EFAMA

European Fund and Asset Management Association

# EFAMA's RESPONSE TO CALL FOR FEEDBACK ON THE PLATFORM ON SUSTAINABLE FINANCE's DRAFT REPORT ON SOCIAL TAXONOMY

**6 September 2021**

Rue Marie-Thérèse 11 | B-1000 Bruxelles
T +32 2 513 39 69 | www.efama.org
EU transparency register: 3373670692-24

# EFAMA's RESPONSE TO CALL FOR FEEDBACK ON THE PLATFORM ON SUSTAINABLE FINANCE's DRAFT REPORT ON SOCIAL TAXONOMY

## EXECUTIVE SUMMARY

1. **EFAMA supports the development of a social taxonomy** due to increasing ESG awareness of investors and in order to enable funds with social objectives to show their degree of taxonomy alignment, and therefore be distributed according to clients´ sustainability preferences under MiFID Delegated Acts. A social taxonomy would rebalance the focus of the EU sustainable finance strategy towards the social elements of ESG. The ongoing Covid 19 pandemic clearly demonstrates that investments in projects catering for social needs cannot be neglected.

   The social taxonomy should provide a clear framework defining business activities and performance that are widely accepted as socially beneficial. Another key objective of the EU social taxonomy should be that social taxonomy plays a crucial role in deploying the "Just Transition" concept.

2. The social taxonomy should, **above all, be usable and implementable by investee companies** and financial market participants. The environmental taxonomy has shown that prioritising the development of specific criteria can lead to challenges in data availability when applied in practice. Sourcing relevant data is even more challenging for social sustainability, and therefore, the question of data availability must be considered first. For example, the Platform should also identify what legislative instrument would introduce the reporting requirements onto entities.

   Furthermore, usability is also dependent on clear definitions, universally accepted metrics and standard-setting. Currently, well-defined and universal standards and metrics for social objectives are missing due to their dependence on national context and legislation (notably in social affairs). We believe it is essential to **base the social taxonomy on globally recognised principles** and use the concepts embedded in international treaties and conventions instead of referring to the standards enshrined in EU law. This would contribute to universally recognisable standards of social investing and maximise the potential for redirecting capital flows also in emerging economies. In this context, relative thresholds differentiated by the economic development of a country could be considered.

3. **Social data is particularly scarce, and asset managers can't respond to data points that don't exist**. Issuers need to provide the data before asset managers can make the right judgments and report on taxonomy alignment. This data challenge has become apparent in demonstrating minimum safeguards alignment in the environmental taxonomy, and any binding legislative proposal for a social taxonomy should be carefully considered against the availability of such social data. Therefore, the **usability of the social taxonomy would be enhanced by considering the current data availability situation**. By focusing on what is measurable in practice, the criteria for the covered activities can be formulated to direct the capital needed to achieve social objectives.

4. We believe it is currently premature to start categorising activities eligible under the social taxonomy. As a first step, **the policy objectives of a social taxonomy need to be defined**. A key question is whether the social taxonomy should build upon the environmental one in promoting the just transition concept, or have a much broader goal, such as fostering adequate living standards. Furthermore, it is crucial that the geographical focus (EU vs. global level) is defined.

5. In a first stage, we have a slight preference for **Model 1 (a standalone social taxonomy) as it does not require** reopening the level 1 of the environmental taxonomy. Development of a "mirror" of the environmental taxonomy focused on social objectives would the understanding for end-users. Moreover, applying the social taxonomy in combination with environmental taxonomy (model 2) would further narrow down the scope of an already small investable universe of taxonomy-aligned activities. Nonetheless, in the long term, once both taxonomies are fully established in practice, Model 2 could be considered to avoid conflicting situations with one activity qualifying as taxonomy aligned from an environmental perspective, while undermining some social objectives and vice-versa.

6. We highlight the importance of the horizontal dimensions' interlinkages with SFDR concepts, such as the "sustainable investments" definition under Article 2(17) and the adverse impacts indicators. There is a risk of duplicating assessment of similar issues and creating confusion on what these indicators mean when determining if a corporate is sustainable or not. **We recommend that the social taxonomy 'do no significant harm' horizontal dimension is harmonised with SFDR principal adverse impacts indicators** to improve usability and further legislative consistency.

