., the dynamic equilibrium between economic and social aspects. Another important point raised by the author is the need of transmitting awareness from a generation to another and that's why his paper focuses on how sustainable development can be taught in universities and transmitted to future generations.

It is especially because of its dynamic character that the definition of sustainable development is difficult to grasp, nor did economic analysis help, which struggled to find a definition and only used this term to put it in opposition to the "orthodox" economists, on the one hand, and critics of linear economy, on the other. However, since the Brundtland Commission, there has been a growing consensus among economists that the notion of sustainable development is compatible with the classical economic paradigm. Implementing the sustainability concepts in the classical economic paradigm is feasible only if one recognizes the value reserve function of money and capital and the servant character of finance with respect to the real economy and its production processes, in most cases framed within a medium to long time horizon[37]. In this way, the classical paradigm might integrate an economic model based on a dynamic, long-term vision that takes into account the interests of both current and future generations and recognizes the interconnectedness between the three pillars of sustainable development. Over time, there has been a growing realization that the integration of environmental and social consideration into economic processes cannot be separated from the governance of public and private decision-makers, because if companies "*persist in treating climate change solely as a corporate social responsibility issue, rather than a business problem, will risk the greatest consequences*"[38]. This led to the recognition of the interdependence between sustainable development and ESG factors.

The ICJ Case Concerning the Gabčikovo-Nagymaros Project (Hungary v. Slovakia) 1997 is of unquestionable significance in the field of sustainable development, as for the first time this principle has been recognised in a decision of the International Court of Justice. Regarding the facts of the case, in 1977 Hungary and Czechoslovakia had started the construction of several dams. Hungary subsequently decided to suspend their construction activities in 1989 because it feared an excessive environmental impact. In 1993, however, Czechoslovakia proceeded with the construction of the dams on its own. The case came before

[37] SOPPE, ALOY, "*Sustainable Finance as a Connection Between Corporate Social Responsibility and Social Responsible Investing*" Indian School of Business WP Indian Management Research Journal, Vol. 1, No. 3, pp. 13-23, (2009). Available at SSRN: https://ssrn.com/abstract=1336182

[38] PORTER, MICHAEL AND FOREST REINHARDT. "*A Strategic Approach to Climate*." Harvard Business Review, 85, pp. 22-26.

the International Court of Justice, which invoked the principle of sustainable development. The court recognised that new regulations and standards had been developed in recent years, thanks to new awareness and scientific progress. Standards that must be taken into account and that protect the environment. To put it in the Court's words "*This need to reconcile economic development with protection of the environment is aptly expressed in the concept of sustainable development*"[39].

However, the court did not stop there; while leaving the 1977 treaty intact, on the basis of which the construction of dams was regulated, it suggested that the parties should rewrite the treaty. In saying this, the Court gave substantive value to the principle of sustainable development and not merely a recognised and shared value. While not dwelling on the legal status of the principle of sustainable development, it gave normative force to the concept by making it a principle of international law[40].

Parallel to the concept of sustainable development, the concept of Corporate Social Responsibility (CSR) has developed. The term CSR stands for that situation in which a company acts in such a way as to improve the lives and social condition of the people affected by its activities[41]. This creates a connection between the economic activity of companies and the community, a connection that aims to find the balance without undermining either the economic goals or the well-being of either party. The context in which the term CSR can be applied is very wide and varies from small companies to those companies with much larger dimensions that are therefore more exposed to the public and whose reputation runs more risk of adopting policies contrary to CSR. The importance of this phenomenon is increasingly evident, and a survey carried out in the United States showed that[42]:

- 75 per cent of customers would react negatively to irresponsible actions by the company;
- companies that do not respect CSR risk losing 39 per cent of their potential customer base and one in four would say they avoid these companies; and

[39] See ICJ Case Concerning the Gabčikovo-Nagymaros Project (Hungary v. Slovakia) 1997, para. 140.
[40] VOIGT, "*Sustainable Development as a Principle of International Law*", Vol. 2, BRILL, (2008).
[41] FREDERICK, "*Corporate Social Responsibility: from founders to millennials*" Corporate Social Responsibility (Business and Society 360, Vol. 2), Emerald Publishing Limited, Bingley, pp. 3-38, (2018).
[42] AFLAC, "*National survey on corporate social responsibility*" (2016), available at: https://www.aflac.com/docs/about-aflac/csr-survey-assets/2016-csr-survey-deck.pdf

- 83 per cent of institutional investors prefer to invest in companies that are in line with CSR because they are synonymous with transparency and thus less risk.

According to Frederick, two factors have a huge impact on CSR: (i) the scope and commitment to a market economy and (ii) the size, strength, and independence of the corporate sector. The first factor is why in the United States, where the economy is predominantly market-based and the role of business is very important while the role of government is much smaller, the CSR phenomenon has developed extensively since the 1920s.

The reasons for this development can be found in the various revolutionary social upheavals that took place over the years, fueled by new standards of living and prosperity that became established. This phenomenon evolved during the 20th century to reach its peak during the 2000s. The author proposes a distinction of the evolution of the meaning of CSR into five different phases that differ in their drivers and are explained in more detail below.

(i) Corporate Social Stewardship (1950s-1960s)

During this period the corporate managers were seen as public trustees/stewards of broad-scale economic interests. These individuals had control of important resources for the society that was recovering from the Second World War, and for this reason they acted in the public interest without stopping at the sole purpose of creating profit typical of the classical economic paradigm. This adherence by the executive of societies was totally voluntary and without any regulatory direction. The impulses that drove managers to behave in a socially responsible manner were not only their own conscience, but also economic advantages guaranteed by tax laws that privileged companies that directed their capital towards social causes.

The exponent of this current, who is often celebrated as the founding father of the CSR concept, is Howard Bowen who defines social responsibility as "*the obligations of businessmen to pursue those policies, to make those decisions or to follow those lines of action which are desirable in terms of the objective and values of our society*"[43]. The author

[43] BOWEN, "*The Social Responsibilities of the Businessman*" Harper and Row, (1953).

believed that by taking into account social obligations in their decisions, executive could have ameliorating economic problems[44].

(ii) Corporate Social Responsiveness (1960s-1970s)

The tumultuous movements of this historical period radically changed the notion and doctrine of CSR. In the 1960s social upheavals resulting from racial and gender discrimination and from the continuing irresponsible actions of companies such as contamination of neighborhoods or creation of unsafe vehicles, corruption, have led to the imposition of regime change. The government began to take an interest in the issue and established various authorities (i.e., Food and Drug Administration, Mine Safety and Health Administration, Securities and Exchange Commission etc.) to protect these social interests impacted by the activities of corporations. Voluntary adherence on the part of managers was no longer sufficient, and society began to demand changes on the social level from companies as well. Therefore, CSR required social activism that took the form of:

(a) social-impact awareness;
(b) assigning strategic priority to the company's social impacts in order not to jeopardise the functional elements of business;
(c) Organisational redesign and training; and
(d) Implementation of "claimants"[45] into a company's strategy.

(iii) Corporate Business Ethics (1980s-1990s)

In the 1980s and 1990s, a corporate culture began to develop. This culture, influenced by the working environment and the principles shared by the workers who worked there, began to become an emblem of how society related to social problems and the corporate image of that working environment began to take shape. The promotion of workers' and human rights, social welfare and environmental protection became part of the business strategy of companies starting from the bottom, from the individual beliefs of workers.

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[44] ACQUIER, AURÉLIEN, ET AL. "*Rediscovering Howard R. Bowen's Legacy*." *Business & Society*, vol. 50, no. 4, pp. 607–646, (2011).

[45] EELS, "*The Meaning of Modern Business*" *Harvard Law Review*, vol. 74, no. 1, pp. 200–203, (1960). The author writes about "contributor-claimants" who have a contractual bond with the company and "Indirect claimants" who do not have a contractual bond with the business, such as the local community. The term "claimant" was nothing more that the precursor of the term stakeholder, which did not become widespread until the 1980s-90s, but the idea behind to include the claimants' interest into the strategy of a business was the same.

What influenced and generated the development of this societal culture was undoubtedly: (i) a return of religious ideals; (ii) a response to technological and industrial changes that led people to find shelter in long-established community standards; (iii) support for human rights.

In 1984 R. Edward Freeman published his book "Strategic Management: A Stakeholder Approach" in which he argues that you cannot do without considering the claims of society and thus of the "stakeholders" because the survival of society depends on it. Without the lenders, companies can survive but not without the stakeholders. The term "stakeholder" made its first appearance in 1963 in a memorandum at the Stanford Research Institute[46]. That memorandum provided for a definition of this term, according to which the stakeholders are "*those groups without whose support the organization would cease to exist*".

The stakeholder approach, which argues that social responsibilities must be taken into account in corporate strategies, is contrasted by the shareholder approach. The latter, whose foundation can be found in traditional neoclassical theories, argues that the only social responsibility of a company is profit maximization. Milton Friedman published an article in 1970 in which he argued that there are no social responsibilities as claimed by the proponents of stakeholder theory, because responsibilities can only be assumed by a person and not by a legal entity. Friedman argues that the manager is nothing more than an agent vis-à-vis the owners of the company, and his responsibilities are only to them. He does not exclude that the manager, as a person, may have his own ideals and sensibilities that lead him to pursue social ends beyond those imposed on him by his role, but in doing so he acts rather as a principal and not an agent[47].

(iv) Corporate Global Citizenship (1990s-2000)

With the advent of globalization and the crumbling of the ideals of nationalism, the meaning of citizenship has taken on a different spirit. Social responsibilities are no longer confined to small communities whose lives were directly affected by the activities of society, but a common sense of belonging has pushed towards a new phase of CSR, one in which social, environmental, and economic claims are no longer delimited by national boundaries. A new

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[46] FREEMAN, "*Strategic Management: A Stakeholder Approach*" Cambridge University Press, (2010).
[47] FRIEDMAN M., "*A Friedman doctrine: The Social Responsibility of Business is to Increase Its Profits*" The New York Times, (1970).

form of CSR was idealized and new definitions, such as: "*global business citizen is a business enterprise (including its managers) that responsibly exercises its rights and implements its duties to individuals, stakeholders, and societies within and across national and cultural borders*"[48].

New concepts took hold and influenced the CSR doctrine such as that of sustainable development, analyzed above. The CSR doctrine then intersected with the definitions of these new concepts to achieve new and different goals from those traditionally pursued.

(v) Toward a Millennial Future (2000-3000)

The author defines this phase as unknown, unknowable, and unpredictable and that the only possible way to talk about this new phase we are experiencing is to speculate about it.

The concepts that, according to the author, will be instrumental in shaping this new doctrine are sustainability and generational change. Sustainability is a concept that has taken hold in every sector of the economy and of our lives. According to Zabihollah Rezaee, the aim of business sustainability is to create stakeholder value, and he concludes by saying that "*Sustainability strategies should be integrated into corporate decision-making processes in promoting ... EGSEE (Economic, Governance, Social, Ethical, and Environmental) dimensions ...*"[49]. On the other hand, there is the generational change that signifies that change of values, sensitivity to social welfare and environmental issues that are typical of Millennials (i.e., people born between the 1980s and the 2000s).

In conclusion, as most of the concepts used in sustainable finance, CSR might mean a lot of different things depending on the values of the community to which we are referring. The European Commission gave its definition of CSR as "*responsibility of companies for their impact on society*". This definition, despite representing the core of the CSR concept, may, in the eyes of someone totally unfamiliar with the concept, appear as particularly concise and approximate. It may therefore be useful to recall the previous interpretation, also provided by the Commission and contained in the Green Paper of 2001, as it is more detailed, although not able to give a representation of the complexity of the concept. Corporate Social Responsibility expresses "*the voluntary integration of the social and ecological concerns of*

[48] LOGSDON, JEANNE AND WOOD. "*Global Business Citizenship and Voluntary Codes of Ethical Conduct.*" *Journal of Business Ethics*, vol. 59, no. 1/2, pp. 55–67 (2005).
[49] REZAEE, "*Business Sustainability: Performance, Compliance, Accountability, and Integrated Reporting*" Milton Park Routledge, (2017).

companies in their business operations and in their relations with their stakeholders"[50], thus indicating the set of practices and behaviors, adopted in respect of ESG issues and aimed at safeguarding the interests of their collaborators and employees, but also of suppliers, customers, partners, communities, and local institutions. The conciseness of its new version has a meaning, that of shifting the focus from 'voluntary integration' to the need for greater adherence to international principles, given the position of relevance that the phenomenon is gaining prominence among European priorities.

It is therefore evident how difficult it is to give a definition to a concept as vast and complex as CSR. On the other hand, as far as the scope of CSR is concerned, it is, to say the least, unlikely to give a definition, if not completely wrong, for two mains but not exhaustive reasons. Firstly, the experience of the past few years has shown us how the discipline is constantly expanding to new causes; secondly, it would be fundamentally incorrect to give application limits to a practice whose positive effects are increasing in proportion to its expansion. In other words, defining CSR in a fixed perimeter would mean limiting the possible expansion of an activity that can only generate only positive effects.

[50] Communication from the commission to the European parliament, the Council, the European Economic and Social Committee and the Committee of the regions. A renewed EU strategy 2011-14 for Corporate Social Responsibility of October 25, 2011. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011DC0681&from=IT

1.3 Paris Agreement: a landmark of the fight against climate change

1.3.1 Brief introduction

On 12 December 2015, under the United Nations Framework Convention on Climate Change (UNFCCC), 196 countries from all over the world signed an agreement, called the Paris Agreement, which subsequently entered into force on 4 November 2016. This agreement combined the knowledge of all signatory nations to fight a common cause and mitigate the effects of climate change. The agreement consists of a preamble and 29 articles that define the objectives of the agreement as well as its scope and definitions.

To ensure that the targets set are met, the agreement is based on a bottom-up approach, thus leaving the scope of each nation's contribution to its discretion. This was the result of a long negotiation that saw strong divisions between the nations who did not want to see their discretion limited. States must therefore communicate the so-called Nationally Determined Contributions (NDC), i.e., documents in which nations set out their plans on how they intend to contribute to the above-mentioned goals. These documents must be submitted every five years and must still meet the agreement's requirements for transparency and clarity. The Paris Agreement creates an obligation on States to introduce those measures deemed necessary to achieve the goals set out in their NDCs. This implies that the mentioned obligation is an obligation of conduct and not of outcome, i.e., an obligation that requires the obliged party to perform a certain activity without ensuring that any outcome follows from it. As Christina Voigt suggested this obligation of conduct means that the Contracting Parties must pursue those measures "*that are necessary, meaningful and, indeed, effective to function as a means to this end*"[51].

Other authors argue instead that "*the absence of any obligation to achieve the nationally determined contributions, while implying that there is no obligation to implement the nationally determined contributions as such, does not mean that there is also no obligation to implement the domestic measures aimed at reaching the objectives thereof. In fact, the second sentence of Art. 4(2) specifically deals with those measures, rather than the nationally determined contributions*"[52].

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[51] VOIGT, "*The Paris Agreement: What Is the Standard of Conduct for Parties?*" QIL, Zoom-in 26, 17-28 2018, (2016).

[52] GERVASI, "*On the United States' Decision to Withdraw from and Cease Implementation of the Paris Agreement on Climate Change*" Chinese Journal of International Law (Boulder, Colo.), vol. 18, no. 4, pp. 777–809, (2019).

It is argued that here relies on the weakness of the Paris Agreement. In fact, it would seem that, in the event that a party fails to fulfil its NDC, it would find no negative impact related to the legal non-performance of the document for the purposes of state liability law[53]. However, the functioning of obligations of conduct is different, for the state would have to be able to prove that it had taken all those measures necessary for the intended objectives. If and only if it could prove that it had diligently pursued the necessary measures, then it could avoid the negative consequences of the breach of the NDC. Moreover, it is not even certain that a party cannot be found in breach even if the result contained in the document has been achieved[54]. The level of commitment required by the individual state will depend on how high the standards set in the respective NDCs are, but the obligation is deemed to be limited to climate change mitigation measures alone. Furthermore, nations can decide at any time to modify unilaterally their NDCs.

Cooperation is a cornerstone of the Paris Agreement which, with regard to the adaptation goal, says: *"adaptation is a global challenge faced by all with local, subnational, national, regional and international dimensions, and that it is a key component of and makes a contribution to the long-term global response to climate change to protect people, livelihoods and ecosystems, taking into account the urgent and immediate needs of those developing country Parties that are particularly vulnerable to the adverse effects of climate change".*

The agreement places developed countries in a central position to lead "*by undertaking economy-wide absolute emission targets*", whilst developing countries are encouraged to continue their mitigation efforts.

1.3.2 Analysis of Article 2

The Paris Agreement, unlike previous treaties such as the 1997 Kyoto Protocol or the Berlin Mandate, where the main model was to give authority to international public law, shifted the focus from traditional models to one where more focus is placed on national governance.

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[53] RAJAMANI AND BRUNNÉE, "*The Legality of Downgrading Nationally Determined Contributions under the Paris Agreement: Lessons from the US Disengagement*" Journal of Environmental Law, vol. 29, no. 3, pp. 537–551, (2017).

[54] See Certain Activities Carried Out by Nicaragua in the Border Area (Costa Rica v. Nicaragua) whereby the International Court of Justice concluded that the obligation of conduct was breached by Costa Rica even though the outcome was achieved.

Article 2 of the Paris Agreement sets out the objectives that nations must have in mind when implementing this agreement[55]. The article opens by stating that the objective of this agreement is to "*strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty*". This shows the compromise reached by the parties, who were split between those who wanted to limit the final scope of the agreement to climate change alone and those who wanted to broaden its scope to include social issues such as poverty.

(i) Temperature target

It goes on to state that the above-mentioned objective is to be achieved by: *"Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels*".

Article 2(1)(a) of the Paris Agreement is inevitably linked with Article 2 of the UNFCCC, pursuant to which the FCCC's objective is to achieve "*stabilization of greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system*"[56].

The Paris Agreement sets a target that espouses the theory that even an increase of 2°C would have devastating consequences, such as reduced biodiversity in various regions of the world, reduced crop, and fishery productivity, etc.[57]

The language used in the Paris Agreement 'well below 2°C' remains dubious. According to Alexander Zahar, there is no difference between 'below' and 'well below', the result is equivalent[58].

Still controversial is the nature of the obligation that Article 2 creates. According to some commentators, the target set does not impose a legal obligation on States, but rather creates

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[55] CALSTER, GEERT VAN, AND REINS, "*The Paris Agreement on Climate Change: A Commentary*". Edward Elgar Publishing (2021). See generally, RAJAMANI L., "*Ambition and Differentiation in the 2015 Paris Agreement: Interpretive Possibilities and Underlying Politics*" The International and Comparative Law Quarterly, vol. 65, no. 2, pp. 493–514, (2016)

[56] United Nations Framework Convention on Climate Change, 1992. Available at: https://unfccc.int/files/essential_background/background_publications_htmlpdf/application/pdf/conveng.pdf

[57] See IPCC, 2018: Summary for Policymakers, Global Warming Global Warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty.

[58] ZAHAR, "*The Paris Agreement and the Gradual Development of a Law on Climate Finance*", *Climate Law*, vol. 6, no. 1-2, pp. 75–90, (2016).

a global commitment to reduce warming within a predetermined temperature range[59]. On the other hand, there are those who argue that from a legal point of view, this article enshrines a binding target for States[60].

(ii) Adaptation

Under Article 2(1)(b) another way to achieve the objective of the Paris Agreement is by "*Increasing the ability to adapt to the adverse impacts of climate change and foster climate resilience and low greenhouse gas emissions development, in a manner that does not threaten food production*". The Paris Agreement finally focuses on an aspect of the fight against climate change that was ignored by previous treaties. In the FCCC, this notion plays a marginal role compared to the role of mitigation, unlike the Kyoto Protocol where it is given greater prominence by also establishing a special fund for adaptation[61]. In the Paris Agreement, on the other hand, we find an entire article dedicated to it, Article 7.

Although the term does not find its own definition in the agreement, this can be found in the IPCC's report which defines adaptation as "*the process of adjustment to actual or expected climate and its effects. In human systems, adaptation seeks to moderate or avoid harm or exploit beneficial opportunities. In some natural systems, human intervention may facilitate adjustment to expected climate and its effects*"[62].

