HARN63 - Master Thesis in European and International Trade Law

Responsible Investing - ESG and Sustainability in the Contemporary Financial Systems

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ESG

Environmental, Social and Corporate Governance (ESG) investing, often called sustainable investing, responsible investing, socially responsible investing, triple-bottom-line investing, impact investing, mission-related investing, ethical investing or just green investing, is widely understood as a set of factors considered by companies, investors and financial institutions when managing their operations and/or making investment decisions. Through ESG investing, market participants are considering potential environmental, social and corporate governance risks and opportunities that can have material impact on companies' performance. ESG factors cover a wide scope of issues that traditionally are not part of financial analysis, but may have a significant financial relevance. Investors who apply ESG criteria in their decision-making process manage to invest sustainably and at the same time maintain the same or attain higher level of financial returns as they would expect with a more traditional investment approach.

Under the environmental criteria (E) this thesis defines climate change, energy efficiency, pollution, use of natural resources, waste management, clean energy and technologies, biodiversity, deforestation and all other factors, attitudes and actions that can influence the environment.

Under the social criteria (S) the thesis considers diversity agenda, labour relations, employee safety and working conditions, human rights and child labour, product safety, community engagement, supply chain management and all related social issues, that may be a result of a business activity.

This master's thesis acknowledges the governance criteria (G) as a broad independence and diversity, business ethics, risk management and oversight, compensation policies, legal and compliance, anti-money laundering, corruption and other subjects that fall under the corporate governance area.

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Abstract

In the contemporary world when the utmost need of sustainable future and responsible investing is widely discussed in order to create a long term, green, socially accountable and liable future, the financial sector and socially conscious investors are progressively applying Environmental, Social and Governance criteria to the process of analysis to identify material risks and further growth opportunities. Even though ESG is a set of non-financial criteria by its definition and not readily quantifiable in monetary terms, it already has a significant influence on the performance of businesses and financial institutions. An accurate study of the continuous improvements in the environment of existing regulatory instruments allow the assumption that regardless the challenges it faces, the emerging trend of incorporating ESG requirements in business and finance activities is not a temporary trend and will eventually result in a long-term sustainability in the financial sector.

Keywords: ESG; Sustainable Finance; The EU Green Deal; Circular Economy; EU Taxonomy; SFDR; CSRD.

To Grandma Rose

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List of Abbreviations

AIFM	Alternative Investment Fund Manager
AUM	Assets Under Management
CBAM	Carbon Border Adjustment Mechanism
CSR	Corporate Social Responsibility
CSRD	Corporate Sustainability Reporting Directive
EBF	European Banking Federation
EFRAG	European Financial Reporting Advisory Group
ESG	Environmental, Social, Governance
FMPs	financial market participants
FAs	Financial Advisors
GDP	Gross Domestic Product
GHG	Greenhouse Gas
IORP	institution for occupational retirement provision
IFC	International Finance Corporation
NFRD	Non-Financial Disclosure Regulation
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
PEPP	pan-European personal pension product provider
PRI	UN Principles for Responsible Investment
RBC	Responsible Business Conduct
RI	Responsible Investing

SDGs	Sustainable Development Goals
SFRD	Sustainable Finance Disclosure Regulation
SMEs	Small and Medium-sized Enterprises
TBL	Triple bottom line
TEG	EU Technical Expert Group
UN	United Nations
UNEP FI	United Nations Environment Programme Finance Initiative
UNGC	United Nations Global Compact
UNFCCC	United Nations Framework Convention on Climate Change
UCITS	Undertakings for Collective Investment in Transferable Securities
UCITS	Undertakings for the Collective Investments in Transferable Securities.
WTO	World Trade Organisation

1. Introduction

1.1. Background

Environmental, Social and Governance (ESG) investing, often called sustainable investing,[1] has rapidly become a priority over the past decade.[2] A growing number of companies around the world are developing the path to sustainable investments. This growth is produced by the aspiration of investors to maintain not only an economic and financial performance, but also the desire to strengthen a positive environmental and social impact of investing.[3]