7. We don't fully understand the **interaction between the social taxonomy's horizontal dimension and the EU sustainable corporate governance proposal**. The report states that the latter would be the basis for DNSH criteria, but doesn't elaborate on what this means.

# YOUR OPINION

## Merits and concerns

### Question 1.1 Which in your view are the main merits of a social taxonomy?

☒ supporting investment in social sustainability and a just transition

☒ responding to investors' demand for socially orientated investments

☒ addressing social and human rights risks and opportunities for investors

☒ strengthening the definition and measurement of social investment

☒ other

☐ none

### Please specify to what other merit(s) you refer in your answer to question 1.1:

**The first step in developing a social taxonomy should be to determine its precise, measurable policy objectives.** This preliminary stage will guide all other considerations about the design of a social taxonomy.

From an asset manager’s perspective, such taxonomy would rebalance the focus of ESG policymaking, which has been focused on climate and environmental matters, towards the social elements of ESG. A social taxonomy has the potential to provide greater consistency across the finance industry's definitions of social performance.

In connection with the environmental taxonomy, a key priority for a social taxonomy should be to contribute to the "just transition" concept. Should the authorities pursue Model 2, the objective should be to build upon the environmental taxonomy by ensuring a just transition to new competences / expertise due to the environmental transition (with loss of certain categories of jobs). Job losses may result from a phase-out of some activities, but also from automation of certain tasks that will make expertise of some employees obsolete. In our view, such an approach is not reflected in the Platforms' report as a policy alternative.

### Question 1.2 Which in your view are the main concerns about a social taxonomy?

☒ interference with national regulations and social partners' autonomy

☒ increasing administrative burden for companies

☒ other

☐ none

**Please specify to what other concern(s) you refer in your answer to question 1.2:**

**EFAMA strongly supports an increased focus on social sustainability and the integration of social considerations in investment decisions.** To ensure consistency between the different legislations relating to the investment management industry (.e.g. SFDR), we believe **a priority should be to avoid duplicating assessments of similar social issues**. Such a duplication could fail to deliver clear, simple and comparable information to end-investor – preventing them from determining whether an investment is socially sustainable or not.

We highlight that the two dimensions of a social taxonomy (vertical and horizontal) could lead to confusion, especially regarding the practicability of disclosures by companies.

We note that the development of a social taxonomy at European level will face political challenges due to the lacking harmonisation of social policies at the European level, making it difficult to find common social criteria (e.g. the role of trade unions in labour relations is very different between northern and southern Europe). Furthermore, reconciling the horizontal dimension with, for example, OECD and national regulations will be one of the main challenges due to differing norms between rules.

The social agenda is far broader than the climate focus of the current environmental taxonomy. Attempting to "squeeze" an extensive range of topics into a single framework risks missing key issues from that structure. Social criteria are necessarily looser than environmental parameters, less widely accepted and – exacerbated by the consultation's focus on going beyond regulatory or legal standards – less easily tied to business or financial impacts. The consultation highlights a link between social performance and investment benefits and highlights the goal to use a social taxonomy to further the EU's social agenda, which are two different goals conflated in the report.

Challenge also lies in finding companies that genuinely contribute to social objectives without harming any other front (e.g. the environment). For example, some commodity companies are currently a valuable source of employment and provide above-average wages in low-income areas in emerging markets. Also, the measurement and comparison of social objectives, particularly given poor data disclosure, is challenging.

In emerging markets, a longer-term perspective on governance may be required. Notably, some short-term flexibility on the diversity requirements may be needed in view of the skills shortages and the lack of regulatory requirements on ESG data reporting. Furthermore, there are systemic issues in certain emerging markets that mean some governance red flags may not be taken at face value. For example, in Brazil, where the tax system has been subject to corruption and confusing legislation, multiple companies have been penalised and involved in long-running court cases.