With regards to its legal nature, the adaptation goal and its obligations under Article 7 of the Paris Agreement cannot be defined as binding because they lack the legal terminology commonly used, such as "shall" or "should". Instead, Article 7 uses the word "establish", which means that the goal of adaptation is a global aspiration rather than an obligation[63].

In 2020, the World Bank published a report in which defines 6 principles of climate change adaptation that must be followed in order to achieve it. The first principle says that

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[59] CALSTER, GEERT VAN, AND REINS, (38).

[60] EKARDT, WIEDING AND ZORN, "*Paris Agreement, Precautionary Principle and Human Rights: Zero Emissions in Two Decades?*" Sustainability (Basel, Switzerland*)*, vol. 10, no. 8, p. 2812, (2018).

[61] Prior to the Paris Agreement in 2007, the IPCC's fourth report had highlighted adaptation as a necessary measure to tackle climate change, which is why in 2010 this urgency was translated into the Cancun Adaptation Framework (CAF) after three years of negotiations between states. The CAF emphasized the importance of treating climate change adaptation on a par with mitigation and showed what work, under the UNFCCC, needed to be done to promote it.

[62] IPCC, "*Summary for policymakers' in Climate Change 2014: Impacts, Adaptation and Vulnerability. Part A: Global and Sectoral Aspects. Contribution of Working Group II to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change*", 2014.

[63] RAJAMANI, "*The 2015 Paris Agreement: Interplay Between Hard, Soft and Non-Obligations*", Journal of Environmental Law, vol. 28, no. 2, pp. 337–358, (2016).

development should be fast and should increase protection against shocks. The second principle says that countries shall facilitate the adaptation of firms and people. The third principle states that the use of land should be adapted to climate change and critical assets and services of a country should be protected. The fourth principle suggests that firms and people should be helped to cope with disasters and be helped with the recover from them. The fifth principle sustains that policymakers should anticipate and manage macroeconomic and fiscal risks and the last principle says that the priority should be on enacting and monitoring interventions[64].

(iii) Finance

The Paris Agreement recognizes and espouses those theories that recognize the central role of finance and the capital movement in combating climate change by stating under Article 2(1)(c) that to achieve the goal of the Paris Agreement countries should make "*finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development*".

In 2021, a study shows that the finance needed to tackle climate change and to achieve the target temperature of the Paris Agreement must increase to $5 trillion a year globally by 2030. It is therefore clear how key a role finance plays and for that it has long been the focus of climate debates. Nevertheless, this is not reflected in the Paris Agreement, which in Article 2 uses ambiguous language that again does not create an obligation on states. The main problem is that nations lack the public financial resources needed to combat climate change, so it becomes urgent to turn to private capital and investment, which on the other hand are not parties to the Paris Agreement and cannot be held bound by it. In spite of this, the notion of 'Paris aligned' investments has been gaining ground and in particular forms of taxonomies (such as the one adopted by the European Union, which we will analyze in chapter two) are increasingly directing private investments towards environmentally sustainable activities in order to make their contribution to the fight against climate change.

Under Article 9 of the Paris Agreement, developed countries shall provide financial resources to assist developing countries in tackling climate change. In this article, it is reasonable to infer the idea that more developed states, which have contributed more greenhouse gas emissions throughout history, are more to blame, while less developed

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[64] HALLEGATTE, RENTSCHLER, ROZENBERG, "*Adaptation Principles: A Guide for Designing Strategies for Climate Change Adaptation and Resilience*", World Bank (2020).

countries will suffer the devastating consequences of climate change despite having contributed enormously less to environmental pollution.

1.3.3 A UK case study: the Heathrow Case

A very important case was decided before the English Supreme Court on climate change, a case that gives us a better understanding of the legal nature of the Paris Agreement and how this treaty is viewed domestically by one of the developed countries most dedicated to fighting climate change[65].

Before recounting the facts, it is necessary to premise that the Paris Agreement was ratified by the English government on 17 November 2016 but was never incorporated into domestic law. The English dualist system considers an international treaty that has not been transposed into domestic law to be 'unincorporated', and for this reason the obligations it contains are not effective in domestic law.

The issue arose in 2018 with the Airport National Policy Statement (ANPS), a document drafted and presented to parliament by the Secretary of State, which highlighted the need to build a third ramp for Heathrow Airport. The legal basis for the appeal was, *inter alia*, that in designating the ANPS the Secretary of State was in breach of Section 5(8) of the Planning Act 2008, which states that policies such as the ANPS designed in 2018 must contain "*an explanation of how the policy set out in the statement takes account of Government policy relating to the mitigation of, and adaptation to, climate change*". To tackle climate change, the UK introduced the Climate Change Act in 2008 (CCA) in which it set a national carbon target[66].

The Respondents argued before the lower court that within the meaning of the word 'government policy' under Section 5 (8) should also include the Paris Agreement. This argument was not accepted by the court, but its decision was overturned on appeal.

The court of appeal, rejecting the decision of the Divisional Court, held that the meaning of the term Government Policy for the purposes of Section 5 (8) of the Planning Act 2008, was not to be limited to English domestic law (i.e., CCA 2008) but also encompassed the objectives set out in the Paris Agreement ratified by the United Kingdom.

[65] R (on the application of Friends of the Earth Ltd and others) (Respondents) v Heathrow Airport Ltd (Appellant) [2020] EWCA Civ 214.
[66] See Section 1 and Section 4 of The Climate Change Act 2008 (2050 Target Amendment) Order 2019.

The matter came before the supreme court, which, using a purposive approach, held that "*the epitome of "Government Policy" is a formal written statement of established policy…The fact that the United Kingdom had ratified the Paris Agreement is not of itself a statement of Government policy in the requisite sense. Ratification is an act on the international plane. It gives rise to obligations of the United Kingdom in international law which continue whether or not a particular government remains in office and which, as treaty obligations, "are not part of UK law and give rise to no legal rights or obligations in domestic law"*[67]".

This case is very important for a number of reasons, the first being that it demonstrates the growing sensitivity of courts and parties to the issue of climate change. Secondly, is an important case "*that begs the question of what it means to judge well in relation to climate change legislation and thus incorporate climate change into the structure of law*"[68].

1.3.4 Withdrawal procedure: the US disengagement

In examining the withdrawal procedure of the Paris Agreement, another relevant rule comes into play, namely Article 54 of the Vienna Convention on the Law of Treaties (VCLT). According to the above-mentioned article, withdrawal must be effected according to the rules contained in the treaty from which it is being withdrawn or at any time by unanimity of the contracting states. From the moment the withdrawal is effective, Article 70(1)(a) of the VCLT provides that the withdrawing party is no longer obliged to perform the obligations contained in the treaty, and further provides in sub-paragraph (b) that any legal situation, right or obligation created prior to the withdrawal becoming effective shall not be affected by the withdrawal of the treaty[69].

Article 28(1) of the Paris Agreement provides for the possibility to withdraw from the agreement by written notice to the Depositary. This right may, however, be exercised only after the lapse of three years from the entry into force of the Agreement and the withdrawal communicated in the manner set out above will be effective only after the lapse of one year from the date of such communication. This timeframe was introduced to protect the Paris

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[67] See (R (Miller) v Secretary of State for Exiting the European Union [2017] UKSC 5.

[68] BELL AND FISHER, "*The Heathrow Case in the Supreme Court: Climate Change Legislation and Administrative Adjudication*", Modern Law Review, (2022).

[69] CALSTER, GEERT VAN, AND REINS L., (38).

Agreement, which has been the subject of much negotiation and effort on the part of the various countries and represents the will to resolve an issue as pressing as climate change[70].

On 1 June 2017, US President Donald Trump issued a statement in which he announced the withdrawal of the United States of America from the Paris Agreement. The President gave as his reasons that the obligations imposed by the agreement were nothing more than a political ploy to take funds away from the US and to economically benefit other states. He claimed that the US was the only one to have poured more than a billion dollars into the Green Climate Fund without knowing what it would be used for.

This act meant a step backwards for the fight against climate change and could potentially become a dangerous precedent for other states who, like the Trump administration, felt that the Paris Agreement undermined their sovereignty. With the new administration of Joe Biden taking office, there has been a change of course from the previous administration. On 20 January 2021, the United States of America rejoined the Paris Agreement.

Leaving aside the political implications of the affair, what is useful to analyze are the potential consequences on the high level of liability that President Trump's withdrawal could have caused in relation to the obligations undertaken during the effective period of the Agreement.

As explained above, the United States, by signing the Agreement in 2015, had obliged itself to send in its plans to quantify its contribution to the fight against climate change, the so-called NDC. This was on schedule under the Obama administration, which had sent out its first NDC setting the US contribution level at 26-28% reduction in greenhouse gas emissions by 2025, but President Trump decided, however, to immediately cease the implementation thereof. If we agree with the assumption that NDC's targets are binding for the country which submitted it, we might also argue that the United States might be held liable for the non-compliance with its NDC[71] during the period in which the request of withdrawal was pending and not yet effective. Nevertheless, the nature of the approach in the Paris Agreement is "non-punitive" and "facilitating" of compliance among parties. Thus, it would be very difficult to invoke the responsibility of the United States under the Paris Agreement.

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[70] See VOIGT C., (35)
[71] GERVASI M., (35).

However, according to Mario Gervasi, the difficulty of enforcing the Paris Agreement does not exclude the possibility of invoking the general rules on the responsibility of states set out by the International Law Commission in the Article on Responsibility for States for Internationally Wrongful Acts[72]. In fact, the rules providing for the compliance mechanism contained in the Paris Agreement are not derogatory to the aforementioned rules and this is confirmed by the express will of the small developing islands who in various statements published after the ratification of the Paris Agreement specified that they did not intend to interpret the compliance mechanism of the same as derogatory to the general rules.

1.3.5 Where are we?

Various studies have shown that we are a long way from reaching the targets set in the Paris Agreement. Greenhouse gas emissions continue to increase every year and as a result, estimates of the temperature increase between 2017-2021 show that there has been an increase of 1.06°C-1.26°C compared to pre-industrial levels. CO2 emissions, although they came to a halt during the Covid 19 pandemic period where industrial production came to a standstill, have returned to pre-pandemic levels, and there is a gap of 15GtCO2 and 32GtCO2 to reach the 2°C target under the Paris Agreement[73].

The data therefore show that there is still much to be done. Co-operation between states in the use of new technologies as well as a new common sense of sensitivity to this issue are essential to tackle a problem that is becoming more and more urgent.

[72] *Ibid.*
[73] See United in Science 2021: A multi-organization high-level compilation of the latest climate science information, available at: https://library.wmo.int/doc_num.php?explnum_id=10794

1.4 The 2030 Agenda for Sustainable Development

In 2015, the United Nations to promote sustainable development and to provide clear and concise guidance by drawing up a list of 17 goals (SDGs) contained in the 2030 Agenda for Sustainable Development. Each goal is specified in further targets to be achieved for a total of 169[74].

In the sustainability literature, these 17 goals are often divided into three categories: economic, societal, and environmental goals.

(i) Economic goals

The first sustainable development goal in the economic sphere is goal number 8, which states:

"*Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all*"

To support economic growth under Goal 8 it is specified that an increase of at least 7 per cent of gross domestic product in the so-called least developed countries (LCDs) should be aimed for in combination with the reduction of forced labor and child labor until its complete eradication in 2025. A great role is therefore entrusted to the national legislator who must implement those measures necessary to combat these issues and promote sustainable economic growth, without on the other hand sacrificing other sustainable development goals. Inclusion, diversification, and technological development are the pillars of this economic growth that is embodied in new job opportunities, respect for gender equality and inclusion of people with disabilities.

Goal number 9 reads:

"*Build resilient infrastructure, promote inclusive, and sustainable industrialization and foster innovation"*

The three main factors here are innovation, industrialization, and infrastructure. The specified sub-objectives explain how to achieve these three factors. A central role is given to technology, which, especially in LCDs, must provide the research and innovation support to foster sustainable development of small and medium-sized enterprises and greater access

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[74] UNITED NATIONS, "*Transforming our world: the 2030 Agenda for Sustainable Development*", available at: https://sustainabledevelopment.un.org/content/documents/21252030%20Agenda%20for%20Sustainable%20Development%20web.pdf

to information and communication services. This must be achieved by facilitating access to credit and finance, which is necessary to finance a sustainable transition of existing industries.

Goal 10 states:

“*Reduce inequality within and among countries*”

Inequality, the theme of this objective, takes on two levels, one national and one international. The objective is to promote the social, economic, and political inclusion of all persons, regardless of gender, race, political or religious belief, disability or economic status. This goal is to be achieved through the progressive implementation of social policies and measures that aim at equality. At the international level, this goal must also be achieved through better migration policies that facilitate the movement of people from one country to another. The focus is on the least developed countries, which are to receive special treatment under World Trade Organization agreements. The goal is to reduce the cost of moving migration flows to less than 3 per cent and to eliminate remittance corridors with costs exceeding 5 per cent.

The last of the economic goals is the 12th which recites:

“*Ensure sustainable consumption and production patterns*”

Objective number 12, and specifically sub-objective 12.1, refers to the 10-Year Framework of Programmes on Sustainable Consumption, adopted at the United Nations Conference on Sustainable Development in June 2012. The underlying principle of this framework is the need to change society's consumption habits in order to achieve sustainable development[75]. The aim is therefore to decrease food waste through the encouragement of reuse and recycling activities and to educate society to integrate sustainable practices into their daily lives. On the corporate side, the aim is to encourage companies to adopt sustainability policies and to include them in their reports.

(ii) Societal goals

The first goal of this category is Goal 1, which says:

“*End poverty in all its forms everywhere*”

[75] The 10 Year Framework of Programmes on Sustainable Consumption and Production Patterns (10YFP), available at: https://sustainabledevelopment.un.org/content/documents/1444HLPF_10YFP2.pdf

The poverty level is calculated based on the daily income a person has and the minimum threshold above which a person is considered to be in poverty is $1.25 per day. The goal is to reduce the percentage of people of all ages and genders in poverty to less than 50 per cent by 2030.

This goal is emblematic, it ranks first among all sustainable development goals and highlights the importance of this issue in modern society. The poverty level has continued its descent, which has its origins in the 1990s. However, this phenomenon came to a halt in 2020 due to the crisis caused by the Covid 19 pandemic, which had catastrophic consequences for the global economy. The halt in industrial production as well as the quarantine imposed on workers led to an increase in the poverty rate from 8.3% in 2019 to 9.2% in 2020. Countries with less income have taken an 8–9-year step backwards and this situation has been exacerbated by recent inflation and the war in Ukraine. It is estimated that these events will increase the number of people living in poverty by 75 to 90 million.

The second goal of this category is goal 2, according to which:

"*End hunger, achieve food security and improved nutrition and promote sustainable agriculture"*

The sub-targets to achieve Goal 8 specify actions that must be accomplished within a specific timeframe (i.e., 2030), including ending all forms of malnutrition as well as doubling agricultural productivity and replacing the current agricultural production model with a more sustainable model that encourages the adaptation of production to climate change and preserves ecosystems.

Goal 3 states:

"*Ensure healthy lives and promote well-being for all at all ages*"

This goal focuses on reducing infant mortality, thus reducing the neonatal mortality rate to 12 deaths per 1000 births as well as reducing the mortality rate of children under 5 years of age to 25 deaths per 1000. The other focus of this SDG is to reduce infectious diseases (such as AIDS, tuberculosis, hepatitis) and to prevent drug abuse as well as to promote people's psychological well-being.

Goal 4 recites:

"*Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all*"

Education is the main focus of this objective, which aims to ensure an inclusive education system that offers equal opportunities to each individual. Among the knowledge to be promoted is that of sustainable development in order to become aware of the most important issues such as human rights, gender equality, cultural diversity in order to avoid racial discrimination and sustainable lifestyles.

The fifth objective gives focus to a very important issue by saying:

"*Achieve gender equality and empower all women and girls*"

The sub-objectives focus mainly on the protection of women by stipulating that they must end all forms of discrimination and violence in the private and public sphere, as well as put an end to mutilation practices that have impacted the lives of many women, especially in less developed countries where such practices are still widespread. In this respect, the national legislator will have to work to introduce reforms that guarantee equal rights and opportunities for women.

Goal 7 says:

"*Ensure access to affordable, reliable, sustainable and modern energy for all*"

The target number lies on the borderline between the three categories. In fact, it not only promotes the use of sustainable energies, such as renewable energies, which therefore also aims to protect the environment, but also to ensure that affordable energy is available to every individual. The aim is to increase the available infrastructure to enable a fair supply of energy through technological development, especially in less developed countries.

"*Make cities and human settlements inclusive, safe, resilient, and sustainable*"

This is goal number 11 which aims to guarantee affordable housing and a transport service accessible to all and which takes into account the special needs of people in a fragile state, so as to ensure their mobility. Another goal is to protect cultural heritage and ensure suitable green spaces that also contribute positively to clean air and ensure a better quality of life.

Goal number 16 states the following:

"*Promote peaceful and inclusive societies for sustainable development, provide access to justice for all, and build effective, accountable, and inclusive institutions at all levels*"

The main concept around which the sub-objectives revolve are those of justice and peace. To this end, all forms of violence must be reduced and the fight against crime and organized crime must be strengthened, and corruption in all its forms in the world must be reduced. Ensure a decision-making process among institutions that is representative and inclusive, and at the global level include the least developed countries more in decisions.

(iii) Environmental goals

An ecosystem that allows human life is the basis of sustainable development, without an ecosystem there can be no social or economic goals as there would no longer be a society or economy to protect, which is why the last category of goals includes has as its object the prevention and protection of the environment and covers Goals 6, 13, 14 and 15.

Goals 6 says:

"*Ensure availability and sustainable management of water and sanitation for all*"

What the sub-goals suggest in order to achieve Goal 6 is to focus on water management and to ensure water cleanliness in order to improve its wholesomeness.

Goal 13:

"*Take urgent action to combat climate change and its impacts*"

The role of finance is essential here. In fact, Goal 13.a says that a jointly mobilization of $100 billion annually by 2020 is necessary to address climate change. This Goal is linked with the United Nation Framework Convention on Climate Change and the Green Climate Fund in which the capital necessary to tackle this issue is transmitted.

Goal 14 recites:

"*Conserve and sustainably use the oceans, seas and marine resources for sustainable development*"

Marine pollution is one of the most critical issues of this moment. The situation does not seem to have improved since these targets were set in 2015. Data show that ocean acidity, as well as eutrophication, are increasing[76]. On the other hand, the adoption of measures to

[76] Report of the Secretary-General of the UN Economic and Social Council "*Progress towards the Sustainable Development Goals*" advance unedited version, 2022. Available at: https://sustainabledevelopment.un.org/content/documents/29858SG_SDG_Progress_Report_2022.pdf

combat illegal fishing, which impacts marine biodiversity and negatively affects the ecosystem, has increased on average.

Goal 15:

"*Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss*"

The last objective focuses on the preservation of terrestrial ecosystems and in particular discourages the use of practices that undermine their balance. This means combating desertification and deforestation, which are a major cause of biodiversity loss, as well as the trafficking of protected species. Once again, one of the objectives focuses on the financial system, which must provide the necessary capital and resources to combat this issue and preserve biodiversity.

1.4.1 Implementation and critical reflections

The latest report published by the UN Economic and Social Council on progress towards achieving the Sustainable Development Goals (SDGs) requires us to make some critical observations on these goals. Firstly, the report shows that almost all of the goals are far from being achieved. Among the most obvious are the figures on the poverty rate that we analyzed above when discussing the first target. Furthermore, target number thirteen, which postulates the need to combat climate change, is the most worrying. The data show how, according to forecasts, to limit global warming it would be necessary to reduce gas emissions by at least 45% by 2030, these are instead expected to increase by 14%. Again, data on inequality within and between countries show that more than 24 million people were forced to leave their countries due to various issues such as war, human rights violations, and persecution, not counting the more than 4.5 million refugees who fled Ukraine due to the relatively recent Russian invasion. In addition, a basic resource such as drinking water is only available to 74% of the world's population, an increase of only 4 percentage points since 2015. These figures stress the importance that these goals place on the human and global consciousness, in an interconnected world such as the one we live in, where these issues are now before our

eyes every day, one can no longer look the other way, everyone in their own small way must do their part[77].