Just 30 years ago, despite the scientific proof, investors were not considering climate change as a substantial risk to investment. 'Globalization, financialization, and digitalization' of business activities have contributed to the transnational capacity of applying ESG.[4] Meanwhile, both the 2008 economic crisis and the COVID-19 pandemic has proved that environment, as well as society are equally important for businesses to build resilience into their system.[5] The pandemic has brought ESG risks and sustainability to the surface,[6] after which, both the policymakers and the financial institutions started realizing that investing requires a different perspective due to unexpected risks related to potential crises caused by pandemic and climate change.[7] As a result of a rising number of evidences of risks, motivations for engagement, initiation of and improvements in regulations, investors are including climate considerations into their investment decision-making processes, expecting that companies where they invest will provide sufficient disclosures.[8]

[1] In a business context, sustainability is about company's business model, which indicates how products and services contribute to sustainable development.
[2] Boffo, R., and Patalano. R., *ESG Investing: Practices, Progress and Challenges*, (OECD, 2020) 6. <www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf > accessed 27 April 2022.
[3] ibid 11.
[4] Yeoh. P., *Environmental, Social and Governance (ESG) Laws, Regulations and Practices in the Digital Era.* (Kluwer Law International, 2022) 20.
[5] Ernst & Young LLP, *Risk, returns and resilience: Integrating ESG in the financial sector* (2020) 5.
[6] Ziolo. M., Filipiak. B., Tundys. B., *Sustainability in Bank and Corporate Business Models. The Link between ESG Risk Assessment and Corporate Sustainability.* (Palgrave Studies in Impact Finance, 2021) 1.
[7] Ernst & Young LLP, *Risk, returns and resilience: Integrating ESG in the financial sector* (2020) 7.
[8] ibid 10.

In its report 'ESG Investing: Practices, Progress and Challenges'[9] the Organisation for Economic Co-operation and Development (OECD) defines three factors of adopting ESG criteria and sustainable investing. First factor ensures that ESG-based investing adds value to successful risk management and improves traditional investments. The second factor addresses the increasing demand of the societies that influence investors, also growing impact on corporate performance as a result of the gradual rise of awareness about risks from climate change, benefits of responsible business systems and diversity in the workplace. The third factor refers to the need of changing short-term vision on potential risks and financial returns to the long-term planning for investment sustainability.

Providentially, in our contemporary world, businesses are willingly implementing a wide range of sustainability practices to respond to stakeholder expectations and rising challenges across the ESG area.[10] Investors are demanding to integrate ESG criteria into their investments in order to incorporate long-term financial risks and opportunities into their investment decision-making processes aiming at generating long-term sustainability values.[11] As a result, investors are integrating sustainability performance data in their capital allocation decisions,[12] classifying sustainability issues as strategically important.[13] Those actual and potential changes highlight that the financial sector is a major player for sustainable development.[14]

The growing interest of investors in ESG elements indicates that environmental, social and corporate governance issues, including risks and opportunities, can reasonably affect financial and overall performance in the long term, thus creating a solid foundation for consideration of ESG principles when making investment decisions.[15]

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[9] Boffo, R., and Patalano. R., *ESG Investing: Practices, Progress and Challenges*, (OECD, 2020) 6. <www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf > accessed 27 April 2022.

[10] Global Alliance for Banking on Values (GABV), European Investment Bank (EIB), Deloitte. *Do Sustainable Banks Outperform? Driving value creation through ESG practices* (2019) 2.

[11] Boffo, R., and Patalano. R., *ESG Investing: Practices, Progress and Challenges*, (OECD, 2020) 11. <www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf > accessed 27 April 2022.

[12] Khan. M., Serafeim. G., Yoon. A., *Corporate Sustainability: First evidence on Materiality*. (Harvard Business School, Working Paper 15-073) 1.

[13] ibid 2.

[14] Swedish Investors for Sustainable Development (SISD). *Investors and the SDGs, Examples from SISD members*, (2019) 2.

[15] Boffo, R., and Patalano. R., *ESG Investing: Practices, Progress and Challenges*, (OECD, 2020) 6. <www.oecd.org/finance/ESG-Investing-Practices-Progress-and-Challenges.pdf > accessed 27 April 2022.