On the other hand, our perception is that while the EU is leading on the environmental taxonomy, many countries outside the EU now start working at least conceptually on the development of social taxonomies. Therefore, there is a risk that if uncoordinated, these initiatives will produce inconsistent results that might fail to ensure a shared understanding and thus, not meet the expectations of significantly increasing capital flows in socially responsible investments. Therefore, when developing a social EU taxonomy, it is crucial:

- To base the concepts as far as possible upon international treaties and conventions instead of referring to standards enshrined in EU law;

To collaborate with other jurisdictions, e.g. in the context of the International Platform on Sustainable Finance, to strive for a framework recognised as a benchmark for socially sustainable investments at the international level.

## Structure of the social taxonomy

The draft report suggests a structure for a social taxonomy distinguishing between a vertical and a horizontal dimension. The vertical dimension would focus on directing investments to activities that make products and services for basic human needs and for basic economic infrastructure more accessible, while the horizontal dimension would focus on human rights processes.

The objective linked to the vertical dimension of the social taxonomy would be to promote adequate living standards. This includes improving the accessibility of products and services for basic human needs such as water, food, housing, healthcare, education (including vocational training) as well as basic economic infrastructure including transport, Internet, clean electricity, financial inclusion.

The objective linked to the horizontal dimension would be to promote positive impacts and avoid and address negative impacts on affected stakeholder groups, namely by ensuring decent work, promoting consumer interests and enabling the creation of inclusive and sustainable communities.

### Question 2. In your view, are there other objectives that should be considered in vertical or horizontal dimension?

☒ Yes

☐ No

☐ Don't know / no opinion / not applicable

### Please explain your answer to question 2:

The Platform's report differentiates between the contribution to social objectives made through products and services sold by companies (vertical dimension) and the contribution made through processes, value chains, and conducts to respect human rights (horizontal dimension). We agree that both aspects need to be reflected in a social taxonomy.

However, the report discusses various options and methodological approaches to the structure of a social taxonomy, and how the vertical and horizontal dimension can be applied. The multiple options and approaches can be hard to navigate through, and it isn't easy to fully comprehend how the two dimensions should work in practice. More systematism in the way the different options and approaches are presented and applied would be beneficial.

We believe that the best policy option **for reducing the social washing risks of the vertical dimension would be to focus solely on positive, social impact activities**. It will also be essential to clarify how the horizontal and vertical dimensions are envisaged to interact (i.e. whether they are complementary or discrete criteria). Alternatively, for the vertical dimension, one could also include activities considered as negative. Finally, it will be important that metrics are considered in the context of the industry in which each company operates.

### Question 3. Which of the following activities should in your view be covered in the vertical dimension (social products and services)?

☐ A1 - Crop and animal production,

☐ A1.1 - Growing of non-perennial crops

☐ A1.2 - Growing of perennial crops

☐ A1.4 - Animal production

☐ A3 - Fishing and aquaculture

☐ C10 - Manufacture of food products

☐ C10.8.2 - Manufacture of cocoa, chocolate and sugar confectionery C10.8.3 - Processing of tea and coffee

☐ C10.8.6 - Manufacture of homogenised food preparations and dietetic food C13 - Manufacture of textiles

☐ C20.1.5 - Manufacture of fertilisers and nitrogen compounds

☐ C20.2 - Manufacture of pesticides and other agrochemical products

☐ C21 - Manufacture of basic pharmaceutical products and pharmaceutical preparations

☐ C23.3 - Manufacture of clay building materials

☐ C23.5 - Manufacture of cement, lime and plaster

☐ C25.2.1 - Manufacture of central heating radiators and boilers C30.1 - Building of ships and boats

☐ C30.2 - Manufacture of railway locomotives and rolling stock

☐ C30.3 - Manufacture of air and spacecraft and related machinery

☐ C30.9.2 - Manufacture of bicycles and invalid carriages

☐ C31 - Manufacture of furniture

☐ C32.2 - Manufacture of musical instruments

☐ C32.3 - Manufacture of sports goods

☐ C32.5 - Manufacture of medical and dental instruments and supplies

☐ D35.1 - Electric power generation, transmission and distribution

☐ D35.3 - Steam and air conditioning supply

☐ E - Water supply; sewerage; waste management and remediation activities

☐ E36 - Water collection, treatment and supply

☐ E37 - Sewerage

☐ E38 - Waste collection, treatment and disposal activities; materials recovery

☐ E38.3 - Materials recovery

☐ E39 - Remediation activities and other waste management services

☐ F41 - Construction of buildings

☐ F42.1 - Construction of roads and railways

☐ F42.1.2 - Construction of railways and underground railways

☐ F42.2.2 - Construction of utility projects for electricity and telecommunications