Certainly, these figures are influenced by recent events that have affected the global economy to an extent that has not happened in a long time, think of the Covid 19 pandemic or the war in Ukraine and the recent inflation, but they give us the opportunity to reflect not only on the merits of these goals, but also on their structure and how they were designed. According to an independent study of the SDGs[78], out of 169 targets 29% of them are well developed, 54% could be more specific and 17% require significant work.

These targets are more political than legal, but they have the potential to fit within a larger legal framework and contribute to the sometimes-fallacious system that is international law[79]. In fact, SDGs "*are to be implemented in a manner that is consistent with the rights and obligation of States under international law*". The 2030 agenda is inevitably linked with treaties of international law and conventions already concluded between states. Among those mentioned are the UN Charter, the Universal Declaration of Human Rights and the Rio Declaration on Environment and Development. Some, therefore, believe that the SDGs can best be defined as a subset of existing intergovernmental commitments and can potentially be used to coordinate international treaty law that creates a very often fragmented legal framework[80]. Indeed, it happens that established institutions and authorities or nations themselves, in pursuit of a certain goal, make tradeoffs and sacrifice another goal. This creates discord and often obstacles for the various parties involved that prevent the achievement of the objectives.

The issue with the SDGs is that they reflect the same structural problem of International Law. We started the discussion by dividing the SDGs in three categories and while the 2030 Agenda says that these are integrated and indivisible, in practice, however, they are compartmentalized and do not easily fit together, as they are all placed with the same priority. This lack of hierarchy often leads to clashes and limitations in achieving these

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[77] Report of the Secretary-General of the UN Economic and Social Council "*Progress towards the Sustainable Development Goals*" advance unedited version, 2022. Available at: https://sustainabledevelopment.un.org/content/documents/29858SG_SDG_Progress_Report_2022.pdf
[78] ICSU and ISSC, "*Review of Targets for the Sustainable Development Goals: The Science Perspective*", Journal of Education for Sustainable Development, vol. 9, no. 2, p. 237, (2015).
[79] KIM, "*The Nexus between International Law and the Sustainable Development Goals*" Review of European Community & International Environmental Law, vol. 25, no. 1, 2016, pp. 15–26, (2016).
[80] PAUWELYN, "*Fragmentation of International Law*", Oxford University Press, (2006).

goals[81]. The idea behind several scientific studies is that the protection of the environment must be the priority, in fact the environment is regarded as a 'condicio sine qua non'. For this reason, one way to solve this structural shortcoming of the SDGs, would be that "*each goal could include an overall carbon intensity target so that implementing the goal did not undermine targets in the climate or other environmentally-related goals*"[82]

[81] KIM, R.E., (65).
[82] ICSU and ISSC, 2015 (65).

1.5 Impact of Covid 19

During 2020, humanity faced one of the greatest challenges since the Second World War. The spreading Covid 19 pandemic causing millions of deaths forced governments to implement extreme emergency measures to cope with this crisis. Restrictions on freedom of movement and social contact were imposed in most developed countries where people were forced to stay in their homes to avoid further social contact that could lead to increased contagion. This had devastating consequences on our economy and an unprecedented social impact. The global Gross Domestic Product in 2020 amounted to $84.91 trillion with an annual growth contraction of -3.3%. To better understand the magnitude of the economic crisis, consider that the contraction of annual GDP growth during the 2007-09 crisis reached -1.3%[83].The impact this economic crisis has had on people's lives has been immeasurable. Estimates show that the Covid 19 pandemic has caused an increase of 72.4 million people in poverty worldwide[84]. Companies, particularly those that relied on the tourism industry, restaurateurs, and merchants, suffered a drop in their revenues due to restrictions on movement imposed on citizens that led to national lockdowns and a halt in movement in and out of countries.

The crisis resulting from the Covid 19 pandemic caused a setback to the achievement of the 2030 Agenda for Sustainable Development, goals that were already far from being met. A UN report argues that if governments had put more effort into achieving this Agenda, and specifically if they had committed to better health coverage, then we would not have the same number of deaths that we have seen in recent years. On the contrary, in many nations, investment in the health sector had declined sharply and this only exacerbated the effects of this health crisis that an inadequate system without adequate resources has been fighting against[85].

On the other hand, as far as environmental issues are concerned, the imposition of a lockdown and thus the decreasing industrial production as well as the less frequent use of motor vehicles, has led to a reduction in Co2 emissions into the atmosphere[86]. Despite this

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[83] Data provided by The World Bank website at: https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2021&start=2005

[84] *Ibid.*

[85] United Nations report "*Shared Responsibility, Global Solidarity: Responding to the socio-economics impacts of Covid 19*", March 2020. Available at: https://unsdg.un.org/sites/default/files/2020-03/SG-Report-Socio-Economic-Impact-of-Covid19.pdf

[86] TURNER, ALEXANDER ET AL., "*Observed Impacts of COVID-19 on Urban CO2 Emissions.*" Geophysical Research Letters, vol. 47, no. 22, (2020)

7% reduction in Co2 emissions compared to the level of Co2 emissions in 2019, it must be considered that these reductions were caused by the implementation of temporary measures that did not affect the modern industrial system that is primarily based on the use of fossil fuels, which have a huge impact on the environment. Indeed, estimates show that already by July 2021, CO2 emissions have returned to pre-pandemic or higher levels[87].

Elliott Harris, UN Chief Economist and Assistant Secretary-General for Economic Development said, "*While we need to prioritize the health response to contain the spread of the virus at all cost, we must not lose sight how it is affecting the most vulnerable population and what that means for sustainable development. Our goal is to ensure a resilient recovery from the crisis and put us back on track towards sustainable development*.[88]". The Covid 19 crisis could therefore be a turning point for sustainable investments. The crisis, which entailed the biggest recession since World War II, might be an opportunity to invest in sustainable development. Such a massive movement of capital by public institutions is historic, and the task of directing this debt towards a sustainable future, so that it is not just a burden on future generations, will be difficult. According to a survey conducted by J.P. Morgan, 71% of investors believe that Covid 19 has increased investor and societal awareness of the need to combat high probability risks such as those related to climate change[89].

One financial instrument that proved particularly useful during the Covid 19 pandemic was the Social Bond. This financial instrument, which aims to raise capital to finance social projects, served during the pandemic phases to provide resources to governments and companies to cope with the health crisis and, at the same time, to support sustainable development, which showed all its criticalities during this period[90]. According to the definition given by the International Capital Markets Association (ICMA) in its "Social Bonds Principles" (SBP) is: "*Social Bonds are any type of bond instrument where the proceeds, or an equivalent amount, will be exclusively applied to finance or re-finance in*

[87] See United In Science 202, (73).
[88] UNITED NATIONS DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS, "*Covid-19 likely to shrink global GDP by almost one per cent in 2020*", available at: https://www.un.org/es/desa/covid-19-likely-shrink-global-gdp-almost-one-cent-2020
[89] J.P. MORGAN, "*Why Covid-19 could prove to be a major turning point for ESG investing*", 2020. Available at: https://www.jpmorgan.com/insights/research/covid-19-esg-investing
[90] INTERNATIONAL FINANCE CORPORATION (IFC), "*Social Bonds Can Help Mitigate the Economic and Social Effects of the COVID-19 Crisis*", 2020. Available at: https://www.ifc.org/wps/wcm/connect/ec548185-5e62-4f34-86db-b4d92872cd8e/EMCompass_Note+89-SocialBonds-web.pdf?MOD=AJPERES&CVID=niz4yOT

part or in full new and/or existing eligible Social Projects and which are aligned with the four core components of the SBP". These social projects may consist in several different things such as (i) finance the access to essential services; (ii) finance housing; (iii) building basic infrastructure. The first social bond ever issued was in 2018 by Danone, but the market had never reached the size of the green bonds that had long since established themselves in the bond market. With the advent of the pandemic, on the other hand, the market for social bonds skyrocketed to previously unimaginable levels, and this bodes well for the increasing use of this tool, which is useful and essential for the achievement of the 2030 Agenda for Sustainable Development.

II. The European Legislative Framework

2.1 Reorienting Capital Flows Towards a more Sustainable Economy: the 2018 Sustainable Finance Action Plan

The European Union has established itself as one of the pioneers in combating climate change and promoting sustainable development.[1] The legislation that has been introduced is wide-ranging and touches on many different topics that are worth analyzing in order to better understand where the Platform on Sustainable Finance's proposal for a new social taxonomy fits in. In the wake of the wave of success in sustainability over the last two decades, the European Union issued a communication in April 2011, highlighting the need to introduce reforms to contribute to sustainable development[2].

In 2016 the European Commission appointed a High-Level Expert Group on Sustainable Finance (HLEG) whose aim was to develop guidelines for a sustainable development in Europe. The main objective was to reorient capital flows towards a more sustainable economy. The group consisted of 20 representatives of the financial markets, the academic world and observers from European institutions. In January 2018 the HLEG published its final report[3] in which it proposed its recommendations for "switching" the financial system to sustainability. The actions to which priority has given were: (i) to enact an EU sustainability taxonomy; (ii) include a longer-term view in investors 'duties and make them take into account ESG considerations in their investments decisions; (iii) enhance disclosure; (iv) make sustainable investments available also to retail investors; (v) develop official European sustainability standards for some financial assets (such as green bonds); (vi) integrate sustainability in the governance of financial institution and in financial supervision.

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[1] See for example the speech of the President of the European Commission Ursula Von der Leyen at COP26, "The European Union will fully contribute to achieve our global goals on adaptation. With close to USD 27 billion in 2020, Team Europe is already the largest provider of climate finance. Almost half of our finance is for adaptation. And we pledge an additional USD 5 billion up to 2027 from the EU budget. And we will double our funding for biodiversity, especially in vulnerable countries. And fourth and finally, innovation and technology is available. Now we have to scale up and deploy it." Available at: https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_21_5741

[2] EUROPEAN COMMISSION, "*Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions: Single Market Act Twelve levers to boost growth and strengthen confidence "Working together to create new growth",* 2011. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52011DC0206&from=EN

[3] EU High-Level Expert Group on Sustainable Finance, "*Financing a Sustainable European Economy*", 2018. Available at: https://ec.europa.eu/info/sites/default/files/180131-sustainable-finance-final-report_en.pdf

Based on this report, the Commission developed an EU Action Plan on Sustainable Finance which was presented on March 22, 2018[4]. The commission's effort reflects the desire to connect the world of finance with the specific needs of citizens and the global economy for the benefit of the planet and society[5]. In particular, the 2018 EU Action Plan on Sustainable Finance sets itself three objectives:

1) Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;

According to the European Investment Bank (EIB) 180 billion more are needed to reach the targets by 2030. Thus, the European Commission proposed 5 actions to achieve the first objective of the EU Action Plan. The first action is to create a classification system in order to further understand what sustainable means. This classification system, i.e., the EU Taxonomy later adopted in 2020, allows investors and market players of the financial world to understand what activities can be deemed as sustainable and by doing so it hopes to encourage investments towards more sustainable and inclusive companies. The Commission adopted a "step-by-step" approach, by firstly proposing to adopt a taxonomy on climate change and later on a taxonomy on social activities.

The EU Taxonomy was intended to put an end to the development of national and market practices that would result in divergent classifications, and therefore creates confusion for investors. A uniform classification across the EU would serve as a reference point for financial market participants to develop green financial products[6].

The second action proposed by the Commission was to adopt standards and labels for financial products that will help to increase the interest of investors. In this direction, the European Commission in 2020 proposed a European green bond standard (EUGBS) based on the recommendations of the Technical Expert Group on Sustainable Finance. The standard will have four requirements: (i) taxonomy alignment; (ii) transparency; (iii) external review; (iv) supervision by the European Securities Markets Authority (ESMA). On 16 May, the

[4] Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the regions, "Action Plan: Financing Sustainable Growth", 2018. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

[5] BUSCH D., FERRARINI G., GRUNEWALD S., "*Sustainable Finance in Europe*", Springer International Publishing AG, (2021).

[6] Principles for Responsible Investment, "*The European Commission Action Plan*", 2018. Available at: https://www.unpri.org/download?ac=5173

proposal was amended by inserting an additional requirement, namely that companies wishing to issue green bonds must have verified transition plans and have, therefore, processes in place to identify and limit the main negative impacts of their activities. This requirement was inserted because it is intended to discourage 'brown' companies, i.e., those that conduct their activities in highly polluting industries, from using the standard to appear more sustainable than they are.

The third action included in the EU Action Plan was to foster investment in sustainable projects. Given the impact that infrastructures have on the emission of greenhouse gases[7], the Commission also wanted to focus on this issue by including among the actions required to achieve the first objective of the action plan, that of increasing the volume of projects and infrastructures that are sustainable and do not have a major impact on the environment.

Action 4 concerns the incorporation of sustainability in financial advice. The committee then adopted an amendment to the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD). This amendment to MiFID II and in particular to the Delegated Regulation 2017/565[8], was adopted with the aim of including within the duties of financial advisors, that of providing advice to the client on the risks and opportunities associated with the possible investment, environmental and social issues. To this end, it was stipulated that all financial advisors are obliged to: (i) obtain information about the client's sustainability preferences[9] and (ii) if that client prefers sustainable investments, to follow those preferences when recommending an investment. These new provisions came into force on August 2, 2022, and by then all financial advisers must comply with them[10].

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[7] OECD, "*Investing in Climate, Investing and Growth*", 2017, according to which infrastructure contributes to about 60% of greenhouse gas emissions.

[8] See Commission Delegated Regulation 2021/1253 available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1253&from=EN

[9] The Commission Delegated Regulation 2021/1253 provides for a definition of "sustainability preferences", according to which "sustainability preferences" means a client's or potential client's choice as to whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment: (a) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of Regulation (EU) 2020/852 of the European Parliament and of the Council; (b) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council; (c) a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client;

[10] Allen & Overy, "*New ESG changes to MiFID II – What investment firms and banks need to know*", 2022. Available at:

The last action under the first objective is to develop sustainability benchmarks. A benchmark is a standard which allows the measurement of the performance of a security, a mutual fund, or investment manager. The European Commission believed that traditional benchmarks were not appropriate in measuring the performance of sustainable investments because they reflect the status quo. As such, two benchmarks have been developed: the EU Climate Transition Benchmark and the EU Paris-aligned Benchmark. To be used, the former requires that all the underlined assets are selected for the purpose of directing the portfolio towards a decarbonization trajectory. The latter, instead, requires that all the underlined assets of a portfolio have a grade of emissions compatible with the Paris Agreements targets (i.e., it is required that the underlined assets emit 50% of greenhouse gas less than the investable universe).

2) Manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues;

The sixth action included in the Sustainable Finance Action Plan focuses on the role of sustainability ratings and aims to improve them. The role these have played, as explained by the Commission, has been central in the allocation of capital towards sustainable finance. On the other hand, low standardization of how social, environmental and governance performance is assessed by credit agencies has undermined their effectiveness. For this reason, the Commission wanted to focus on this aspect. The Commission therefore envisaged amending the Credit Rating Agency Regulation so as to include in the mandate of credit rating agencies the obligation to include sustainable factors in their assessment. ESMA, however, gave its advice to the Commission, arguing first and foremost that ESG factors are factors that come into play to a different extent depending on the asset and that the rating provided by the agencies is not an opinion on ESG factors. In addition, it would not be appropriate to amend the mandate of the credit rating agencies in the CRA Regulation, rather it would be advisable to introduce provisions that would lead to a better transparency of the credit rating agencies on how they consider ESG factors in their ratings[11].

The seventh concrete action is to clarify the duties of institutional investors and asset managers. Indeed, many provisions of the European regulatory framework require these

file:///Users/giuse/Downloads/New%20ESG%20changes%20to%20MiFID%20II%20What%20investment%20firms%20and%20banks%20need%20to%20know.pdf

[11] BUSCH D., FERRARINI G., GRUNEWALD S., (94).

figures to act in the best interests of their clients. This relationship is often referred to as the 'fiduciary duty' that asset managers have towards their clients. In this regard, the Commission wanted to point out that in the investment evaluation process, asset managers often fail to take into account the sustainable factors and risks involved. Hence the introduction of European Regulation 2019/2088 on sustainability reporting in the financial services industry, the so-called Sustainable Finance Disclosure Regulation, which will be analyzed in the following paragraph[12].

Action 8 concerns the incorporation of sustainability into prudential requirements. The Commission, recognizing the role that banks, pension funds and insurance companies play in the financial market and in the transition to a sustainable economy, has pointed out that these institutions are also exposed to the risks of climate change and the risks of an economy that does not promote sustainable development. However, these risks are not reflected in the prudential regulation that the Commission intends to amend with the Capital Requirements Regulation III and Capital Requirements Directive VI package. The ESG-related proposals contained in the CRR3-CRD6 package mainly concern the information that intermediaries are required to provide to the market (Pillar III disclosure) and the safeguards they must adopt to ensure risk-aware governance (Pillar II discipline). The current discipline (CRR2-CRD5) already provides for public disclosure obligations on ESG issues, but only for large, listed intermediaries (banks and investment firms). In particular, it requires them to publish, among other information, the so-called Green Asset Ratio (GAR) 19, aimed at showing the market how banks are adapting their business strategies to the objectives of the Paris Agreement. These obligations start already from January 2023; the timeframe is extended until December of the same year for the GAR disclosure and until June 2024 to include among the emissions of corporate borrowers also those generated along the entire value chain. The main change introduced with the Commission's proposal concerns the extension of the third pillar ESG obligations to all intermediaries (banks and investment firms subject to the prudential regulation of banks 20), thus including less significant banks. For small and non-complex institutions, the proposal calls for the publication of ESG information to be annual rather than semi-annual. A number of important open points remain, however (e.g., the content of the information to be published, which will have to be determined according to the principle of proportionality), on which the European Banking Authority will have to intervene with

[12] *Ibid.*

specific technical standards. With reference to Pillar II, banks are required to have adequate governance structures, strategies and processes in place to assess internal capital needs over a medium- and long-term horizon to take account of ESG risks. Instead, with regards to amendment to prudential requirements, the European Banking Authority will send a report to the Commission by 2023[13].

3) Foster transparency and long-termism in financial and economic activity.

Action 9 of the EU Sustainable Finance Action Plan aims to strengthen sustainability disclosure and accounting rulemaking. A fundamental requirement to support sustainable development and to incentivize investors towards financial instruments that take ESG factors into account is information. This is why the Commission has included this concrete action in its plan for sustainable finance. The aim is to increase the transparency of asset managers and institutional investors as to how they take into account investment risks related to sustainability issues. In this sense, the proposed Corporate Sustainability Reporting Directive aims to amend the Non-Financial Reporting Directive 2014/95 and to implement action number 9 contained in the Action Plan[14].

The last concrete action of the Action Plan on Sustainable Finance concerns the fostering of sustainable corporate governance and attenuating short-termism in capital markets. The Commission asked the European Supervisory Authorities (ESAs) to assess how relevant the short-term investment horizon is in Europe and whether it can be considered a problem. The European Banking Authority (EBA) published its final report in 2019, according to which "*the traditional time horizons of European Union (EU) banks seem to not allow long-term and sustainability challenges, such as climate-related risks, to be fully taken into account and tackled*"[15]. In 2022, the Commission has made a proposal for a Directive on Corporate Sustainability Due Diligence[16], which would incentivize the boards of company to integrate sustainability risks into their strategy in order to broaden the horizon of their activities[17].

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[13] European Systemic Risk Board, "*Review of the EU macroprudential Framework for the banking sector : a concept note : March 2022*", 2022, available at: https://data.europa.eu/doi/10.2849/788994

[14] BUSCH D., FERRARINI G., GRUNEWALD S., (94).

[15] European Banking Authority, "*Report on undue short-term pressure from the financial sector on corporations*", 2019. Available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Final%20EBA%20report%20on%20undue%20short-term%20pressures%20from%20the%20financial%20sector%20v2_0.pdf

[16] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, COM/2022/71 final, 23 February 2022.

[17] LINCIANO, SOCCORSO AND GUAGLIANO, "*Information as a driver of Sustainable Finance*", Springer International Publishing AG, (2022).