Financial actors affect sustainable development in various simultaneous ways. The direct path is through asset allocation. However, they can also influence companies by imposing disclosure and reporting obligations that encourage steps towards healthy development.[16]

Capacity building for development of sustainable investing strategies is an opportunity and a challenge at the same time. Only sustainability trends can create a long-term economic and financial strength for the investors. 'They are also putting in efforts to successfully anticipate how such ESG issues will become financially material either for a particular company or an industry.'[17]

Ziolo, Filipiak, and Tundys suggest that sustainable development is grounded on significant finances. Regulations of the past few years support development of new business frameworks and models of the banks to envision sustainability as one of the priorities.[18]

Sustainable finance and ESG principles continue to lead the agenda in financial services. This is further supported by the increased pressure on the management of financial institutions who are ready to take actions in this direction.[19] According to Ernst & Young, integration of ESG will bring the financial sector and stakeholders to a win-win reality, where stakeholders' voice will always be heard in the decision-making process.[20]

1.2. Historical Overview

Historically, the perception of responsible investing comes from the eighteenth century,[21] when religious institutions believed that investing was not only an activity, rather, it also implied

[16] Swedish Investors for Sustainable Development (SISD). *Investors and the SDGs, Examples from SISD members*, (2019) 2.
[17] Ernst & Young LLP, *Risk, returns and resilience: Integrating ESG in the financial sector* (2020) 10.
[18] Ziolo. M., Filipiak. B., Tundys. B., *Sustainability in Bank and Corporate Business Models. The Link between ESG Risk Assessment and Corporate Sustainability.* (Palgrave Studies in Impact Finance, 2021) 1.
[19] Ernst & Young LLP, *How banking boards are elevating sustainable finance and ESG*, (2021) 2.
[20] Ernst & Young LLP, *Risk, returns and resilience: Integrating ESG in the financial sector* (2020) 5.
[21] Domini. A.L., *Socially Responsible Investing: Making a Difference in Making Money* (Chicago: Dearborn Trade, 2001) 1.

values.[22] This belief led to the first waves of suspicious approach to 'sin companies'[23] whose products opposed the clerical beliefs.[24]

The contemporary understanding of responsible investing and, in general, sustainable development is rooted back in the 1960s when civil rights and social issues became perceptible in the US economic activities and shareholder proposals, highlighting that ethical behaviour has become more prominent.[25] This period is marked with significant number of investment funds excluding the stocks of companies involved in the Vietnam War and considering human rights and environmental protection factors in their agenda.[26]

The recognition of the concept at international level is mostly an outcome of the United Nations' (UN) significant efforts that took start from the Stockholm Conference on the Human Environment[27] in 1972, where the relation between environmental protection and economic development were highlighted for the very first time.[28]

The process of rapid growth of emerging countries after the Cold War triggered the world by an urgent need for an action plan for sustainable development at the outset of the 21st century. Sustainability issues were unimaginable to handle at a national level, therefore the UN decided to initiate a platform for collaboration. Consequently, the next significant step in the field of sustainability and environmental protection was the UN Earth Summit in Rio de Janeiro in 1992. The Rio Declaration on Environment and Development,[29] the Declaration on the protection of

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[22] Nakajima. T and others, *ESG Investment in the Global Economy (*Springer 2021) 2.
[23] Today we call them 'sin stocks,' which mostly applies for gambling, alcohol, tobacco and gun businesses
[24] Louche. C & Lydenburg. S. *Dilemmas in Responsible Investment (*2017) 18.
[25] Nakajima. T and others, *ESG Investment in the Global Economy (*Springer. 2021) 2.
[26] ibid.
[27] UN General Assembly, *United Nations Conference on the Human Environment*, 15 December 1972, A/RES/2994, See particularly principles 4, 13, 15-20. <https://documents-dds-ny.un.org/doc/UNDOC/GEN/NL7/300/05/IMG/NL730005.pdf?OpenElement> accessed 28 April 2022.
[28] Barral. V., *Sustainable Development in International Law: Nature and Operation of an Evolutive Legal Norm (*The European Journal of International Law Vol. 23 no. Oxford University Press) 379.
[29] United Nations, *Rio Declaration on Environment and Development;* Statement of Forest Principles: The final text of agreements negotiated by governments at the United Nations Conference on Environment and Development (UNCED), 3-14 June 1992, Rio de Janeiro, Brazil. United Nations Dept. of Public Information. <https://www.un.org/en/development/desa/population/migration/generalassembly/docs/globalcompact/A_CONF.151_26_Vol.I_Declaration.pdf> accessed 27 April 2022.