☐ F43.3 - Building completion and finishing

☐ G45.2 - Maintenance and repair of motor vehicles

☐ G46.1.6 - Agents involved in the sale of textiles, clothing, fur, footwear and leather goods

☐ G46.1.7 - Agents involved in the sale of food, beverages

☐ G47.5.1 - Retail sale of textiles in specialised stores

☐ H49.1 - Passenger rail transport, interurban

☐ H49.2 - Freight rail transport

☐ H49.3 - Other passenger land transport

☐ H49.3.1 - Urban and suburban passenger land transport

☐ H50.1 - Sea and coastal passenger water transport

☐ H50.3 - Inland passenger water transport

☐ H51.1 - Passenger air transport

☐ J58.1 - Publishing of books, periodicals and other publishing activities

☐ J59.1 - Motion picture, video and television programme activities

☐ J60 - Programming and broadcasting activities

☐ K - Financial and insurance activities

☐ L68.2 - Renting and operating of own or leased real estate

☐ M71 - Architectural and engineering activities; technical testing and analysis

☐ M72.1.1 - Research and experimental development on biotechnology

☐ N77.1.1 - Renting and leasing of cars and light motor vehicles

☐ N77.2 - Renting and leasing of personal and household goods

☐ N78.1 - Activities of employment placement agencies

☐ N78.2 - Temporary employment agency activities

☐ N78.3 - Other human resources provision

☐ O84.1.2 - Regulation of the activities of providing health care, education, cultural services and other social services, excluding social security

☐ O84.2 - Provision of services to the community as a whole

☐ O84.2.4 - Public order and safety activities

☐ O84.2.5 - Fire service activities

☐ O84.3 - Compulsory social security activities

☐ P85.1 - Pre-primary education

☐ P85.2 - Primary education

☐ P85.2.0 - Primary education

☐ P85.3 - Secondary education

☐ P85.3.2 - Technical and vocational secondary education

☐ P85.4.2 - Tertiary education

☐ Q - Human health and social work activities

☐ Q86.1 - Hospital activities

☐ Q86.2 - Medical and dental practice activities

☐ Q87 - Residential care activities

☐ Q88 - Social work activities without accommodation Q88.9.1 - Child day-care activities

☐ Q88.9.9 - Other social work activities without accommodation n.e.c. R - Arts, entertainment and recreation

☐ R93.1.3 - Fitness facilities

☐ S95 - Repair of computers and personal and household goods

☐ S96.0.4 - Physical well-being activities

☒ Other

**Please specify to what other activity(ies) you refer in your answer to question 3:**

As a financial services trade association, we are not ideally placed to evaluate the social contribution of specific activities. Moreover, we believe categorising entire sectors and economic activities against social criteria should emerge from a transparent, public discussion and be subjected to a political decision. As an industry body representing asset managers, EFAMA refrains from making judgements about specific sectors.

As a first step, **we believe the policy objectives for a social taxonomy need to be defined**. A key question is whether the social taxonomy should build upon the environmental one in promoting the just transition concept, or have a much broader goal, such as fostering adequate living standards. Assessment of which activities can make substantial contributions to these objectives can only be a second step in the process. In this regard, it is crucial to base the concepts on international treaties and conventions and **strive for universally recognisable standards** of social investing that would maximise the potential for redirecting capital flows.

While all activities listed above could be eligible to be covered by the vertical dimension, we believe that aligning this list with the environmental taxonomy would result in the highest usability. Furthermore, by aligning the activities, the vertical dimension of the social taxonomy can benefit from processes already put in place to collect taxonomy alignment data from investees. This would enhance the practical application of the regulation and avoid creating excess complexity. Needless to say, where activities under the environmental taxonomy will be extended, this should also be done for the social taxonomy.