2.2 Information disclosure as a driver of Sustainable Finance: from the Non-Financial Reporting Directive to the Sustainable Finance Disclosure Regulation

The public sector alone cannot provide the amount of capital needed to achieve the goals that states have set themselves in recent years towards sustainable development[18]. The World Bank Group (WBG) has estimated that the amount of investment needed to achieve the goals of the 2030 Agenda is equal to 4.5-8.2% of low- and middle-income countries' GDP per year during 2015-2030[19]. This lack of public funds to finance a step change towards sustainable finance must be remedied through an incentive for private individuals to shift their investment focus towards investments that take ESG issues into account. This can only happen if all financial players, starting from companies up to financial advisors, disclose all sustainability-related information and are transparent in their activities. In fact, this is the only way to eliminate those information asymmetries that hinder the development of sustainable finance. In order to build this information ecosystem capable of stimulating sustainable investments, an intervention of the legislator is necessary. In the past, in fact, sustainability was left to market practice, which sought to self-impose rules on what information should be disclosed. This led to market imperfections and failures that justified intervention by the regulator.

The dense web of European legislation on the disclosure of non-financial information affects two economic actors in particular. These are companies and financial market participants. In order to facilitate the analysis of the European framework, the aim of this section is to analyze the current legislation by focusing on the actors affected by it.

2.2.1 Disclosure requirements for companies

In this respect, central is the role played by the Non-Financial Reporting Directive 2014/95 (NFRD), which amended the Accountability Directive 2013/34. The NFRD aims to increase the transparency of companies with regard to non-financial information and in particular with regard to sustainable development and, as a result, (i) increase the accountability of companies; (ii) better understand the risks and opportunities arising from non-financial information so as to integrate it into their strategies; (iii) improve the functioning of the capital

[18] LINCIANO N., SOCCORSO P., GUAGLIANO C., (106).
[19] VORISEK D., SHU Y., "*Understanding the Cost of Achieving the Sustainable Development Goals*", Policy Research Working Paper; No. 9164. World Bank, (2020).

market[20]. Article 19a of the amended Directive is therefore modified to include the obligation for large public interest companies (or PIEs) with more than 500 employees to include a non-financial statement in the management report or in a separate report. According to a study conducted by the European Commission, the number of companies in the European Union, which are subject to the provisions of the NFRD are, as of November 2020, are 1956, of which 1604 are listed companies in, 278 are banks and 74 are insurance companies[21].

The categories of companies which are subject to the NFRD are the following:

- Banks;
- Insurance companies;
- Listed companies;
- Other companies of public interest entities[22].

The types of information that companies are obliged to include in management reports include as a minimum, social and environmental issues, respect for human rights, anti-corruption, and bribery information. In particular, companies must give a description of:

their business model;

The business model is nothing more than a descriptive model of how the company operates and how it generates value from its services and how it preserves it in the long run. The guidelines specify which areas reports should focus on when disclosing information about the business model. In particular, this information should include, inter alia, how the company is structured and the market in which it operates, as well as the main factors that will influence its development.

(i) policies adopted on the above issues and due diligence;

The relevant information they must disclose in this context must give a fair view of their policies, i.e., their approaches to objectives and non-financial aspects, taking into account the specific circumstances of the company. With regard to due diligence processes, companies must instead disclose all information relevant to understanding how these processes are carried out and how these processes are intended to prevent negative impacts. Should these

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[20] European Commission, "Study on the Non-Financial Reporting Directive Final Report", 2020. Available for downloading at: https://op.europa.eu/en/publication-detail/-/publication/1ef8fe0e-98e1-11eb-b85c-01aa75ed71a1/language-en

[21] *Ibid.*

[22] LOMBARDI, "*The Going-Concern Problem in Non-Financial Disclosure*", Springer (2021).

policies or due diligence processes change, this information must be reflected in the following financial year's report.

(ii) the outcomes of these policies;

By providing relevant information about e.g., the relationship between financial and non-financial results and non-financial KPIs, companies help stakeholders better understand the company's strengths and weaknesses.

(iii) the main risks these companies are exposed to;

This must include all information on how these risks are mitigated, which may be of various kinds and relate to different aspects of a company's business. All risks, both exogenous and endogenous, must also be considered.

(iv) relevant non-financial key performance indicators[23];

These KPIs, defined as "material narratives and indicator-based disclosures" should be in line with the metrics used in the company's management and risk assessment.

The selection of information which are required to be disclosed under the NFRD is guided by the principle of double materiality. When the NFRD was adopted, the information that had to be published was that “necessary for an understanding of the undertaking's development, performance, position and impact of its activity”. Thus, if an information was financially material for the company, i.e., it has an impact on the company’s value, it should have been included in the report (single materiality). Later on, however, the European Commission wanted to provide further guidance to explore and further specify the principle of materiality of information to be disclosed. With the Communication from the Commission: Guidelines on non-financial reporting: Supplement on reporting climate-related information (2019/C 209/01) the principle of materiality takes on a double perspective. The first, financial perspective is focused on the short term, while the second type of materiality covering environmental and social factors is focused on the long term. It explains that not only information about the impact of the climate on financial performance must be disclosed, but also information about the impacts of the activities carried out by the company have on the

[23] Article 19a (1) of Directive of Directive 2013/34 as amended by Directive 2014/95. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN

environment, which in the long run can potentially turn into negative effects on the financial performance of the company itself.

One concern expressed in the adoption of this Directive was the administrative costs that the company had to incur in order to find all the information it was obliged to disclose under this legislation. The study conducted by the European Commission shows that the total amount of administrative costs incurred by companies in all of the above-mentioned sectors amounts to 200 million euros for the first year of disclosure, while this figure drops to 137 million in subsequent years. What the study shows is that larger companies, which had long since started to include such information in their annual reports in order to gain the favor of investors who are increasingly sensitive to such issues, incur fewer administrative costs than smaller companies[24].

On 21 April 2021, the European Commission put forward a proposal to amend the NFRD. This amendment is deemed necessary in light of the issues that have arisen during these years regarding sustainable disclosure. Companies very often fail to comply with the reporting obligation, resulting in investors not having the appropriate information to assess the social and environmental impacts of a company. Increasing investor awareness and, consequently, a growing demand for information about sustainability, convinced the Commission to propose an amendment to this directive in order to improve its functioning. The aim of this amendment is to improve sustainability reporting in such a way that companies, from which investors expect to receive information about their impact on environmental and social issues, will have to publish all information that investors consider relevant to make such an assessment. The aim is thus to improve the level of comparability and accuracy of disclosures between companies.

The proposed Corporate Sustainability Reporting Directive (CSRD), which would amend the NFRD, expands the scope of application of companies that must be compliant with the disclosure requirements. In fact, the CSRD extends the NFRD's scope to all large companies, even if they are not listed, as well as all listed companies on regulated markets. Furthermore, the CSRD proposes a mandatory auditing of the reported information which will be reported in accordance with EU standards. These standards will be developed by the European

[24] European Commission, (91). The share of companies' turnover used to finance these report amounts to 0.009% of turnover on average for the first year, while for larger companies amounts to 0.004% of turnover and for smaller companies amounts to 0.01% of turnover.

Financial Reporting Advisory Group (EFRAG) by 31 October 2022, and they will help small and medium enterprises (SMEs) to report non-financial information[25].

2.2.2 Disclosure requirements for financial market participants and for financial advisers

The Sustainable Finance Disclosure Regulation 2019/2088 (SFDR) is the main framework regulating the sustainability of financial products. In order to direct capital towards more sustainable investments, governments are increasingly enacting new laws to increase the transparency of financial products and, in particular, to meet investors' need for more information to evaluate sustainable investment options[26].

The SFDR introduces us with many new legal concepts. Nevertheless, this Regulation only adopted Level 1 regulation, whilst Level 2 regulation is planned to be applied on 1 January 2023. Essentially, according to the Lamfalussy regulatory approach, Level 1 regulation means that the European Parliament and the Council adopted the basic laws proposed by the Commission. Instead, Level 2 regulation means that the European Commission has been delegated to adopt technical provisions contained in the Delegated Acts[27].

The main objective of the SFDR is to combat market fragmentation[28]. In fact, there have been many initiatives by national governments trying to meet market demands on the disclosure of sustainable factors by financial participants. The Commission argued that such initiatives by both Member States and commercially driven private market players caused market fragmentation in sustainability disclosure standards. This fragmentation in turn caused a distortion of competition, created barriers to the internal market and confused or distorted investors' investment decisions. Thus, the second objective of the SFDR is to reduce information asymmetries in principal-agent relationships. By introducing the SFDR, the European Commission wanted to create a harmonized rules on transparency in order to increase the comparability of data and therefore make a more informed investment decision.

[25] LINCIANO N., SOCCORSO P., GUAGLIANO C., (106).
[26] J.P. MORGAN, "*Understanding SFDR*", 2021. Available at: https://am.jpmorgan.com/kr/en/asset-management/institutional/investment-strategies/sustainable-investing/understanding-SFDR/
[27] The Lamfalussy architecture is explained on the European Commission's website, available at this link: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/regulatory-process-financial-services/regulatory-process-financial-services_en
[28] See Sustainable Finance Disclosure Regulation 2019/2088 Recital 9, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN

The scope of the Regulation is very broad, and it applies to financial market participants as defined under Article 2 (1) of the SFDR[29], as well as to financial adviser and financial products. The set of obligations under the SFDR can be differentiated into two macro-areas, which are distinguished from each other according to the level they affect: the entity level or the product level.

With regards to the entity level of the SFDR both financial market participants and financial market advisers shall disclose on their websites their policies on the integration of sustainability risks in their investment decision-making process[30]. In addition, these subjects are required to include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks, and this information shall be published on their websites. Originally, the European Commission's proposal required the disclosure also the remuneration policies' consistency with sustainable investment targets of the financial products and services[31]. However, the existing legal regime does not require to adopt remuneration policies and the disclosure requirements in the SFDR wanted to reflect this legal regime[32].

With regards to the product level, the SFDR describes different types of products in three provisions, i.e., Article 6, 8 and 9. Depending on which description the financial product meets a different disclosure requirement will be applicable to it.

Article 6 states that:

"Financial market participants shall include descriptions of the following in pre-contractual disclosures:

(a) the manner in which sustainability risks are integrated into their investment decisions; and

[29] The SFDR defines financial market participants as "(a) an insurance undertaking which makes available an insurance-based investment product (IBIP); (b) an investment firm which provides portfolio management; (c) an institution for occupational retirement provision (IORP); (d) a manufacturer of a pension product; (e) an alternative investment fund manager (AIFM); (f) a pan-European personal pension product (PEPP) provider; (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or (j) a credit institution which provides portfolio management;

[30] See Article 3 of the SFDR.

[31] See Article 4(1)(c) and 4(2)(c) of the European Commission Proposal for a Regulation on disclosure relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341, 24 May 2018, COM (2018) 354 final.

[32] COLAERT, "*Sustainable Finance in the European Union and Belgium*" Anthemis, (2021).

(b) the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available."

Basically, this is the category of financial product which are not sustainable, but it essentially says every financial product should disclose in pre-contractual information sustainability risks. Article 2(22) of the SFDR provides a legal definition of "sustainability risks", pursuant to which they are "an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment".

Recital 21 of the SFDR acknowledges that at present, several financial products have been developed and each of these has a different degree of ambition with respect to sustainability goals. It is for this reason that the SFDR wanted to introduce two types of more or less ambitious financial products, which fall under Article 9 and 8 respectively.

The first category of sustainable financial product is the less ambitious Article 8 which states:

"Where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6(1) and (3) shall include the following: (a) information on how those characteristics are met; (b) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.".

There was a lot of discussions on whatever is the meaning of the words "promote environmental characteristics" used in Article 8 and that created a lot of confusions for financial market participants. The European Commission clarified in a Q&A that in order to be classified as an Article 8 financial product, that product must be compliant with certain ESG requirements and these characteristics are also promoted in the investment policy of the financial product. Moreover, the term "promote" means "an impression that investments pursued by the given financial product also consider environmental or social characteristics in terms of investment policies, goals, targets or objectives or a general ambition…"[33]. Later on, in an Explanatory Memorandum the European Council specified that under the meaning of ESG characteristics must fall several different strategies, even those which claim to be

[33] Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088). Available at: https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf

oriented towards environmental, social or governance characteristics but in practice they lack any sustainability-linked materiality[34]. What the EU meant by this phrase remains obscure and disputed. It certainly wanted to emphasize the fact that, unlike Article 9 products, products falling under Article 8 do not have to prove anything more than the mere assumption or impression that they are pursuing and promoting ESG characteristics but have no material relevance to the impact on these factors. Trying to give an example, if an asset manager whose core investment strategy is to invest in motor vehicles, then he is allowed to disclose under Article 8 of the SFDR that his investment will not provide capital to a tobacco or arms manufacturing company. Although it is therefore clear that his central investment strategy is not to make a concrete contribution to ESGs, this individual nevertheless discloses that he is "promoting", in this case, social characteristics. Pursuant to Article 6 of the Regulation 2020/852 (EU Taxonomy), the information that must be disclosed under Article 8 of the SFDR, if an Article 8 product also has "sustainable investment" objectives, must also include the following:

(a) the information on the environmental objective or environmental objectives set out in Article 9 of the EU Taxonomy to which the investment underlying the financial product contributes; and

(b) 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 EU Taxonomy.[35]

The other category of financial product is the more ambitious Article 9 of the SFDR, which says:

"Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following: (a) information on how the designated index is aligned with that objective; (b) an explanation as to why and how the designated index aligned with that objective differs from a broad market index"

[34] Explanatory Memorandum, Commission Delegated Regulation of 21 April 2021 amending Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms (C(2021) 2616 final). Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=PI_COM:C(2021)2616&from=EN

[35] Article 6 and 5 of Regulation 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

Sustainable investment is defined in the SFDR under Article 2 (17) as "an investment that contributes to an environmental objective…or an investment in an economic activity that contributes to a social objective…provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices". The language used in this definition reminds us of the EU Taxonomy, which is analyzed below, even though there are some differences. In fact, the EU Taxonomy uses the term "substantially contributes" whilst in the SFDR only an investment that "contributes" fall under the umbrella of Article 9. In 2020, the Taxonomy amended the SFDR and specified furthermore the definition of sustainable investment. In fact, pursuant to recital 19 of the Taxonomy, the term environmental objective, to which an Article 9 product must contribute, should also include investments into environmentally sustainable activities within the meaning of the Taxonomy. Despite this, the European Commission further said that an investment aligned with the Taxonomy is necessarily a sustainable investment, but the opposite cannot be said, a sustainable investment is not always necessarily aligned. In the Q&A of the European Commission, it was clarified that in order to fall under the scope of Article 9 a product must invest only in sustainable investments as defined above. Nevertheless, if a product includes investments for certain specific purposes (e.g., hedging or liquidity) for being compliant with sectoral specific rules or prudential product-related rules, can be deemed as an Article 9 product because this article nothing says about the product design, or the investment tools engaged. However, it must disclose how these investments comply with the sustainable investments' objective of the financial product.

In conclusion, how can we draw a line between these three different products?

Article 6 is often defined as a "default" article which essentially includes every product because they do not have any sustainable characteristics or investment. However, the European Commission specified that "integration per of sustainability risks is not sufficient for Article 8 to apply"[36]. Thus, we can imply that, in order to fall under Article 8, something more is needed than simply assessing the impact of ESG on the value of the investment. As such, Article 8 is often defined as the "catch all" category because of the vagueness of this term which attracts many financial products.

[36] Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088). Available at: https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf

The main problem arises when we have to distinguish between an Article 8 product and Article 9 product. The European Commission said that in essence "nothing prohibits financial products that fall under Article 8 to be, in part, invested in sustainable investments". The main difference between these two financial products is that the sustainable investment is the main objective of a financial product which falls under the scope of Article 9. An Article 8 product does not need to have a sustainable investment objective, but it can choose to do so and disclose the information necessary. As reported by Morningstar in 2022, assets which fall under Article 8 and 9 of the SFDR reached 4.05 trillion at the end of December 2021 and they represent 42.4% of all funds sold in the European Union[37]. The report's findings show us that there is still a lot of confusion among asset managers on what constitutes an Article 8 product or a product which has a sustainable investment objective in it. In fact, the strategies categorized under Article 9 are often very similar to the strategies which fall under Article 8. Thus, we can assume that asset managers are approaching the classification in different ways: with a too-prudent approach or with a too-generous approach. This differences in the approach used is exactly the opposite of what the objective of the SFDR was in the first place. A lack of clear policy guidance has resulted in confusion among the asset managers, and even though the objective of the SFDR was to create a harmonized system of disclosure, each individual is developing its own interpretative approach to the provisions of Article 8 and 9. Another issue that could result from this situation is greenwashing because, in order to gain some advantages, asset managers might be incentivized to say that their product is an Article 9 product even though it has no sustainable investment.

[37] MORNINGSTAR, *"SFDR Article 8 and Article 9 Funds: 2021 in Review"*, 2022. Available at: https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/bltd0f4649e9dbfcd1f/620292b71586404a56476df2/SFDR_Article_8_and_Article_9_Funds_2021_in_Review.pdf

2.3 An attempt to define sustainable activities: Regulation 2019/852 the Environmental Taxonomy

The European Parliament and the Council, on 18 June 202, adopted, on the basis of Article 114 of the Treaty on the Functioning of the European Union (TFEU), Regulation 2020/852 on the establishment of a framework to facilitate sustainable investment and amending Regulation 2019/2088 (the EU Taxonomy or the Taxonomy). The EU taxonomy entered into force on 12 July 2020 and is directly applicable across all Member States and it is considered one of the prominent legislations in the framework of sustainable finance in the EU. With the EU Taxonomy, the European Union wanted to create a harmonized language, because in order to facilitate sustainable investment, you need to understand what economic activities can be categorized as sustainable, so that these activities can be the underlined products of financial products that are sustainable. Thus, the main objective of the Taxonomy is to define when an economic activity can be defined as sustainable. This Regulation does not provide a definition of sustainable, instead it goes more into detail of specifying whether an activity can be deemed "green". In fact, the social and governance factors, which are always related with the term sustainable, are mainly put it aside[38].

The EU decided that it was necessary to introduce a taxonomy because financial markets were starting to develop several sustainable products without a regulatory framework and there were several national initiatives[39] that would have created market fragmentation, thus resulting in confusion for investors which would have been more exposed to the risk of greenwashing. By introducing a taxonomy, instead, the EU aimed to help investors to make informed decisions by building their trust in the market of what is really "green". As we said above the ultimate goal of a taxonomy is to redirect capital flows towards more sustainable investments and to help facilitate the transition for companies, by providing them with the necessary funds to move their businesses from more polluting sectors to less ones. Besides this, the taxonomy is also a useful tool to create a basis for the creation of other policies and

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[38] PWC, "*The EU Taxonomy and the acceleration of Sustainable Finance*", available at: https://www.pwc.com/jp/en/knowledge/column/taxonomy-and-sustainable-finance.html

[39] The French legislator, already in 2015, decided to act in the field of sustainable finance by enacting its Energy Transition for Green Growth Law and provided with two different sustainability labels: (i) the Socially Responsible Investment label and the Energy and Ecological Transition label. Germany introduced a specific sustainability label, i.e., the FNG, which as the French labels was based on the Climate Bonds Initiatives guidelines. Luxembourg co-founded a labeling agency, called the LuxFlag, which provides a label based on the taxonomy introduced by the International Development Finance Club. Moreover, Denmark, Sweden, Norway and Finland used the Nordic Swan Ecolabel.

legislation to support the development of sustainable finance, even inspire other legislation outside the EU because the idea was also to be the front runner in this field and develop the most advanced framework in the world[40].

2.3.1 Users

The EU Taxonomy provides for three group of mandatory users: (i) financial market participants; (ii) large companies and (iii) the EU and Member States. Apart from those named above, others may use the taxonomy voluntarily.

The first category of users refers to financial market participants who offer financial products in the EU[41]. The idea behind the Taxonomy regulation is to ensure investors is that when a financial product is offered to them and presented as "green" or environmentally sustainable, the financial market participant who is offering that product shall disclose how this is product aligned with the provisions of the Taxonomy which defines what is an environmentally sustainable financial product. They must disclose this alignment in form of a percentage of the investment, fund or portfolio which is Taxonomy-aligned.