We also note that a vertical taxonomy, in addition to a horizontal one, could lead to unnecessary complexity and increase the risk of "social washing" with all activities being eligible. Therefore, we would recommend restricting this dimension exclusively to positive social impact activities if the vertical taxonomy is pursued**.**

**Question 4. Do you agree with the approach that the objectives in the horizontal dimension, which focuses on processes in companies such as the due diligence process for respecting human rights, would likely necessitate inclusion of criteria targeting economic entities in addition to criteria targeting economic activities?**

☒ Yes

☐ No

☐ Don't know / no opinion / not applicable

**Please explain your answer to question 4:**

We agree that some aspects of social sustainability by nature do not relate to specific economic activities, but become relevant at the entity level. This pertains in particular to standards for respecting and promoting employees' rights and decent employment conditions, but potentially also to other general quality standards supporting human rights and promoting responsible market practices. In this regard, the possibility of addressing selected sustainability goals at entity level and developing significant contribution criteria for the company, rather than a specific economic activity, should be explored while respecting the general structure and level of ambition of the taxonomy framework.

We believe that **entity-level criteria should align with the SFDR as it also calls for measuring social/human rights adverse impact based on specific indicators**. The horizontal dimension appears to have significant overlap with the principal adverse impact indicators of SFDR. If this approach is taken, the taxonomy and SFDR requirements should be fully aligned and harmonised to prevent duplication and confusion among corporates and investors.

## Harmful activities

The report envisages harmful activities as those which are fundamentally and under all circumstances opposed to the objectives suggested in this proposal for a social taxonomy. There would be two sources on which this rationale can be build: internationally agreed conventions, e.g. on certain kinds of weapons & detrimental effects of certain activities, for example on health.

### Question 5. Based on these assumptions, would you consider certain of the following activities as 'socially harmful'?

☒ A1.1.5 - Growing of tobacco

☒ B5 - Mining of coal and lignite

☐ B7 - Mining of metal or iron ores

☐ B9 - Mining support service activities

☒ B9.1 - Support activities for petroleum and natural gas extraction

☐ C10.8.1 - Manufacture of sugar

☐ C10.8.2 - Manufacture of cocoa, chocolate and sugar confectionery

☐ C10.8.3 - Processing of tea and coffee

☐ C11.0.1 - Distilling, rectifying and blending of spirits

☐ C11.0.2 - Manufacture of wine from grape

☐ C11.0.5 - Manufacture of beer

☐ C11.0.7 - Manufacture of soft drinks;

☒ C12 - Manufacture of tobacco products

☐ C13 - Manufacture of textiles

☐ C15.2 - Manufacture of footwear

☒ C20.2 - Manufacture of pesticides and other agrochemical products

☒ C25.4 - Manufacture of weapons and ammunition

☐ C25.4.0 - Manufacture of weapons and ammunition

☐ C30.4 - Manufacture of military fighting vehicles

☐ G46.1.6 - Agents involved in the sale of textiles, clothing, fur, footwear and leather goods

☒ G46.3.5 - Wholesale of tobacco products

☐ G46.3.6 - Wholesale of sugar and chocolate and sugar confectionery

☐ G46.4.2 - Wholesale of clothing and footwear

☒ G47.1.1 - Retail sale tobacco predominating

☐ N80.1 - Private security activities

☐ O84.2.2 - Defence activities

☒ Other

**Please specify to what other activity(ies) you refer in your answer to question 5:**

As mentioned in our response to the question on the scope of vertical activities, the categorisation of activities listed above as universally harmful needs to be subjected to an open political process and is not to be made by the industry bodies. In this response, we refrained from ticking the boxes beyond those sectors which can be universally perceived as harmful, such as tobacco and coal.

Nonetheless, such a clear-cut assessment of most of the listed sectors is not possible and further differentiation is needed. This is a reason why a top-down stipulation of activities that shall be considered as socially harmful under all circumstances must be very carefully considered. Falling under a particular activity (e.g. textile production) does not automatically mean that such an activity is harmful and it largely depends on the local circumstances and the treatment of the labour force by the corporate, which varies between firms and jurisdictions. In this respect, it could make sense using the social taxonomy as a dictionary of acceptable and non-acceptable social standards (e.g. aligned with social PAIs in SFDR and social aspects of DNSH) rather than tying to economic activities that promote social objectives or end products.