The second group of mandatory users are large companies who are subject to the Non-Financial Reporting Directive as prescribed by Article 8 of the Taxonomy Regulation, pursuant to which large companies are required to disclose in their non-financial statements to what extent their activities are aligned to the Regulation. More specifically, large companies shall disclose the proportion of their turnover arising from sustainable activities, as such defined in the Taxonomy and the proportion of their capital expenditure related to such activities. The idea under including large companies in the scope of the Taxonomy is to create a linkage between the EU framework of sustainable finance legislation.

The last group of users which are compelled to be compliant with the Regulation are the EU and the Member States. This means that whenever a Member State of the European Union wants to issue a green label it has to do so in compliance with the standards and provisions contained in the Taxonomy.

2.3.2 Main provisions

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[40] GORTSOS, "*The Taxonomy Regulation: More Important Than Just as an Element of the Capital Markets Union*". In: BUSCH, D., FERRARINI, G., GRÜNEWALD, S. (eds) Sustainable Finance in Europe. Springer International Publishing, Cham, 2021, pp. 351–395, (2021).

[41] The EU Taxonomy's definition of "financial market participants" refers to the definition given to them in Regulation 2019/2088. For the full definition please see note 29 above.

The main idea behind the introduction of the Taxonomy was to create a regulation, linked to scientific figures, that could give a definition of what are sustainable activities. In an attempt to do this, the Taxonomy provides in Article 3 criteria, based on which one can determine to what level an investment can be considered environmentally sustainable.

The criteria set out in Article 3 are:

1) Substantially contribute to at least one of the six environmental objectives;

The key criterion of the Taxonomy is the first of the above criteria, which links Article 3 and Article 9, which on the other hand states what are the environmental objectives. Those environmental objectives are:

(i) Climate change mitigation;
(ii) Climate change adaptation;
(iii) The sustainable use and protection of water and marine resources;
(iv) The transition to a circular economy;
(v) Pollution prevention and control;
(vi) Protection and restoration of biodiversity and ecosystems.

The taxonomy further specifies in Articles 9 through 15 which types of activities can be qualified as substantially contributing to the environmental objective under consideration. The reason for this is that a common definition of substantial contribution cannot follow the principle of one size fits all, and so the scope of delegation to the Commission has been limited by also specifying what the thresholds are for meeting the requirement of substantial contribution.

2) Do not significantly harm any of the environmental objectives;

The idea behind this criterion is that even if an activity has a positive impact on one of the environmental objectives in Article 9, it negatively impacts another objective, then it cannot be considered as sustainable. The Taxonomy specifies when an activity impairs each objective. To give an example, an activity harms the objective of climate change mitigation if it leads to an increase in greenhouse gas emissions. This criterion is fundamental to the proper functioning of the taxonomy, as it does not allow activities that are very detrimental to one of the objectives to be considered aligned.

3) Be carried out in compliance with minimum safeguards;

Even though the Taxonomy focuses mainly on environment, a little emphasis is given to the social factors. In fact, a company, in order to carry out an activity which is Taxonomy-aligned, shall align[42] itself with OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights. Initially, the Commission's proposal[43]was to limit the required alignment of society to only the International Labour Organisation on Fundamental Principles, but later, during negotiations, it was decided to expand the scope of the Taxonomy to include the 3 human rights guidelines.

4) Comply with technical screening criteria.

Technical screening criteria classifies which activities are deemed as environmentally sustainable by setting, for each activity, thresholds and criteria. This criterion can therefore be considered, not as a stand-alone criterion, but as a specification of the first three. These technical screening criteria were long overdue and, until now, the European Commission has only introduced criteria referring to the first two environmental objectives (i.e., climate change mitigation and adaptation). On 4 June 2021, the European Commission adopted the first Taxonomy Climate Delegated Act[44], which set out technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation and climate change adaptation. Estimates say that the activities described in the delegated act account for about 40 per cent of the listed companies in the sectors responsible for more than 80 per cent of greenhouse gas emissions in Europe[45]. They are based on scientific evidence and developed on the basis of the precautionary principle contained in Article 191 TFEU[46]. There was much debate about the inclusion of the use of nuclear energy and gas within the sustainable economic activities of the delegated act. The activities related to these two types of energy are considered by some

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[42] Article 18 of the Taxonomy.

[43] Article 13 of the Commission proposal.

[44] COMMISSION DELEGATED REGULATION (EU) of 4.6.2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. Available at: https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-delegated-act-2021-2800_en.pdf

[45] EU Taxonomy Info, “Introduction of the first two environmental objectives”.

[46] Article 19 of the Taxonomy.

to be essential for an ecological transition, but to date they do not possess the necessary technology to reduce the climate impact they produce. This debate, which is purely political, has created strong tensions and doubts about the effectiveness of the taxonomy in the event that the above-mentioned activities are chosen for inclusion. In fact, those who were not in favor of inclusion argue that there is no room for investment in gas fossil projects in order to achieve the goals set by the Paris Agreement and the European Green Deal. Thus, qualifying fossil gas and nuclear as 'transitional activities' not only risks legalizing greenwashing, but also increasing the EU's dependence on gas from Russia.[47] Proponents, on the other hand, argue that the use of gas and fossil gas is essential for an ecological transition. These were the words of Commissioner McGuiness at the European Parliament plenary debate on the EU Taxonomy Complementary Climate Delegated Act: “Gas is a fossil fuel – it is not green…But some Member States moving from dirty fossil fuel may need gas in transition – and that is where we have placed gas in this Taxonomy. Nuclear power…is part of our energy mix in transition too. And that is why it is in the transition category of the Taxonomy.”. The Commissioner went on to point out that the Taxonomy does not bind investors to invest in a particular financial product, but it does shed light on how economic activities are aligned with the Taxonomy. The debate, although still heated, was stopped by the adoption of the Complementary Climate Delegated Act[48], which qualified nuclear power and the use of fossil gases as transitional activities.

Before the end of 2022, the European Union is expected to introduce the additional delegated act concerning the technical screening criteria of the remaining 4 environmental targets.

The Taxonomy, after listing environmental objectives in Article 9, then divides economic activities into three macro-categories. The first category includes all those economic activities that are green in an absolute sense and then provides for two further categories that represent activities that are not strictly definable as environmentally friendly but are included in the scope of the Taxonomy due to their instrumentality in achieving the objectives set by the European Union.

These categories are:

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[47] See Climate Bonds Initiative’s position on EU Taxonomy Complementary Delegated Act, available on its website: https://www.climatebonds.net/policy/eu-taxonomy-complementary-delegated-act

[48] COMMISSION DELEGATED REGULATION (EU) 2022/1214 of 9 March 2022 amending Delegated Regulation (EU) 2021/2139 as regards economic activities in certain energy sectors and Delegated Regulation (EU) 2021/2178 as regards specific public disclosures for those economic activities.

1) Low-carbon activities

These are the activities that form the basis to which the Taxonomy refers. They include, for example, the installation of a wind turbine for the production of renewable energy or the production of electric cars. In short, all those activities that directly contribute to the reduction of greenhouse gas emissions[49].

2) Transitional activities

Then there are those activities that do not make a substantial contribution to one of the objectives in Article 9 but are still considered aligned to the Taxonomy if they support the transition to a climate-neutral economy[50]. In order to be considered as transitional activities, these activities, on the one hand, must not have a level of gas emissions lower than the best performance in the sector and, on the other hand, must not hamper the development of low-carbon alternatives. In addition, to qualify as transitional activities, it must also not lock up assets that are carbon intensive[51]. The rationale behind including this category in the scope of the Taxonomy is also to include those activity for which there is not a feasible low-carbon alternative yet, but still is crucial for the economy. For instance, the industry of cement is still crucial for the building sector, but still no alternatives more environmentally friendly has been found. Thus, the Taxonomy, by providing that, in order to be aligned, the activity must have a greenhouse gas emission level equal to the best performance in the sector, incentivize the development of new technologies for improving sectors that, as of today, are still very polluting.

3) Enabling activities

This category includes all those activities that, while not making a substantial contribution to one of the environmental objectives, enable other activities to do so. The requirements for this activity to be aligned with the Taxonomy are that it must have a substantial positive environmental impact and must not result in a lock-in of assets that undermine the achievement of environmental objectives in the long term. Consider, for example, the production of iron or steel, which at first glance may not seem sustainable, but which enables

[49] Article 10 (1) of the Taxonomy.
[50] Article 10 (2) of the Taxonomy.
[51] PACCES, A.M ET AL. "*Sustainable Corporate Governance: The Role of the Law*." Sustainable Finance in Europe, 2021, 366.

the production of e.g., electric cars or wind turbines which, in turn, contribute directly to environmental goals.

The most important feature of the Taxonomy is that it does not create itself a framework for labeling financial product or issuer of such financial product as sustainable, instead it provides clarity on which activities can be defined as environmentally sustainable. Member States, therefore, shall use the Taxonomy, and in particular Article 3, as a reference for labelling those financial products or issuers[52].

In conclusion, one of the biggest changes brought about by the Taxonomy was the changes made to the disclosure obligation of companies subject to the NFRD[53]. Indeed, as of 2022, companies will also have to disclose standardized quantitative metrics on the taxonomy alignment of their activities[54].

[52] Article 4 of the Taxonomy.
[53] Article 8 of the Taxonomy.
[54] STEUER S. AND TROGER T.H., "*The Role of Disclosure in Green Finance*", LawFin Working Paper No. 24, p. 15, (2021).

2.4 Increasing the shareholders 'engagement: the SRD II

Capital markets have always been characterized by a great dispersion of shareholders. This structural characteristic has brought with it various problems, the most important of which is the coordination of shareholders in influencing the managerial decisions of the companies in which they invest. For this reason, shareholders are referred to as "passive" or "rationally apathetic". The traditional theory of corporate governance of "rational apathy" argues that shareholders are unlikely to engage in collective monitoring or disciplining of company managers, since they are dispersed among themselves, and the shareholder base is diffuse[55]. Another factor that contributed to the proliferation of the idea that shareholders were indifferent to the company's affairs was the fact that there was a widespread notion that managers were in a better position to assess the best strategy for managing the future of the company. Therefore, the most rational choice was to be "apathetic" towards the management of the company, and this manifested itself most in the exercise of their voting rights. The choice to intervene was only justified if the gain from exercising one's voting rights was greater than the cost of exercising them. The foundations of this theory collapsed with the advent of the 2008 global financial crisis. What the financial crisis brought to light was certainly the structural defect of companies to be oriented towards short-termism. This is why, following the crisis, the concept of stewardship, understood as "responsible and thoughtful ownership" which has a tendency to be oriented towards creation of long-term value, began to spread[56]. This concept saw shareholder engagement as a means of combating the structural defect of capital markets and had as its main objective to incentivize investors, especially institutional investors, to participate more actively in company decision-making. Shareholder engagement can be understood as the influence exercised by the shareholders of a company in its decision-making process, and the higher the amount of this influence, the greater the control exercised by the shareholders, which in so doing, can lead to a reduction in the "managerial malfeasance and board inattention"[57]. As of today, however, a company's shareholder base is anything but apathetic, and it is therefore safe to say that the corporate governance norm of rational apathy has been superseded[58]. Some authors have also argued

[55] BERLE AND MEANS, "*The modern corporation and private property*", Rev. ed., Harcourt, Brace and World, (1968).
[56] Financial Reporting Council, "*The UK Stewardship Code*", 2012.
[57] LISA M. FAIRFAX, "*Mandating board-shareholder engagement*", 2013, University of Illinois law review, vol. 2013 (3), p.821.
[58] LISA M. FAIRFAX, "*From Apathy to Activism: The Emergence, Impact, and Future of Shareholder Activism* as *the New Corporate Governance Norm*", Boston University Law Review 1301, (2019).

that companies where there is more shareholder engagement outperform companies where it is 8.5% lower each year[59]. Furthermore, it is clear that for shareholders, environmental, social and governance issues have become major concerns, the subject of pressure on the management of the company in which they invest their capital[60]. Riding this wave, policy makers tried to introduce new regulations to increase shareholder engagement and to voice their concerns about ESG issues.

A substantial portion of the equity market today, as recent studies show[61], is held by investors, often institutional ones, with a long-term investment structure. Starting from this fact, one can understand the logic behind the introduction of policy measures adopted by regulators with the aim of facilitating a long-term view of companies, by increasing the shareholders 'activity in monitoring the development of the company by enhancing the information available to them. The main assumption is the insufficient monitoring role of shareholders towards the companies in which they invest, who focus on short-term gain and lack a long-term investment vision. Therefore, their engagement needs to be strengthened to reflect the long-term goals, which investors increasingly have in mind, in the management choices of the listed company. Thus, increasing shareholder engagement could result in significant impacts on the management of companies and thus their approach to sustainability issues.

The Shareholder Rights Directive (SRD II)[62] fits within this context aiming to establish a long-term mentality, but the road to its adoption was arduous and very long. The evolution of the concept of stewardships in the European Union can be traced back in history to 1992, when the Cadbury Report[63] was published. This document laid the foundation for the first major comparative study of corporate governance practices, namely the "Comparative Study"" conducted by Weil, Gotshal & Manges LLP[64]. This study analyzed the rules used in Europe at that time concerning shareholders' rights. This study represented a landmark for the field of shareholders' engagement. In fact, in 2003 the European Commission communicated two

[59] GOMPERS, ISHII, & METRICK "*Corporate governance and equity prices.",* 2003, Quarterly Journal of Economics, 118, 107–155.
[60] ISS for the Investor Responsibility Research Center Institute, "*Defining engagement: An update on the evolving relationship between shareholders, directors and executives"*, 2014.
[61] OECD "*The future of corporate governance in capital markets following the Covid-19 crisis*", 2021, Fig. 2.34.
[62] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.
[63] Cadbury Committee, "*Report of the Committee on the Financial Aspects of Corporate Governance*", 1992.
[64] WEIL, GOTSHAL & MANGES LLP, "*Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States*", 2002. Available at: https://www.dea.univr.it/documenti/OccorrenzaIns/matdid/matdid886114.pdf

different objectives for enhancing corporate governance in the European Union[65]: (i) strengthening shareholders rights and third parties' protection and (ii) fostering efficiency and competitiveness of business. On this basis, the European Union adopted in 2007 the first Shareholder Rights Directive (SRD I)[66], which set itself the goal of facilitating the conduct of general meetings and the exercise of voting rights, including through means of electronic participation. Following the adoption of this directive, the corporate governance framework introduced proved insufficient in the face of the 2008 financial crisis. In 2010, the Commission recognized that one of the biggest structural flaws was the lack of shareholder proactivity as well as a weak level of shareholder engagement[67]. Hence, a discussion arose about a possible amendment of SRD I to better regulate the issues of managers' remuneration, related party transactions, and transparency of institutional investors. Finally, a Proposal for amending the SRD I was advanced in 2014 and in 2017 the SRD II was adopted.

This is the background to SRD II, which impacts various market players. Intermediaries, as stipulated in Article 3 (c) of SRD II, must allow the easy exercise of shareholder rights, especially voting rights and participation in the general meeting. Asset owners and asset managers must disclose publish an engagement policy in which they explain how they intend to monitor the company in which they invest and how they intend to exercise their rights regarding strategy, financial and non-financial performance, and the risks associated with these issues. In addition, institutional investors and asset managers must report annually on how they intend to execute the engagement policy[68]. Article 3 (j) of the SRD II provides that proxy advisors shall disclose reference to a code of conduct which they apply and report on the application of that code. The SRD II also introduced remuneration legislation, stipulating that companies must disclose a report on their remuneration policies and that shareholders must have the right to vote on these policies[69].

2.4.1 Directors 'remuneration: new policy measures to foster long-termism

[65] European Commission, "*Communication from the Commission to the Council and the European Parliament: Modernizing company law and enhancing corporate governance in the European Union – A plan to move forward*", COM (2003) 284 final 8.
[66] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.
[67] European Commission, "*Green paper on corporate governance in financial institutions and remuneration policies*" COM (2010) 284 final 8.
[68] Article 3 (g) of the SRD II.
[69] Article 9 (a) (b) of the SRD II.

The area of directors' remuneration is central to the discourse of incentivizing companies towards long-term development, and in recent years this field has developed various mechanisms and incentives to steer directors towards sustainable management that takes into account the companies' long-term. Indeed, various studies have observed how individuals prefer a short-term view, choosing rewards they can receive in the present rather than investing in the future[70]. A fortiori, directors have more reasons (e.g., career concerns, pressure to meet quarterly targets and remuneration anchored to short-term goals) to prefer the present than the future. In a survey conducted in 2005, the percentage of directors interviewed who admitted to sacrificing long-term value for easier earnings was 78%[71].

The reasons why companies should change their orientation towards a more long-term investment is obvious. Stakeholders are essential for the survival of a company and to maintain their competitiveness in the market, as well as to stimulate its growth. Customers are increasingly attached to sustainable issues and finding in a company a reflection of their ideals encourages their loyalty. All these arguments show how, in the end, a company's financial performance is inevitably influenced by the governance choices and investment orientation of its directors. In the words of Novo Nordisk CEO Rebien Sørensen, "corporate social responsibility is nothing but maximizing the value of your company over a long period of time, because in the long term, social and environmental issues become financial issues".

One of the tools that has developed in recent years in the area of directors' remuneration is CSR contracting, i.e., linking remuneration to non-financial performance. A study published in 2019 shows how the use of this technique has increased over time, rising from 12% of S&P 500 companies linking their directors' remuneration to ESG issues to 37% in 2013. The study also analyzed how CSR has impacted company performance and found that the adoption of CSR has led to (i) an increase in long-term investment; (ii) an increase in company value; (iii) an increase in social and environmental initiatives; (iv) a reduction in greenhouse gas emissions; and (v) an increase in green patents[72].

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[70] FREDERICK, S., LOEWENSTEIN, G., & O'DONOGHUE, T., "*Time discounting and time preference*", Journal of Economic Literature, 100(3), 468-505, (2002).
[71] GRAHAM, J. R., HARVEY, C. R., & RAJGOPAL, S., "*The economic implications of corporate financial reporting*.", Journal of Accounting and Economics, 40(1–3), 3–73, (2005).
[72] FLAMMER, C, HONG, B, MINOR, D., "*Corporate governance and the rise of integrating corporate social responsibility criteria in executive compensation: Effectiveness and implications for firm outcomes*", Strategic Management Journal, 40: 1097– 1122, (2019).

For all the above reasons, SRD II extensively amended the legislation on directors' remuneration to encourage a long-term view. This is aligned with the G20/OECD International Principles of Corporate Governance, which explicitly recognize the stakeholders' interest in the long-term performance of companies, as well as in their success and in the interest of the link between the remuneration policy adopted and the long-term performance of the company. In addition, these international principles state that shareholders should have a say in the remuneration of board members and executives[73].

Recital 29 of the SRD II states: "…The remuneration policy should contribute to the business strategy, long-term interests and sustainability of the company and should not be linked entirely or 20.5.2017 Official Journal of the European Union L 132/5 EN mainly to short-term objectives. Directors' performance should be assessed using both financial and non-financial performance criteria, including, where appropriate, environmental, social and governance factors…". The SRD affects the field of directors 'remuneration in different ways. Firstly, it prescribes that the shareholder shall have the right to vote[74] at the general meeting the remuneration policy of directors adopted by the company, and such policy must give a contribution to the company's business strategy and long term-interests and sustainability. This remuneration policy shall be clear and understandable and shall explain how it intend to implement the long-term interests and sustainability. The policy shall specify the variable and fixed components of the remuneration and must also specify the criteria that are applied to calculate the remuneration related to variable components and in particular distinguishing between financial and non-financial performance. Companies are allowed, under the SRD II, to temporarily derogate from the remuneration report if there are exceptional circumstances that refer to the long-term interests of the company and its sustainability.

In conclusion, it can be said that SRD II provides a set of forecasts that have the potential to impact the investment vision of companies and make them focus on long-term development. On the other hand, the market will determine how and whether ESG factors will be utilized and anchored in the variable component of directors' remuneration. This process could be accelerated by institutional investors who, through the new tools provided to them by the

[73] G20/OECD Corporate Governance Principles. Available at: https://www.oecd-ilibrary.org/docserver/9789264236882-en.pdf?expires=1660127584&id=id&accname=oid025361&checksum=DE5247F3C2EBF8521F17ABDC783BD6A4

[74] Article 9a (1) of the SRD II.

SRD, will be able to exert more pressure on the company to take more account of the sustainability factor[75].

[75] LINCIANO N., SOCCORSO P., GUAGLIANO C., (17).

2.5 Proposal: Corporate Sustainability Due Diligence Directive

In recent years, there has been much debate about the introduction of a law that would oblige companies to conduct internal due diligence to assess the impacts of the activity in question on the environment and respect for human rights throughout the value chain. David Boyd, UN Special Rapporteur on human rights and environment stated, on 4 July 2022, that “Businesses operating in the global economy routinely abuse the right to a clean, healthy and sustainable environment and other human rights”. Rights holders find themselves in a powerless situation because they do not have the tools at their disposal to be able to fight abuses with respect to the environment and human rights. In 2019, the Human Rights Business Benchmark conducted an evaluation of about 100 companies, which showed the serious situation we are in. In fact, the average percentage points scored by companies on human rights due diligence is around 21% and about half of the companies scored zero points in this area. The evaluation therefore called human rights due diligence "a key weakness for most companies"[76]. For this reason, many consider the introduction of such disciplines to be necessary to ensure that such abuses are not perpetrated.

A problem that sometimes leads to confusion is finding a definition of the concept of due diligence in relation to environmental and human rights issues. In fact, the concept of due diligence is often used within the corporate world as a process to manage business risk. However, the origins of this concept can be found in Roman law, which used due diligence as a standard of conduct. This standard, which was measured in the conduct the paterfamilias would exercise, was the yardstick for holding a person liable for negligent wrongdoing. A legal definition is given in the Max Planck Encyclopedia of Public International Law, according to which the concept of due diligence is "an obligation of conduct on the part of a subject of law”, i.e., an obligation whose breach does not consist in not obtaining the result wanted but rather not having taken the necessary steps towards that result. In common law jurisdictions if often related to the term “duty of care” which “refers to the circumstances and relationships giving rise to an obligation upon a defendant to take proper care to avoid causing some form of foreseeable harm to the claimant in all the circumstances of the case in question”[77].

[76] Corporate Human Rights Benchmark 2019 Key Findings. Available at: https://assets.worldbenchmarkingalliance.org/app/uploads/2021/03/CHRB2019KeyFindingsReport.pdf
[77] LexisNexis’ definition available in the Glossary.

Notwithstanding all of the above, in the context of human rights due diligence, this concept has been defined by United Nation Guiding Principles on Business and Human Rights (UNGPs) as "*an ongoing management process that a reasonable and prudent enterprise needs to undertake, in the light of its circumstances (including sector, operating context, size and similar factors) to meet its responsibility to respect human rights*"[78]. The UNGPs, developed in 2011 by the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, comprises 31 principles created with the aim of raising standards and practices in business and human rights[79]. According to UNGP 17 the process of human rights due diligence should:

(i) Include an assessment of actual and potential human rights impacts;
(ii) integrate and act upon the findings;
(iii) track responses; and
(iv) communicate how impacts are addressed.

As previously analyzed, Action 10 of the Sustainable Finance Action Plan states that essential is fostering sustainable corporate governance and attenuating short-termism in capital markets. To promote corporate governance the Commission had assessed "the possible need to require corporate boards to develop and disclose a sustainability strategy, including appropriate due diligence throughout the supply chain[80]." The European Commission Directorate-General Justice and Consumers mandated a study on due diligence throughout the supply chain to the British Institute of International and Comparative Law (BIICL)[81]. The aim of the study was to analyze existing regulations on due diligence and to assess regulatory options for requiring due diligence activities for human rights and environmental impacts. As can be seen from this study, many EU member states had begun a process of adopting national legislation to regulate the area of human rights and environmental due diligence. For example, in France, the 2017 French Duty of Vigilance Law was adopted, or in the UK, the Modern Slavery Act was adopted, which imposes due diligence requirements on child labor. In this

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[78] OFFICE OF THE HIGH COMMISSIONER OF HUMAN RIGHTS, "*The Corporate Responsibility to Respect Human Rights: An Interpretive Guide*." 2012, available at: https://www.ohchr.org/Documents/Publications/HR.PUB.12.2_En.pdf.

[79] UNITED NATIONS, "*Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework*", 2011.

[80] See (4) above.

[81] European Commission, Directorate-General for Justice and Consumers, TORRES-CORTÉS, F., SALINIER, C., DERINGER, H., ET AL., "*Study on due diligence requirements through the supply chain: final report*", Publications Office, 2020.

area, the NFRD imposes on large companies to publish a non-financial statement containing a description of the major risks to which the company is exposed. The companies must publish also the policies adopted to avoid these kinds of risks, including due diligence activities carried out by the company. The obligation imposed on large companies by the NFRD is to report these policies implemented, but it does not include in its scope an obligation to have such policy.

The study conducted by the BIICL, proposed different options to regulate the area of human rights and environmental due diligence, ranging from no legislation at all to the introduction of a regulation requiring mandatory due diligence as a standard of care. The European Commission decided to go with the last option and on February 23, 2022, it proposed a Directive on Corporate Sustainability Due Diligence[82] (CSDD). This Directive aims to (i) improve corporate governance practices and thus integrate risk management and mitigation processes of human rights and environmental risks; (ii) avoid market fragmentation; (iii) increase corporate accountability; (iv) improve access to remedies for those affected by adverse human rights and environmental impacts; and (v) integrate in the EU legislative framework for sustainable finance and complement other measures[83].

2.5.1 Scope: a company-by-company approach

The proposed Directive applies to various companies, depending on two characteristics: size and the sector in which they operate. In fact, the Directive starts by including in its scope companies that had (i) more than 500 employees on average and (ii) a net worldwide turnover of more than 150 million in the last financial year. There is then an exception to these thresholds which says that the Directive is applicable also to companies which had (i) more than 250 employees on average and (ii) a turnover of 40 million, provided that the half of this turnover was generated in one of the sectors mentioned[84](e.g., agriculture, forestry, fishing, manufacture of textiles, leather, and related products; extraction of mineral resources).

The Directive applies also to non-EU companies which had generated the amounts of turnover mentioned above in the Union (i.e., 150 million or 40 million if it operates in one of the sectors mentioned), but no mention is made of thresholds for the number of employees. This company-by-company approach chosen by the European Commission has been criticized by

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[82] European Commission, "*Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937*", COM (2022) 71 final.
[83] *Ibid.* Explanatory Memorandum p. 3.
[84] Article 2 of the CSDD.

academics because it does not take into account the economic reality in which companies operate, since the largest multinationals operate in groups. By saying that the Commission adopted a company-by-company approach it means that the thresholds criteria and the requirements are applied to each company rather than the group as a whole. This could potentially lead to some disadvantages such as creating a supervisory complexity, i.e., each subsidiary in a group may be subject to different supervisory requirements, and opportunistic behavior of the group that, in order to avoid a subsidiary reaching the thresholds and thus being subject to the requirements of the Directive, may shift the investments from a subsidiary to another, which is either well below the thresholds or well above[85].

Small and medium enterprises are formally not included in the scope of the CSDD, however large companies are required, under Article 5(1)(c), that also the companies with which they have an established business relationship must comply with the code of conduct included in the due diligence policy (see paragraph below). By inserting this provision, the Commission has entrusted large companies with the task of controlling not only themselves but also the companies with which they have a stable relationship. This seems to go against the OECD principle, according to which every company must be held responsible for any negative impact it produces, and, within the limits of its possibilities, must exert its influence on those with whom it cooperates in an attempt to bring about change[86].

2.5.2 Obligations

The proposed Directive provides for two different sets of due diligence obligations: on the company as such and on the directors.

1) Company level

Article 4 of the proposed Directive mandates Member States to ensure that each company carries out a due diligence process on human rights and on environment. The company must integrate into their policies a due diligence process which must include a code of conduct which all subsidiaries of the company and employees must follow. The due diligence process must be conducted on the company's value chain, which is defined as "activities related to the production of goods or the provision of services by a company, including the development

[85] EUROPEAN CORPORATE GOVERNANCE INSTITUTE, "*Day 1: European Commission Directive on Corporate Sustainability Due Diligence*", 2022, video available at: https://www.youtube.com/watch?v=qe8QMgRh28g
[86] MOSCO G.D., FELICETTI R., "*Prime riflessioni sulla proposta di direttiva Ue in materia di Corporate Sustainability Due Diligence*", Analisi Giuridica dell'Economia 1/2022.

of the product or the service and the use and disposal of the product as well as the related activities of upstream and downstream established business relationships of the company"[87]. The scope of the directive is therefore very broad, as it requires companies to carry out environmental and human rights due diligence also on companies with which they have "established business relationships"[88]. It must take appropriate measures to identify actual and potential adverse impact arising from breaches of the international standards. Article 7 of the CSDD prescribes that companies must take appropriate measures to prevent or mitigate potential adverse impacts identified or if they are already occurring, they must bring them to an end or minimize them. An important feature to understand about this proposal is that it creates an obligation of conduct and not an obligation of result. In fact, the provisions require companies to take appropriate measures which are reasonably expected from a company depending on the situation and the impact which are referred to.

2) Director's duty of care

Article 25(1) of the CSDD requires Member States to ensure that directors of companies must consider the consequences of their decisions on sustainability matters in the long-term and in the medium term, in particular on human rights and environment. The directors are responsible for the oversight of the due diligence process, and they must report to the board of directors. In addition, they must take the appropriate steps to implement a corporate strategy which takes into account the potential adverse impacts identified.

Returning then to the subject of remuneration, already discussed in the section in which we analyzed SRD II, the CSDD stipulates that the company, when setting the variable component of directors' remuneration, must also take into account their contribution to long-term interests. It might be argued that there could be an overlap between the CSDD and Article 9(a)(1) of the SRD II, since the remuneration of directors is already required by the latter to be decided depending on the contribution made by the directors to the business strategy and the long-term interests of the company.

2.5.3 Complaints procedure

[87] Article 3 (g) of the CSDD.

[88] The term is defined under Article 3 (f) of the CSDD as "a business relationship, whether direct or indirect, which is, or which is expected to be lasting, in view of its intensity or duration and which does not represent a negligible or merely ancillary part of the value chain".

In addition, the Directive is also concerned with regulating the procedures for complaints from individuals who have legitimate concerns that the company is impacting the environment and human rights through its activities. According to Article 9 (2), the persons entitled to submit a complaint to companies are: (i) persons affected by an adverse impact or that have reasonable grounds to believe that they might be affected; (ii) trade unions and other workers 'representatives; (iv) civil society organizations. The company must establish a procedure to deal with these complaints.

On the other hand, Article 17 prescribes that each member state will have to appoint an authority, while entrusting it with wide-ranging powers, including the power to impose fines, to supervise that the obligations imposed by the CSDD are complied with by the companies subject to the discipline. Every person has a right under Article 19 of the CSDD to report a company which is not compliant with the obligations arising from this Directive.

The sanctioning system has been described by various authors as excessively broad, which risks hampering the economy[89], and this has been particularly criticized with regard to Article 15 of the CSDD, which requires companies to adopt a plan to limit global warming to 1.5 degrees Celsius in line with the Paris Agreement, and for certain categories of particularly polluting companies to additionally include targets to reduce greenhouse gas emissions within this plan. This article, not only criticized by some authors for imposing not a means but a result obligation, could result in the authorities' power to intervene directly in the adopted climate change plan. By doing so, the authorities would have immense power over the business strategy of companies, thus violating the fundamental right, protected by the Charter of fundamental rights of the European Union and the Member States' constitutions, on freedom of enterprise[90]. This great extension of powers has led some commentators to argue that a settling-in period is necessary before the rules on supervision, sanctions and liability come into force so as to assess the impact of the directive on directors and society[91].

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[89] MOSCO G.D., FELICETTI R., "*Fin troppa diligenza sulla sostenibilità delle società*", 2022

[90] EUROPEAN CORPORATE GOVERNANCE INSTITUTE, "*Why Article 15 (combating climate change) should be taken out of the CSDD*", available at: https://ecgi.global/blog/why-article-15-combating-climate-change-should-be-taken-out-csdd

[91] MOSCO G.D., FELICETTI R., (86).

2.6 The role of social factors in the EU's regulatory framework

The role of social factors has always been neglected within the European legislative framework. The urgency of action required by climate change has shifted the legislator's attention away from social issues to focus more on environmental issues. Despite this, the social factor deserves much more space than it has been given in recent years. This was even more evident in the aftermath of the Covid-19 pandemic and Russia's recent invasion of Ukraine. The Covid-19 pandemic led to an increase in the global poverty rate from 7.8% to 9.1% and globally it is estimated that 3 to 4 years of progress that had been made to eradicate poverty was lost[92].

Since the Rio Declaration of 1992, all three factors - environmental, social and governance - have always been subsumed under the term sustainability. As we have seen in the first chapter, policy makers must embrace an integral approach of all three mutually influencing factors in order to effectively aim at sustainable development. In her election speech, President Ursula Von der Leyen emphasized the importance of environmental issues as much as achieving an "economy that works for people".

And again, Executive Vice-President-designate Frans Timmermans emphasized that the European Green Deal aims at protecting the environment as well as protecting social issues, which could also emerge from the fight against climate change itself. Indeed, in order to achieve a transition to a greener economy, it will be inevitable to reduce the portion of the economy that is characterized by a high level of pollution (e.g., oil or coal plants). This, on the other hand, will have an impact on the workers and people who live off these sectors. For these reasons, the European Commission has always advocated a just transition that does not neglect the needs of the people affected by the ecological transition. However, the movement of private capital that we have seen growing in recent years towards more environmental investments has not matched what we are seeing in the social sphere. This is also dictated by the absence of incentives and a clear definition of what the S-factor encompasses.

The S-factor has always been difficult to measure and analyze and is often only connoted qualitatively, unlike the E-factor, with reference to which a quantification of a specific objective supported by scientific data has been achieved. There are several reasons for this

[92] WORLDBANK, "*Covid-19 leaves a legacy of rising poverty and widening inequality*" 2021. Available at: https://blogs.worldbank.org/developmenttalk/covid-19-leaves-legacy-rising-poverty-and-widening-inequality#:~:text=The%20decline%20in%20income%20has,less%20than%20%245.50%20a%20day.

difficulty. First of all, the social sphere is inevitably correlated with the concept of CSR, which has to take into account a multitude of stakeholders that come into play. Secondly, the social, cultural, religious, economic, and legal contexts greatly influence what is included in the S-factor. One thinks of the strong relocation of companies' production chains to countries where social demands are inadequately met, to the point of sometimes not even respecting the cardinal principles that are now taken for granted in the most advanced economies.

Given the difficulty of finding a precise definition of what is contained in the social factor, and also given the climate emergency that has demanded more focus from policy makers, the European Union has embraced a milder approach, concentrating mainly on environmental issues, and touching marginally on social issues. As analyzed in the previous paragraphs, three main regulations have been introduced in the area of sustainable finance, namely the NFRD, the SFRD and the Taxonomy.

The first requires the publication of a non-financial statement containing social and environmental issues, respect for human rights, anti-corruption, and bribery information. The European Commission has later issued, pursuant to Article 2 of the NFRD, non-binding guidelines related to social issues, and in doing so, some authors argued that the Commission could have made these guidelines binding for the companies and could have submitted a report with legislative proposal rather than strengthening in 2019 guidelines related to the climate issues[93]. These guidelines, drafted based on the recommendations of the Task Force on Climate-related Financial Disclosures, failed to provide processes on how to take unintended social consequences into account and focused only on climate-related issues rather than also strengthening the social sphere. Nevertheless, the main issue companies face in disclosing non-financial information is a lack of standardization and common understanding of what is actually socially material. As shown in a consultation conducted by the European Commission, 82% of the respondents believed that an application of a common standard for non-financial information would resolve the problems of reliability, comparability, and companies not reporting all relevant information[94].

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[93] VANDER STICHELE M., "*Strengthening green finance by better integrating the social dimensions in the European Union Sustainable Finance Laws*", 2020, Making the Financial System Sustainable, Cambridge University Press, pp. 299–326. The author proposes that the European Commission should have given binding nature to the guidelines according to Article 3 of the NFRD, which states that the European Commission shall publish a report on the implementation of the NFRD and in particular referring to the level of guidance and methods provided.

[94] EUROPEAN COMMISSION, "*Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive 20 February 2020 - 11 June 2020*", 2020, Available at:

The SFRD's main aim is to combat market fragmentation in the area of disclosure of sustainability factors related to financial products. As previously analyzed, according to the definition given by the SFRD of "sustainable investment", an investment is socially sustainable in the event that contributes to a social objective. While disclosure requirements for environmental investment have been better specified following the introduction of the Taxonomy, which has thus anchored the definition of what is environmentally sustainable to the disclosure requirements under the SFRD, there is still a lot of confusion among investors on what constitute an investment that contributes to a social objective. In the absence of a Social Taxonomy, we can assume that everything that is not environmental or related to governance is socially sustainable. As argued above when analyzing the SFDR discipline, the lack of a clear definition and guidelines has led to great confusion among asset managers who have therefore adopted different approaches to interpreting the term socially sustainable. This result goes against the ultimate goal of the regulation, which was to create a clear and harmonized system of disclosure in order to avoid market fragmentation.

The approach used by the European Union within the Taxonomy has been to focus on providing financial market players with a definition of activities that are environmentally sustainable, while at the same time, giving it a marginal role, requiring companies to meet minimum safeguards in order to be considered as aligned with the Taxonomy. These minimum safeguards were the subject of much debate in the marketplace as it was difficult to understand how a company should be compliant with these standards. First of all, it is worth noting the difference between this requirement and the first two, namely, to contribute substantially to at least one of the six environmental objectives and to do not significantly harm any of the other objectives. In fact, while the first two requirements refer to the activity aiming to be classified as environmentally sustainable, the third requirement requires the undertaking as a whole to be compliant with the minimum safeguards. Recently the European Commission mandated the European Platform on Sustainable Finance to issue recommendations on how the undertakings shall be compliant with these safeguards. The Platform published in July 2022 a draft report on minimum safeguards[95], in which it identified 4 main core areas to which undertakings must be compliant:

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https://www.consob.it/documents/46180/46181/Ares%282020%293997889_summary_report.pdf/bf9a64eb-3b24-4ade-bc5e-c7a1e238ca89

[95] EUROPEAN PLATFORM ON SUSTAINABLE FINANCE, "*Draft report on minimum safeguards*", 2022. Available at:

(i) Human rights, including workers ‘rights;
(ii) Bribery/Corruption;
(iii) Taxation; and
(iv) Fair Competition.

The Platform issued 4 main recommendations, the first one focuses on the processes that the undertaking shall implement in order to be deemed as compliant with the minimum safeguards under Article 18 of the Taxonomy and, therefore, be deemed as Taxonomy-aligned. In fact, the undertaking shall implement an adequate due diligence process on human rights, including labour rights, bribery, taxation, and fair competition. In the event that such process is not adequate nor existent, this is a sign of non-compliance with minimum safeguards. Moreover, the undertaking shall not be convicted in court in respect of any of those topics and shall cooperate with a National Contact Point, which assess the undertaking’s compliance with the OECD guidelines. Such compliance is in turn essential to be compliant with Article 18 of the Taxonomy. Finally, indifference to the allegations made by the Business and Human Rights Resource Centre should be considered a sign of non-compliance.