Should the Commission choose the approach of listed activities, we believe that only activities that are in any event harmful to consumers and communities should fall under this category. This should probably include activities of growing, manufacturing and selling tobacco as well as gambling and betting activities (O.92.71), tar sand production, arctic drilling for fossil fuels, palm oil production, and adult entrainment production, operation and distribution, which are missing in the list. We would also suggest adding production and distribution of controversial weapons (ABC weapons, landmines and cluster munition) to the list of socially harmful activities.

For other activities, the overall assessment should be more differentiated. For example, production of clothes or cocoa becomes problematic due to the working conditions in certain regionsbut can be practiced in better circumstances. These sectors should therefore not be stigmatised as generally harmful under the social taxonomy.

## Governance objectives

**Question 6. Sustainability linked remuneration is already widely applied in sustainable investment. In your view, would executive remuneration linked to environmental and social factors in line with companies' own targets, therefore also be a suitable criterion in a social classification tool such as the social taxonomy?**

☐ Yes

☐ No

☒ Don't know / no opinion / not applicable

**Please explain your answer to question 6:**

We choose no opinion, as this is a complex question that should not precede discussions related to the foreseen Sustainable Corporate Governance proposal (EFAMA's consultation response can be found here). Otherwise, the social taxonomy could lead to overlaps, duplications and inconsistencies with the SCG proposal. We also note that remuneration considerations are not specific to social taxonomy and are also valid for the environmental taxonomy. A transversal approach is more appropriate on these matters.

We observe that **sustainability linked remuneration is an important** tool that more and more companies are implementing as part of their remuneration policies, and that it is a market standard independent of regulation, where shareholders can exercise their influence on the general assembly, when discussing and approving executive compensation. A survey from Willis Towers Watson confirms this and finds that 78% of 168 respondents are planning to change how they use ESG with their executive incentive plans, 41% plan to introduce ESG measures into their long-term incentive plans over the next three years while 37% plan to introduce ESG measures to their annual incentive plans. Additionally, about a third plan to raise the prominence of Environmental and Social/Employee measures in their incentive plans.

We suggest that any regulatory measure in the Sustainable Corporate Governance proposal should rather aim at **increasing transparency as to whether and how a share of variable remuneration has been linked to sustainability performance**, instead of imposing any prescriptive measures. Therefore, we believe that regulation focusing on transparency would be sufficient at this stage. In the case of investment managers, as noted by ESMA , due to the substantial remuneration rules for investment funds which have already been put in place in recent years, there is no need for any legislative action in terms of remuneration. For example, the Sustainable Finance Disclosure Regulation (SFDR) already sets rules on making remuneration policies publicly available and ensuring that they are consistent with the integration of sustainability risks.

Both the share of variable remuneration and the choice of relevant non-financial KPIs must be consistent with the companies' business and strategy. Shareholders' have a right to vote on the remuneration to warrant effective control and correction of excessive pays by shareholders. Such additional control mechanism is particularly fit in case of weak governance structures, e.g. involving close links between executive and non-executive directors. With regard to sustainability considerations, voting helps promoting proper alignment of the remuneration metrics with the ESG targets defined in the business strategy of a company.

We also note that ESG KPIs in remuneration are used in very different and heterogenous ways.

Sometimes, as witnessed during the covid-19 crisis, ESG metrics have been used to compensate financial underperformance. Therefore, the existence of such KPIs in itself is not an indication of a company's social sustainability.

**Question 7. The report envisages governance objectives and analyses a certain number of governance topics. Please select the governance topics which in your view should be covered:**

☐ Sustainability competencies in the highest governance body

☒ Diversity of the highest governance body (gender, skillset, experience, background), including employee participation.

☒ Transparent and non-aggressive tax planning

☒ Diversity in senior management (gender, skillset, experience, background)

☐ Executive remuneration linked to environmental and social factors in line with companies' own targets

☒ Anti-bribery and anti-corruption

☐ Responsible auditing

☒ Responsible lobbying and political engagement

☐ Other

**Please specify to what other governance topic(s) you refer in your answer to question 7:**

While we support inclusion of most of the proposed governance topics, their precise treatment under the social taxonomy should not preempt the foreseen developments under the Sustainable Corporate Governance initiative.