It is therefore clear that whenever one enters the field of social sustainability there is widespread confusion among investors and market players, as in the absence of a clear definition and guidelines creating a harmonised system everyone adopts a different system. This goes against the principle of fair competition and puts investors at risk of social washing as they are deprived of the information they need to make an informed choice. For these reasons, in the following chapter we will analyze why it is necessary to introduce a Social Taxonomy and look at the recent proposal made by the European Platform on Sustainable Finance of how this could be structured.

https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/draft-report-minimum-safeguards-july2022_en.pdf

III. Social Taxonomy as a tool for classifying social investments

3.1 The rationale of a Taxonomy Regulation

We have seen how the market for sustainable finance has skyrocketed in recent years. Investors are increasingly integrating sustainable investments into their decision-making choices. A study conducted by Eurosif in 2018 shows how from 2009 until 2017 the sustainable investment market grew by 20% from $130 billion to $580 billion[1]. Bloomberg published a report in 2021 showing that by 2025 global ESG assets could exceed $53 trillion, which would be equivalent to one-third of the world's assets under management[2]. The data also shows how investors are focusing on the social side of ESG, leading to an increase in social bond usage from $20 billion in 2019 to $147.7 billion in 2020[3], and in 2021 this trend held steady with over $90 billions of social bonds were issued in the first quarter alone[4]. A social bond is defined, according to the International Capital Markets Association's definition (ICMA), as "*applied to finance or re-finance in part or in full new and/or existing eligible social projects and which are aligned with the four core components of the social bond principles*"[5]. The main reason behind this dramatic increase was the Covid-19 pandemic. Sovereign states were faced with immense public expenditure to cope with the health crisis that saw the public health system show great weaknesses. In addition, the recession that followed the pandemic necessitated a major response from governments and the European Union, which therefore decided, in addition to using public funds, which still remain the main source of funding for the welfare state, to resort to private capital through the use of this financial instrument, namely social bonds.

Despite this sudden increase in sustainable investments, there is still a long way to go. To date, the investment gap needed to achieve sustainable development amounts to $3.7 trillion

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[1] EUROSIF, "*European SRI Study 2018*", 2018. Available at: https://www.eurosif.org/wp-content/uploads/2021/10/European-SRI-2018-Study.pdf

[2] BLOOMBERG PROFESSIONAL SERVICES, "*ESG assets may hit $53 trillion by 2025, a third of global AUM*", 2021. Available at: https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/

[3] BLOOMBERG PROFESSIONAL SERVICES, "*Social Bonds Propel ESG Issuance to Record $732 Billion in 2020*", 2021. Available at: https://www.bloomberg.com/news/articles/2021-01-11/social-bonds-propel-esg-issuance-to-record-732-billion-in-2020#xj4y7vzkg

[4] MOODY'S INVESTOR SERVICES, "*Sustainable bond volumes soar to record $231 billion in Q1*", 2021. Available at: https://www.moodys.com/research/Moodys-Sustainable-bond-volumes-soar-to-record-231-billion-in--PBC_1283271

[5] ICMA, "*June 2021 Social Bond Principles Voluntary Process Guidelines for Issuing Social Bonds 2021*", 2021. Available at: https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Social-Bond-Principles_June-2022-280622.pdf

each year. This number has been further exacerbated by the pandemic crisis, as while it amounted to $2.5 trillion before the pandemic, it has increased by 50% in 2020 as a result of the health crisis[6].

What needs to be done therefore at governmental and European level is to create an environment that encourages sustainable investments and protects investors from the risk of green or social washing. According to a report published by the OECD, "*The lack of universal rules and standardisation is a shared and enduring source of concern cited by participants in the market. Convergence towards commonly accepted definitions will be essential to maximise the effectiveness, efficiency and integrity of the market.*"[7]. The market, as it has always done, tries to provide definitions in order not to confuse investors and to provide a well-defined framework. So, the question that arises is why we need a taxonomy and how we justify regulatory intervention if market practices continually seek to provide a definition. Taxonomy is a classification system used in science. This tool has been transposed to the world of sustainable finance in order to be able to classify what investment can be considered sustainable, with the assumption that by providing a precise definition of what is ESG aligned, we can give more certainty to investors interested in long-term investments and thus incentivize the market. Sustainable finance taxonomies are defined as "*a set of criteria which can form the basis for an evaluation of whether and to what extent a financial asset can support given sustainability goals. Its purpose is to provide a strong signal to investors, and other stakeholders, and assist their decision making – by identifying the type of information investors need to assess the sustainability benefits of an asset and to classify an asset based on its support for given sustainability goals*"[8]. Some authors, even before the EU Taxonomy came into force, criticized its assumptions. According to these, the world of sustainable finance is very dynamic, and its concepts are difficult to grasp, which is why a rigid classification system such as the Taxonomy could hinder the innovation of new sustainable financial instruments. The task of identifying which investments are truly sustainable should, according to the author, be left to the players in the financial market themselves, as it is they

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[6] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD), "*Mobilising nstitutional investors for financing sustainable development in developing countries Emerging evidence of opportunities and challenges*", 2021. Available at: https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD(2021)11&docLanguage=En#:~:text=A%20shift%20of%20only%203.7,%2C%202020%5B2%5D).

[7] OECD, "*Mobilising Bond Markets for a Low-Carbon Transition*", 2017. Available at: https://dx.doi.org/10.1787/9789264272323-en.

[8] EHLERS T., GAO D. AND PACKER F., "*A taxonomy of sustainable finance taxonomies*", 2021, BIS Papers No 118.

who risk losing their money and it is they who have a greater incentive to remove from the market those investments that turn out not to be truly sustainable. In addition, the author argues that large companies can engage in lobbying activities to include their activities in the definition of what is sustainable, while smaller companies, which lack the resources to support lobbying activities, are often the ones that are more innovative in terms of sustainability[9].

What one can agree with the author is that the world of sustainable finance is a highly dynamic world that changes daily. On the other hand, however, the author has not taken into account an immanent characteristic of sustainability, namely subjectivity. Indeed, as we have already seen when analyzing the European legislative framework, the lack of clear and common definitions leads to the use of different approaches to concepts related to sustainable development. This characteristic is even more felt in the social side of ESG, where concepts are influenced by various political, cultural, religious, and geographical factors. Take for example the construction of new housing for homeless people, one might consider the financing of this project as socially sustainable, but if in order to carry it out it was necessary to evict an indigenous tribe, another more sensitive party might not consider it as such.

The benefits of adopting a taxonomy are potentially greater than leaving the market to regulate itself. Among the main benefits is certainly more clarity in the market. By providing a common definition, investors know for sure whether the capital they are investing in a particular asset will be used to finance a sustainable project. They will be aware of what green and sustainable investments are, and therefore may have more incentive to invest in such types of activities. All this could result in a reduction of time and money, especially in the due diligence activities that are still carried out by investors to assess the social and environmental impact of an investment. On the other hand, companies wishing to pursue a sustainable project have the certainty that, once their product is classified as green or social, they will receive the necessary funds to complete it. Finally, the prices of financial products could also be more comparable as the products priced would be based on a common definition.

A further benefit that could be derived from the adoption of a Taxonomy on Sustainable Finance is to increase market integrity. Adopting a common standard of definition would help prevent greenwashing, which constitutes a reputational risk for both those who buy the financial product and those who offer it in the market. In this context, it will be necessary to

[9] SCHOENMAKER D., "*Sustainable Investing: How to do it*", Bruegel, p. 5, (2018).

introduce a control and verification procedure at the national level that monitors the compliance of financial market participants with the provisions of the Taxonomy, providing, in the event that these provisions are violated, for a system of sanctions that deters the perpetration of such violations. Finally, a major difficulty being experienced within the market is that of incorporating ESG factors into asset pricing[10], and in addition, some studies confirm that ESG factors could become a systemic risk in the future[11]. Therefore, the role that taxonomies will play, coordinated with other regulations, will be crucial to ensure that these risks do not create an imbalance in the financial market.

The real challenge for taxonomies is to create a system that incentivizes investment towards sustainable development and has an impact on the goal it sets itself. Various studies have been conducted over the years analyzing and comparing the sustainable finance taxonomies that exist to date (in particular the European and Chinese taxonomies, which have been the main source of inspiration for other taxonomies). One study, commissioned by the Bank for International Settlements, came up with five cardinal principles on which every policy maker, in adopting a taxonomy, should base itself[12].

These five principles are:

1) Alignment with high-level policy objectives and measurable interim targets

If taxonomies are not aligned with high-level policy objectives, they cannot be regarded as sustainable in the long run, so alignment must be the guiding principle when developing a taxonomy. Furthermore, in order to measure what impact the taxonomy is having in relation to its objective, it is good to have intermediate objectives, especially in light of the fact that taxonomies, like sustainable finance in general, look to the long term.

2) Focus on one single objective ("one taxonomy, one objective")

Taxonomies are, as mentioned above, useful tools to send a strong signal to investors. This signal can be confused or deflected if the taxonomy has different underlying objectives. The approach used by most taxonomies to date is to provide underlying objectives and state that, to be considered sustainable, a product or activity must not create harm to another objective,

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[10] BROUNEN D. ET AL. "*Pricing ESG Equity Ratings and Underlying Data in Listed Real Estate Securities.*", Sustainability, vol. 13, no. 4, pp. 1–20, (2021).
[11] LETERME J., "*Can ESG factors be considered as a systematic risk factor for equity mutual funds in the Eurozone?*", Louvain School of Management, Université catholique de Louvain, (2020).
[12] EHLERS T., GAO D. AND PACKER F, (8), pp.14-16.

the so-called "do not significantly harm" principle. This principle, however, presupposes a clear definition of what the product or activity must not harm. If such a definition is lacking, some investments that are indeed sustainable may not be considered sustainable because they do harm to another objective, even if the latter has been interpreted differently for an investment, this time not sustainable, that does not harm it. For this reason, the study that the DNSH principle should have very high thresholds so not to hamper the signaling objective of the taxonomy.

3) Outcome-based using simple and disclosed key performance indicators (KPIs)

In addition to increasing the level of clarity provided to investors, who can thus assess the financial benefits of a sustainable financial product or asset, the outcome-based approach is also useful in providing the taxonomy with a degree of adaptability needed to reshape criteria and thresholds as circumstances change.

4) Incorporation of entity-based information whenever possible

If such information lacks in a taxonomy, the ultimate purpose of the legislation could be called into question. In fact, consider the case where a company does not change its total greenhouse gas emissions, but still performs an activity that is classified as sustainable. It is for this reason that the taxonomy must also be effective towards the companies where the decisions are made.

5) Sufficient granularity, covering both high and low sustainability performance

To be able to make an informed decision and understand whether a particular investment is aligned with his or her investment strategy, the investor must be able to choose between various levels of sustainable performance of a product or asset. Limiting the scope of an investor's choice to 'green' and 'not green' is undesirable from an investor's perspective. For this reason, the European Union has recently been reflecting on whether to make a change to the EU Taxonomy and introduce a so-called, traffic light system[13].

[13] CLEARY GOTTLIEB, "*Beyond just "Green": the EU Taxonomy Traffic light – From Red, to Amber, to Sustainable*", 2022. Available at: https://www.clearygottlieb.com/-/media/files/alert-memos-2022/2022_04_11-beyond-just-green-the-eu-taxonomy-as-a-traffic-light_from-red-to-amber-to-sustainable.pdf

3.2 The merits of the social dimension

As explained in the previous chapters, the focus of the European legislator has been on incentivizing the provision of capital to cope with climate change and adaptation. Therefore, regulations that have been introduced to incentivize capital towards social needs have been scarce. This has resulted in a capital shortfall to finance the S-side of sustainability, a shortfall that has been further exacerbated by the Covid-19 pandemic that has increased the poverty rate and even more recently the Russian invasion of Ukraine that has resulted in an increased refugee flow of 4.5 million people. The instrument of social finance was considered very useful and beneficial during the health crisis of 2020. In fact, through the issuance of social bonds, the European Union was able to finance the instrument called Support to Mitigate Unemployment Risks in an Emergency (SURE), which provided Member States with the necessary capital to cope with the impending unemployment problems and the reduced working hours regime imposed by states during the months of the general lockdown, in which workers were restricted in their ability to go to work under emergency regulations. The role that social bonds played during the pandemic crisis showed us the potential of this area of sustainable finance, which has been neglected for too long. Even before the onset of the pandemic, the role of finance was seen as crucial for poverty reduction. Indeed, various studies and research showed that there was a positive correlation between access to microfinance and poverty reduction at a macro level.[14] The choice therefore to introduce new legislation to incentivize social finance will play a major role in achieving the goals the United Nations has set for itself in the 2030 Agenda. Currently, there is an annual funding gap of $2.5 trillion for developed countries.

In addition, the shift towards a greener economy will have a considerable impact on various sectors of industry that are currently heavily polluting. Therefore, the oft-stated need for politicians and economists to make a 'just transition' becomes even more imminent. Frans Timmermans, Executive Vice-President of the European Commission said, "*We must show solidarity with the most affected regions in Europe, such as coal mining regions and others, to make sure the Green Deal gets everyone's full support and has a chance to become a reality*". Think, for example, of the workers in these sectors or the communities that have based their lifestyles on these sources of profit. The term just transition is defined as a "*tool*

[14] KAMEL BEL HADJ MILED, JALEL-EDDINE BEN REJEBA, "*Microfinance and Poverty Reduction: A Review and Synthesis of Empirical Evidence*", Procedia, Social and Behavioral Sciences, vol. 195, 2015, pp. 705–712, (2015).

the trade union movement shares with the international community, aimed at smoothing the shift towards a more sustainable society and providing hope for the capacity of a green economy to sustain decent jobs and livelihoods for all"[15]. In order to achieve a just transition, the European Union has established a Just Transition Fund, which is expected to mobilize €30 billion in investments and alleviate the impacts that the transition to a more sustainable economy may have on society.[16]

As has happened in the past with green finance, the market has anticipated the European legislator. Indeed, investors, in order to cope with the various risks that a less sustainable investment can bring, have moved towards more socially sustainable investments. The risks to which an investment may be exposed are of various kinds, including:

(i) Reputational risks;
(ii) Credit risks;
(iii) Market risks;
(iv) Strategic risks;
(v) Insurance risks;
(vi) Operational risks; and
(vii) Liquidity risks.

Investor demand for a more socially sustainable market has increased significantly and new financial instruments have emerged such as the "Social Impact Bond" defined as an innovative financing mechanism whereby governments and social service providers execute agreements and investors provide the necessary funds to finance these services[17]. What these new financial instruments thus bring is a direct link between investors' financial returns and social outcomes, as social outcomes increase, so do investors' financial returns. The reasons behind the fact that this market is becoming more and more predominant, apart from avoiding the risks mentioned above, is also that there is a growing investor awareness of these issues.

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[15] International Trade Union Confederations definition available at: https://www.ituc-csi.org/IMG/pdf/01-Depliant-Transition5.pdf

[16] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal/finance-and-green-deal/just-transition-mechanism/just-transition-funding-sources_en

[17] OECD, "*Understanding Social Impact Bond*", 2016, OECD Working Papers, available at: https://www.oecd.org/cfe/leed/UnderstandingSIBsLux-WorkingPaper.pdf

This is why Social Impact Bonds, like other social finance instruments, have increased dramatically in recent years[18].

A study conducted in 2019 shows how credit rating agencies struggle to provide ESG ratings that do not diverge from each other. This divergence has several consequences: (i) it makes the measurement of companies' non-financial performance, the primary objective of ESG ratings, more complex; (ii) it disincentivizes companies from investing in a more sustainable business model, as they are not able to understand what actions would get them a high rating from credit rating agencies[19]. This divergence is particularly evident in the categories of human rights and product safety, both of which are social issues.

The main problem, as also found by various surveys[20], is that the majority of investors struggle to incorporate social aspects into their investment decision, as the lack of a common definition of what constitutes the S-factor is hindering the full development of this area of sustainable finance. This is the main reason why the introduction of a Social Taxonomy is necessary, as was the case with the Green Taxonomy whose objective was to clarify to investors which assets could be qualified as environmentally sustainable, the same would be the case for activities that qualify as socially sustainable. A Social Taxonomy would prove to be a very valuable tool for investors who can rely on a clearer definition of what can be considered socially sustainable. This would give more space and visibility to those investments that make a meaningful change to society and people's lives. It would provide the right criteria to guide the decision of investors, who currently rely on their own considerations that are influenced by various factors such as the sector or geography of the investment. Furthermore, the Social Taxonomy would logically fit within a European regulatory framework on sustainable finance. As the lack of consistent and reliable data on social issues is a major impediment, the introduction of this new regulation could clarify what companies are obliged to disclose and thus provide more information to investors. On the other hand, the same thing happened with the SFDR and the Green Taxonomy, where the latter went on to modify the provisions of the former by aligning the disclosure requirements under the SFDR and by requiring that the term

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[18] BROOKINGS, "*Measuring the success of impact bonds: What is the size and scope of the impact bonds market?*", 2020. The number of social impact bonds, starting with the first in the series issued in 2010, has grown to represent a total of $460 million in upfront investment in social services and $460 million in total outcome funding committed.

[19] FLORIAN B., KÖLBEL J. AND RIGOBON R., "*Aggregate Confusion: The Divergence of ESG Ratings*", Forthcoming Review of Finance, (2019).

[20] BNP PARIBAS, "*The ESG Global Survey 2019*", 2019. Available at: https://cib.bnpparibas/app/uploads/sites/2/2021/03/esg-global-survey-en-2019.pdf

environmental objective, under Article 9, shall also include investments that are environmentally sustainable within the meaning of the Green Taxonomy. The ambition is that a Social Taxonomy will be introduced to define what socially sustainable activities are and then link it to the disclosure requirements of the SFRD or the disclosure requirements for companies subject to the NFRD.

On February 28, 2022, the Platform on Sustainable Finance ("PSF"), an advisory body established under Article 20 of the Taxonomy Regulation, published the final version of its Report on Social Taxonomy[21]. This Report, commissioned by the European Commission, proposes a possible structure of the Social Taxonomy, without, however, creating any constraints on the Commission to adopt it or to use the form suggested in this report. However, it is useful to analyze the structure proposed by the Platform and to reflect critically on the objectives and principles contained therein.

[21] EUROPEAN PLATFORM ON SUSTAINABLE FINANCE, "*Final Report on Social Taxonomy*", 2022. Available at: https://finance.ec.europa.eu/system/files/2022-08/220228-sustainable-finance-platform-finance-report-social-taxonomy_en.pdf

3.3 Green Taxonomy as a role model

First of all, the European Commission commissioned the PSF a Report outlining two different models for defining activities that are socially sustainable: (i) modifying the Green Taxonomy in order to define what is environmentally and socially sustainable; (ii) the second model is to introduce from scratch a Social Taxonomy distinct from the Green Taxonomy. A modification of the Green Taxonomy to also include socially sustainable activities is a solution that both the Platform and market practitioners do not want[22]. In fact, the ultimate purpose of the two regulations, while it is necessary to ensure that there is a link between them, is completely different and would result in a lack of transparency for investors who would be confronted with a percentage of sustainable activities, both on the social and environmental side, of a company without fully understanding how much the former and the latter amount to. Furthermore, this approach would lead to a decrease in sustainable activities since they would have to fulfil the requirements to be defined as both environmental and socially sustainable.

Although this solution that implies the modification of the Green Taxonomy is neither practicable nor desirable, the structure that the PSF has proposed to give to the new Social Taxonomy is largely based on the structure of the Green Taxonomy. In fact, the latter, in order to provide a definition of activities that are environmentally sustainable, provides a series of objectives and establishes the criteria according to which an activity contributes substantially to one of them. In addition, as better analyzed in the second chapter, Green Taxonomy establishes the principle according to which an activity, to be considered environmentally sustainable, must not significantly harm any of the other objective which is not pursuing. Lastly, it specifies the minimum safeguards that the economic activity must be compliant with in order to be Taxonomy-aligned. Consequently, the structure of the Social Taxonomy reflects the aforementioned structure by:

(i) Setting social objectives;
(ii) Establishing the criteria for the substantial contribution of an activity towards these objectives;

[22] EUROSIF, "*Statement on the Platform on Sustainable Finance's draft report on a Social Taxonomy*", 2021. Available at: https://www.eurosif.org/wp-content/uploads/2021/09/Eurosif-Statement-on-a-Social-Taxonomy.pdf

(iii) Specifying the principle of do not significant harm in order to avoid that an activity, by substantially contributing to one of the social objectives, does not harm any others;

(iv) Setting the minimum environmental safeguards in order to link the Social Taxonomy to the Green Taxonomy.