More specifically, we believe that it is hard to cover "Sustainability competencies in the highest governance body". Requiring sustainability competences would face two challenges: (1) it would infringe on the right of investors to freely propose members for the highest governance body; (2) it is not clear how sustainability competences should be checked, and which topics should be covered when members are proposed, especially given the broad nature of sustainability.

## Models for linking an environmental and a social taxonomy

The report suggests two models for linking an environmental and a social taxonomy

- **Model 1**: The social and an environmental taxonomy would only be related through social and environmental minimum safeguards with governance safeguards being valid for both. The UN guiding principles would serve as minimum safeguards for the environmental part, while the environmental part of the OECD guidelines would serve as environmental minimum safeguards for the social part. The downside would be thin social and environmental criteria in the respective other part of the taxonomy

- **Model 2**: There would be one taxonomy with a list of social and environmental objectives and DNSH criteria. It would essentially be one system with the same detailed 'do no significant harm' criteria for the social and environmental objectives. The downside would be that there would be fewer activities that would meet both social and environmental 'do no significant harm' criteria

### Question 8. Which model for extending the taxonomy to social objectives do you prefer?

☒ Model 1

☐ Model 2

☐ Don't know / no opinion / not applicable

### Please explain your answer to question 8:

While each model comes with its own advantages and disadvantages, our members show a slight preference for Model 1. Nonetheless, to conduct a better comparative assessment between the two Models, the Commission's impact assessment of the social taxonomy should **study the volumes of activities and entities becoming ineligible** as a result of combining both green and social taxonomy under a single framework.

As it stands, Model 1 seems to be the more optimal option because it is **more pragmatic as it does not require to reopen the level 1 of the environmental taxonomy**. We should first see how the existing environmental taxonomy works in practice and learn for this first experience before adding an additional dimension to the taxonomy framework. In view of the huge complexity of the environmental taxonomy that is likely to rise with the envisaged introduction of further sub-levels of environmental performance, it is key to avoid major system changes in order not to discourage investors and other financial market participant to actively engage with the environmental taxonomy.

Model 1 would also create a "mirror" of the environmental taxonomy focused on social objectives, therefore easing the understanding for end-users.  What is also important for Model 1 is agreeing in principle on equivalence of the environmental and social taxonomies. Both aspects of sustainability are equally important and should be put on an equal footing from a policy perspective, while providing investors with the opportunity to focus on their own individual preferences for positive contribution.

In addition, we believe that **it would be much more difficult to find activities that meet both environmental and social DNSH criteria under the Model 2**. As a result, redirection of capital to sustainable activities would only be possible on a much lower scale.

Minimum E safeguard could go beyond the OECD guidelines but should not be too stringent or granular, at the risk of creating an extremely niche "Social" taxonomy. Similarly, applying too stringent or granular "S" DNSH to the environmental taxonomy (under model 2) would further narrow the scope of an already small investable universe of the environmental taxonomy.

On the other hand, **the clear advantage of Model 2 would be it its provision of a single view of "taxonomy aligned" activities and entities**. This would require further refinement of the environmental taxonomy and consistent parameters applicable to both, environmental and social dimensions. It would also require extension of the environmental taxonomy to include a wider range of industries and activities, creating measures comparable to the horizontal measures outlined in the consultation. Nonetheless, in the long term, Model 2 could be implemented to avoid conflicting situations with one activity qualifying as taxonomy aligned from an environmental perspective while undermining some social objectives.

Finally, besides looking at the interlinkage of the green taxonomy with the social one, asset managers are also concerned by the interlinkages with the concepts in SFDR on sustainable investment definition and the principle adverse impacts indicators. We see a risk of duplicating assessment of similar issues and creating confusion on what these indicators mean when determining whether a corporate is sustainable or not.

## General expectation from the social taxonomy

### Question 9. What do you expect from a social taxonomy?

The social taxonomy should provide a clear framework defining business activities and performance that is widely accepted as socially beneficial. A social taxonomy can align how social aspects are measured and make it easier for investors to make informed decisions, channel resources towards socially sustainable activities and contribute to the SDGs. If designed right, it can drive change at scale.