There are several reasons behind the decision to use the Green Taxonomy as a basic model from which to develop a Social Taxonomy structure. First of all, market professionals are already familiar with the structure of the Green Taxonomy and many financial advisors have already helped their clients in aligning their activities to the requirements of the regulation, so mirroring its structure would avoid complications and difficulties of understanding for the market and make the implementation process by companies smoother. This was welcomed by financial market participants who saw the potential of the Social Taxonomy in the role it should play in stimulating a shift in financing towards more socially sustainable investments[23]. Another reason, which is very important for companies, is the need for them not to be overburdened by the regulatory requirements of both taxonomies, which is why having the same structure could eliminate ancillary costs that would make alignment to the taxonomies too burdensome. On the investor side, on the other hand, they may be better able to compare data on the alignment of a business to the environmental and social side, thus better understanding the extent to which it is contributing to environmental or social goals. Last but not least, the Green Taxonomy has gained, in recent years, a high degree of respect and recognition from the market and from foreign regulators, who have seen in this regulation a starting point from which to develop their own sustainable finance regulations. The same is to be achieved with the Social Taxonomy, which, by drawing inspiration from international law and recognized minimum social standards, can represent a turning point in social finance and in providing more capital for the achievement of the Sustainable Development Goals.

While it is true, as argued above, that the structure should reflect that of the Green Taxonomy, the differences between the two regulations should not be underestimated. These are the result of the intrinsic difference between the two sustainability factors. While on the one hand, the environment is characterized by being highly measurable through the natural sciences, on the other hand, the social sciences or social aspects in general are strongly denoted by the character of subjectivity and cannot be based on scientific data. To explain further, an activity

[23] MOODY'S, "*A Future EU Social Taxonomy: addressing rising focus on social issues*" 2022. Available at: https://esg.moodys.io/insights-analysis-reports/a-future-eu-social-taxonomy-addressing-rising-focus-on-social-issues

that claims to be an environmentally sustainable activity can be scientifically monitored through the impacts and consequences it has on the environment, e.g., the reduction of greenhouse gas emissions. If this activity meets the scientific criteria that the legislator sets as a basis, then it can qualify as a green activity. Science, however, does not have the same capacity to measure the impacts of activities that pursue a social objective. This could be considered one of the main reasons why the role of the social factor has always been neglected and considered as a feature of sustainability but not as its main focus. The difficulty in finding a common understanding and the exposure of social factors to the sensitivity of the individual contribute to making social finance even more elusive. For this reason, the main difference between Green Taxonomy and Social Taxonomy is that the former is based on scientific data and concrete objectives, the latter on the other hand is based on internationally recognized standards and treaties. Antje Schneeweiß, rapporteur of the final draft on the Social Taxonomy and member of the PSF, said "*Whereas the environmental taxonomy is based on science, the social taxonomy is based on international norms, principles and goals and it is very important for me to say that these are not subjective. These are international norms which have been worked out in a long-standing discussion with the stakeholder group and these are the result of compromises*"[24]. The international norms and principles, which the rapporteur is referring to are: (i) the European pillar of social rights; (ii) the European Social Charter; (iii) the principles and rights set out in the eight fundamental conventions identified in the Declaration of the International Labor Organization on Fundamental Principles and Rights at Work; (iv) the International Bill of Human Rights; (v) the OECD Guidelines for Multinational Enterprises; and (vi) the UNGPs.

[24] Climate Bonds Initiative's webinar called "*EU Platform on Sustainable Finance presents: Social Taxonomy*" 2022 which can be viewed at the following link: https://www.youtube.com/watch?v=NvhiM83FzO0

3.4 Proposed structure of a Social Taxonomy

3.4.1 Objectives

Since the foundation of the Social Taxonomy structure proposed by the PSF is based on international norms and treaties, the Platform tried to extrapolate from these a number of topics referring to social issues, including the right to health care, workers' rights, non-discrimination, etc. From these general topics, it then drew up, on the basis of Article 9 of the Green Taxonomy, a list of three objectives to which an activity should make a substantial contribution in order to qualify as socially sustainable. The objectives are:

(i) Decent work

This first goal refers to the right of workers to decent work and is particularly important with regard to the achievement of Goal number 8 of the SDGs contained in the 2030 Agenda, according to which "Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all". From the point of view of the company, it is required to make a substantial contribution throughout the supply chain process in pursuit of this goal. A critical reflection that could be made with regard to this goal is that it may place too great a burden on companies to monitor compliance with this goal throughout their value chain. On the other hand, however, the analysis of this objective must be made in conjunction with the proposed new directive on human rights due diligence, which imposes an obligation on companies falling within the scope of the directive to perform due diligence on their entire value chain. Having therefore already carried out extensive human rights due diligence, which inevitably included an analysis of the work conditions of firms with which they have a stable relationship, the burden of making a substantial contribution to this objective could be alleviated.

The PSF then deemed it necessary to elaborate further sub-objectives which have the purpose of covering every topic relating to the objective to which they refer, and which must not overlap each other. Within the first objective, these sub-objectives refer to three macro areas: (i) promoting decent work; (ii) promote equality and non-discrimination at work; (iii) ensuring respect for the human rights and workers 'rights of affected workers in the value chain. The first macro-area includes, inter alia, the guarantee that workers have a salary that guarantees them a dignified and adequate lifestyle and the health and safety of employees. In order to be qualified as socially sustainable, an activity needs to make a substantial contribution to only one of the subobjective and not to all of them.

(ii) Adequate living standards and wellbeing for end-users

This second objective focuses mostly on the standards of protection and wellbeing of end users, especially with regard to the products and services they use. Consider, for example, the raising of financial capital for the construction of a hospital or a water system in areas of the planet where such services are scarce. This objective is further specified through the non-exclusive list of sub-objectives that focus, among other things, on the safety and health of the products or on the durability of the products themselves.

(iii) Inclusive and sustainable communities and societies

The last objective considered by the PSF is that of more inclusive and sustainable communities. At first glance, it is difficult to fully understand what PSF wanted the activities to pursue in making a substantial contribution to this goal. This is also due to the breadth of the terms used, such as the term sustainable, which we have seen, in the course of the first chapter, to be difficult to interpret. However, thanks to the non-exclusive list of sub-objectives developed by the Platform, it is easier to understand the true meaning of this objective. The sub-objectives are in fact divided into three groups: (i) promoting equality and inclusive growth, through for example providing easier access to basic services in areas where such services are scarce or through a greater inclusion of people with disabilities; (ii) supporting sustainable livelihoods and land rights; (iii) ensuring respect for the human rights of affected communities by carrying out risk-based due diligence.

The structure, analyzed here, was the result of a careful analysis carried out by the Platform of comments made by professionals in the sector following the public consultation of July 2021. In fact, in that month, the Platform had published a draft report on Social Taxonomy[25]. In this report, the approach adopted by the Platform was completely different, as it envisaged two types of objectives: vertical and horizontal.

The vertical aim was to promote adequate living standards and focuses on applying the criteria elaborated by the report at the level of economic activities. The horizontal objective, on the other hand, has a different perspective than the vertical, if, on one hand, the latter focuses on which type of activity can be considered as socially sustainable, the horizontal focus on the

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[25] EUROPEAN PLATFORM ON SUSTAINABLE FINANCE, "*Draft Report by Subgroup 4: Social Taxonomy*", 2021. Available at: https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sf-draft-report-social-taxonomy-july2021_en.pdf

degree to which the economic activities can be considered socially sustainable. This type of structure had attracted criticism from professionals as it turned out to be too complex and could lead to excessive difficulty in using the Social Taxonomy tool[26].

On the basis of the Green Taxonomy model, the PSF also wanted to introduce a list of activities which are considered as socially harmful, and which are fundamentally and under all circumstances opposed to the social objectives set out above. However, what the Platform has failed to do, presumably because it would have entered into the merits of a politically very sensitive issue, is to provide a list of activities that can always be considered socially harmful. It provided only a few examples such as the generally recognized impacts that tobacco has on health and limited itself to identifying the sources from which to derive these types of activities. He then went on to draw up a list of conventions on the use of weapons without never stating, as he had previously done in the July draft report, that weapons are always and, in any case, considered socially harmful.

3.4.2 Types of substantial contribution

The Social Taxonomy, if it were to be implemented with the structure proposed by the PSF, presents three different types of substantial contributions that a company must make to one of the objectives:

(i) Avoiding and addressing negative impact;

The first substantial contribution implies that companies must proactively seek to reduce the harm done to people and workers. They will therefore try to target sectors that are at high risk of human or worker rights abuses or to target sectors that do not contribute to the objectives of the European social pillar. The issue, with this type of substantial contribution, is the risk that companies who respects the minimum safeguards can be qualified as substantially contributing to this objective. Thus, it would be important for the Commission, to exclude from the list of activities which avoid and address negative impact, the activities that are done in compliance with the minimum safeguards, something more need to be done in order to substantially contribute. This type of contribution has been included by the PSF mostly because they wanted to incentivize companies which carry out activities in sectors at high risk of abuses to address these violations and to implement a socially sustainable business model.

[26] NATIXIS, "*EU Social Taxonomy Proposal: simpler and meaningful but half-way through*", 2022. Available at: https://gsh.cib.natixis.com/our-center-of-expertise/articles/eu-social-taxonomy-proposal-simpler-and-meaningful-but-half-way-through

On the other hand, without including this contribution, which we might call a “default” contribution, the activities capable of qualifying as socially sustainable would be too few, therefore the very usefulness of the Taxonomy would fail.

(ii) Enhancing the inherent positive impacts in economic activity;

The assumption made here by the PSF is that economic activities have an intrinsic social value because they are essential to achieving an adequate standard of living. The international treaty that provided the basis for this objective and for this substantial contribution is the Universal Declaration of Human Rights and the International Covenant on Economic, Social and Cultural Rights. This type of substantive contribution will therefore relate to the last two goals proposed by the PSF (i.e., adequate living standards and inclusive and sustainable communities and societies). The aim is to direct investments towards solving situations where basic human needs are not met. And the basis on which the criteria for establishing the types of substantial contributions are proposed to be created is the AAAQ concept, i.e., the concept of availability, accessibility, acceptability, and quality. The criteria should therefore ensure that investments are directed to those cases where the need is not available in sufficient quantities, accessible both economically and physically without any kind of discrimination, acceptable in the sense that it is ethically and culturally appropriate, and of quality, i.e., that it meets the minimum international requirements to be considered safe. Consequently, there are already today activities which provides goods and services for basic human needs which already attract capital today even without being classified as promoting social objectives, but the investments that really make a substantial contribution, according to PSF reasoning, and therefore deserve to be classified as promoting a social objective, and consequently attracting more capital, are those that provide these types of goods and services in places where the AAAQ concept is not respected.

(iii) Enabling activities

Like the Taxonomy, which defines enabling activities as "economic activities that, by provision of their products or services, enable a substantial contribution to be made in other activities. For example, an economic activity that manufactures a component that improves the environmental performance of another activity”, a role is also given to those activities that make a substantial contribution to another activity possible.

One criticism that has been voiced by market practitioners[27] is that it is difficult to delineate a substantial difference between activities that reduce negative impacts and those that enhance positive impacts. Indeed, if, following the Report's reasoning, an extra step is needed for an activity to contribute to reducing the negative impacts of its activities does this not mean enhancing social impacts? On the other hand, however, this is a typical feature of sustainable finance, as we noted in chapter one, there are two types of sustainable finance, one negative and one positive. The former aims at reducing negative impacts on the environment or social aspects, while the latter brings an additional benefit such as providing a product or service in an area where such a good is not available.

3.4.3 Do not significant harm principle

The principle of Do Not Significant Harm (DNSH) made its first appearance in the SFDR under the definition of sustainable investment in which it is stated that a sustainable investment cannot be considered as such if it creates significant harm to one of the objectives of sustainability[28]. This principle was later reused in the Green Taxonomy as a criterion for determining whether an activity is environmentally sustainable[29]. The role played by this principle in Social Taxonomy is therefore similar to the role it plays in Green Taxonomy. An activity, which makes a substantial contribution to one of the objectives set by the Taxonomy, must not harm any other objective in order to qualify as socially sustainable.

The main difference, and perhaps a main point of criticism of the DNSH principle in the Social Taxonomy compared to the Green Taxonomy, is that the level of specificity of the objectives, including sub-objectives, is much higher. It will therefore be extremely complicated and potentially burdensome for companies wishing to pursue a social objective to ensure that they do not also cause harm to another of the sub-objectives. The lack of hierarchy between the objectives and sub-objectives does not even allow for this principle to be departed from in the event that one objective is pursued that is deemed more deserving than another, or in any case in the event that the harm done is so minimal as to justify the qualification of a given activity anyway. On the other hand, however, creating a hierarchy of objectives would be even more difficult for the European legislator because the sensitivities of individuals would come into play here, leading to an endless process of negotiation.

[27] NATIXIS, (26).
[28] Art. 2 (17) of the SFDR.
[29] Art. 3 of the EU Taxonomy.

According to the PSF, the main characteristic that the DNSH principle will have in a Social Taxonomy will certainly be that of playing a crucial role in outlining the criteria for substantial contributions, especially in the event that the activities in question cannot be linked to turnover or expenditure.

3.4.4 Minimum safeguards

The logic behind the inclusion of minimum safeguards within a Taxonomy is to prevent an activity from being declared environmentally sustainable, in the case of Green Taxonomy or socially sustainable, in the case of Social Taxonomy even if such activity involves a violation or an abuse of an issue that sustainability intends to resolve. The term sustainable, in fact, is a dynamic and holistic term which, in order to be fully defined, must encompass all three pillars, namely environmental, social and governance. For this reason, it cannot be declared a sustainable activity, even if pursuing an environmental purpose such as that of reducing the emission of greenhouse gases, if in the persecution of this objective it commits violations of human rights or workers' rights. We analyzed Article 18 of the Green Taxonomy which introduced the minimum social standards that must be respected in order for an activity to be declared as environmentally sustainable. Likewise, the PSF has reasonably advised to introduce minimum environmental standards to ensure that a socially sustainable activity does not damage the environment. The challenge will be to understand if it is necessary to reflect in the Green Taxonomy the same minimum safeguards that are contained in the Social Taxonomy and vice versa. It would therefore be a way to include issues in the Social Taxonomy for which it is difficult to develop a principle of DNSH or substantial contribution, without, however, renouncing that the activities respect these types of issues.

3.5 Concerns about a Social Taxonomy

The PSF report on Social Taxonomy was a highly anticipated work by financial market professionals and academics studying the world of sustainable finance. Since the introduction of the Green Taxonomy, the idea of giving a more marked role to social factors emerged, either by extending the scope of Green Taxonomy also to the S side or, alternatively, developing a Social Taxonomy that was independent from the latter. As explained above, the climate emergency and the need for more sudden action on the environment have obscured the issue. The recent historical events that have drastically marked the daily life of communities and the sensitivity of people, as well as investors, have revived the need to introduce a new discipline that was logically connected with the European framework on sustainable finance.

Despite this, perplexities and concerns remain about the introduction of this new Taxonomy. The PSF published in July last year a draft report on Social Taxonomy and conducted a round of public consultations in which it collected the opinions of academics, companies, authorities etc. According to the figures, 15% of the people interviewed did not see any kind of merit in introducing a Social Taxonomy, while 78% of the respondents stated that they agreed with at least one of the merits. The most popular one is that the introduction of a Social Taxonomy would strengthen the definition and measurement of socially sustainable investments. On the other hand, 83% of respondents said they had at least one concern about the introduction of this discipline. The main source of concern is that it would exacerbate administrative costs for companies that want to be socially sustainable. If it is true that the Taxonomy would introduce new costs for businesses, it is also true that it must be kept in mind that this tool would still be voluntary, and it would be an incentive for businesses that want to attract more capital from the market. The real challenge will be to understand whether the advantages of introducing this regulation outweigh the disadvantages for businesses.

Furthermore, a major issue that has always discouraged policy makers from delving into this discipline has been the divergence of social policies that are of competence of national legislators. Think for example of the objective of providing decent work, in some countries a law was introduced that fixed a minimum wage, while in other countries this law was never introduced. This regulatory discrepancy, in the absence of uniformity of minimum social standards at European level, could lead to numerous problems for the introduction of a Social Taxonomy. First of all, the concern is that this taxonomy favors more those companies that

carry out their business in a country with more stringent legislation than elsewhere. In this regard, the report did not provide much information to the Commission and the risk is that the political nature of the subject will cause this proposal to run aground. What the Platform has limited itself to saying is that the problem could be overcome by using as the basis and foundation of the Taxonomy the international treaties that are recognized by all Member States of the European Union.

Secondly, the concern is that we fail to provide a specific definition of what socially sustainable activities are because this qualification depends on the context in which the activity is carried out. A context that is mainly defined at a national rather than European level. It is clear that the differences in the national legislation of each Member State will be a crucial aspect that will have to be examined in more detail by the Commission; one way out of this problem could be to set the criteria for a Social Taxonomy from national legislation. This would certainly make it more difficult to develop the criteria for defining what is socially sustainable, but the need to implement such a regulation must be the driving force that will agree the various parties towards a common solution, just as it was done for the Green Taxonomy, so it must be done for the Social Taxonomy.

Conclusions

As Larry Fink, President of Blackrock, wrote in his 2018 letter to CEOs "*We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.".* This letter demonstrates the real need to include companies in the process of transforming our society towards a more sustainable culture. Since the 1987 Burtlandt Commission in which an attempt was made to define what sustainable development means, the discipline of sustainable finance has changed enormously by incorporating more and more principles and issues that were previously overlooked. The Paris Agreement and the 2030 Agenda represent a turning point. Since these two agreements, the international landscape has turned towards an increasing awareness of environmental and social issues that require urgent action from policy makers and individuals. The European Union has increasingly sought to establish itself as a leader and promoter of sustainable development. These were the words of European Commission President Ursula von Der Leyen in presenting the European Green Deal "*And we want to really make things different. We want to be the frontrunners in climate friendly industries, in clean technologies, in green financing. But we also have to be sure that no one is left behind… We do not have all the answers yet. Today is the start of a journey. But this is Europe's 'man on the moon' moment. The European Green Deal is very ambitious, but it will also be very careful in assessing the impact and every single step we are taking.*".

The economy can no longer be negligent towards these issues because without the support of stakeholders, companies cannot live long and would be exposed to risks for which, without immediate action, they would not be provided with the right tools. On the other hand, the world of sustainable finance needs more coordination, standardization, and clarity because in order for capital to be properly redirected towards sustainable investments that support this change, investors need to be able to inform themselves on what and for what reasons can truly be considered sustainable. This is the main reason why we need a European, if not global,

definition that clarifies the concept of sustainability. So far, the European Union has tried to introduce and implement a regulatory framework to incentivize the private sector to be included in this change. Starting with the NFRD, which recognized the role played by the disclosure of non-financial information, to the SFRD, which gave a central role to the disclosure of information related to sustainable products. We have analyzed, however, how these regulations have been difficult to be implemented by the market practitioners, or at least, they have not been able yet to fully express their potential in shifting the economy to a more sustainable one. Subsequently, the Green Taxonomy came into play, this in providing investors with a definition of what are environmentally sustainable activities has provided a useful tool for investors, that more and more wants to include, in their investment decision, sustainable investments. However, the focus of the European Union was, up until now, on environmental issues, and, on the other hand, social factors, which are crucial for the achievement of a sustainable development, were neglected and treated as a feature rather than the main focus.

The social investment market has grown enormously in the last period. Social bonds are an example of how investors are becoming increasingly interested in social investments. On the other hand, the lack of public funds needed to deal with the dramatic events of recent years has highlighted the importance the private sector can play in the world of social investment. For these reasons, we need a Social Taxonomy that provides investors and companies wishing to pursue a social objective with clarity on what qualifies as socially sustainable. Like the Green Taxonomy, the Social Taxonomy aims to provide a definition to incentivize a shift of private capital towards socially sustainable investments. It will certainly be challenging to agree on the various issues we have outlined and to try to develop a taxonomy that is not overly burdensome for companies. Beyond this, leaving it to the market to standardize and provide a definition of sustainable investments does not seem to me to be appropriate, as each party would interpret the concept on the basis of its own experience and culture, thus creating a fragmentation of the market that would confuse investors, as well as the possibility of inducing them to invest in investments that claim to be socially sustainable, when in fact they are not. In conclusion, it is to be hoped that the introduction of such a regulation will not be delayed by the politicization of the issue and that this instrument will be introduced as soon as possible, in a well-considered manner and with the right structure, in order to fill the void that is currently limiting the potential role that the private sector could play in the world of social finance.

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