It is crucial that the social taxonomy clearly defines its thematic (just transition vs. broader social impact) and geographical focus (EU vs. global level). Whereas the impact of the green taxonomy via GHG reductions, creates global benefits by default, social impacts can be locally confined depending on a company's supply chain. EU has a global responsibility beyond the supply chain to promote a socially just global economy transition. Given this, it is essential to base a social taxonomy on globally recognised principles and norms to maximise the potential for redirecting capital flows, also beyond EU border

Our members encounter great interest from investors to invest in a socially responsible manner and to contribute to the social SDGs. However, there is currently no universally recognised concept or comparable parameters and metrics for socially oriented investing that would allow them to exploit this potential on a large scale. Against this background, a social taxonomy should:

- **Provide a universally valid benchmark for social investments by defining social sustainability objectives and essential characteristics of investments that would qualify as socially sustainable**. This would provide much-needed guidance for both institutional and retail investors and enable them to make informed investment decisions. It would also help redirecting capital flows to those activities and projects that make significant contribution to the promotion of social standards.

- **Rely on existing global standards** (based on international treaties and conventions) instead of referring to standards enshrined in EU law. In this regard, the Platform and subsequently the EU Commission must seek to collaborate with other jurisdictions, e.g. in the context of the International Platform on Sustainable Finance. The ultimate goal should be to develop a social taxonomy that is recognised as a global benchmark for socially sustainable investments at the international level. The existing taxonomy focuses on investments but will also naturally be applicable to lending. Therefore, it is also vital that credit institutions can use it as an effective tool for social transformation across geographies. **This calls for relative thresholds in the social taxonomy.**

It is also important that a social taxonomy counterbalances the environmental taxonomy, inspiring a more holistic ESG approach. The ongoing Covid 19 pandemic clearly demonstrates that investments in projects catering for social needs cannot be neglected. Moreover, the envisaged transition to a net-zero and climate-resilient economy will result in fundamental changes to business operations of companies that will very likely entail several challenges in social terms. The social taxonomy should help to emphasise the social impact of such changes and reduce the risk of an unjust transition for workers and communities.

The environmental taxonomy entails enormous complexity for reporting companies and their users. There is the risk that with the introduction of a social taxonomy, this complexity will be further increased and the taxonomy framework will become barely operational for small and medium-size market participants. Especially **the level of detail of the DNSH test should be reduced** under both taxonomy frameworks. The current approach to the DNSH assessment under the environmental taxonomy has failed the practice test, since it is impossible to apply the DNSH criteria without corresponding disclosures by issuers. Even in future, however, data for the DNSH assessment can be expected only for EU companies or some non-EU issuers active in the EU markets under the proposed CSRD regime. If the taxonomy doesn't not reflect current data availability, it risks low adoption, as the cost of generating data and documentation for issuers could overweigh the benefits of the social investment label. Without such data and with only a limited possibility to use estimates, the taxonomy will not exploit its potential for steering investments towards sustainable activities.

Therefore, **the social taxonomy should prioritise usability**. The environmental taxonomy has shown that prioritising the development of criteria can lead to challenges in data availability when applied in practice, with data availability being even more challenging for social elements. We believe the usability will benefit from first considering data availability. By focusing on what is measurable in practice, the criteria and specifics such as the covered activities can be formulated to direct capital where it is needed most to achieve social objectives.

We also note that the horizontal dimension's 'do no significant harm' criteria are similar to the SFDR principal adverse impact indicators. Therefore, we believe the Commission **should harmonise the horizontal dimension of the social taxonomy with the SFDR** principal adverse impacts indicators to improve usability. Regarding alignment with other regulations, we believe reconciling the horizontal dimension with, for example, OECD and national regulations will be hard due to different norms and their interpretation. Therefore, we suggest closely monitor how the horizontal dimension works in practice if implemented.

***

## About EFAMA

EFAMA, the voice of the European investment management industry, represents 28 Member Associations, 58 Corporate Members and 24 Associate Members. At end Q4 2020, total net assets of European investment funds reached EUR 18.8 trillion. These assets were managed by more than 34,350 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,650 AIFs (Alternative Investment Funds). At the end of Q2 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 24.9 trillion.

More information is available at www.efama.org.

## Contact

**Dominik Hatiar**
Regulatory Policy Advisor
Dominik.hatiar@efama.org | +32 2 513 39 69 ..