forests,[30] the Convention on Biological Diversity[31] and Climate Change Convention (UNFCCC)[32] are significant observed outcomes of the summit.[33]

The Rio +10 Summit was the next step towards sustainability, which took place in Johannesburg in 2002. The Johannesburg Declaration on Sustainable Development[34] is the main outcome of the summit grounded on the declarations made at the UN Conference on the Human Environment (Stockholm, 1972) and at the Earth Summit (Rio de Janeiro, 1992).

UN Principles for Responsible Investment (PRI)[35] was the following big step in developing responsible investing. In 2005, then the UN Secretary-General, Kofi Annan, invited a group of the world's largest institutional investors to join a process to develop the Principles for Responsible Investment. The signatories are responsible for trillions[36] of USD in assets worldwide and include some of the world's largest and most influential investors.[37] The organisation is dedicated to promoting environmental and social responsibility among global investors. These principles further support the idea that the 'performance of investment portfolios can be affected by ESG issues.'[38]

When discussing the historical development of responsible investing, it is crucial to mention that in 1994, John Elkington[39] developed the concept – 'the triple bottom line' (TBL or 3BL), consisting of three 'P's' – Profit, People and Planet, which aims at measuring financial, social and

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[30] ibid.

[31] United Nations, *The Convention on Biological Diversity* (5 June 1992, 1760 U.N.T.S. 69); < https://www.cbd.int/doc/legal/cbd-en.pdf> accessed 27 April 2022.

[32] UN General Assembly, *United Nations Framework Convention on Climate Change*, 20 January 1994, A/RES/48/189, <https://unfccc.int/files/essential_background/background_publications_htmlpdf/application/pdf/conveng.pdf> accessed 27 April 2022.

[33] Which in turn led to Kyoto Protocol and Paris Agreement.

[34] United Nations, *The Johannesburg Declaration on Sustainable Development*, 4 September 2002, <https://ec.europa.eu/environment/archives/wssd/documents/wssd_pol_declaration.pdf> accessed 27 April 2022.

[35] Principles for Responsible Investment. <https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment> accessed 27 April 2022.

[36] As of March 2020, the collective AUM represented by PRI signatories increased by 20%, from US$86.3 trillion to US$103.4 trillion, representing 3,038 signatories.

[37] *PRI Annual Report 2020*. <https://www.unpri.org/about-the-pri/annual-report-2020/6811.article> accessed 27 April 2022.

[38] Nakajima. T and others, *ESG Investment in the Global Economy (*Springer. 2021) 2.

[39] Founder of British consultancy called 'Sustainability,' bestselling author and an entrepreneur. The Convention on Biological Diversity of 5 June 1992 (*1760 U.N.T.S. 69*);

environmental performance of the corporation in a given timeframe[40], and changing the 'tomorrow's capitalism.'[41]

The history of development of legal framework for Responsible Investing counts couple of decades. The progress is quite impressive – it already reaches almost all levels of economic and financial activities and provides space for further improvements.

1.3. Aim and Research Question

The purpose of this thesis is to research and analyse legal support to the setting and achieving ESG goals in the financial sector, particularly their investment activities for long-term sustainability. The legal framework will be discussed in the light of international and regional (on the EU level) legal instruments. The master's thesis intends to analyse literature, reports and content of different agreements throughout the EU.

To fulfil this purpose, this master's thesis has three general research questions that need to be answered:

> ***Research Question 1:*** Intends to examine the legal instruments designed for sustainable investing in the EU and Globally.
>
> ***Research Question 2:*** Contemplates to research and analyse whether and to what extent the legal instruments designed for sustainable investing are sufficiently developed to realistically support and ensure financial institutions in setting and achieving ESG goals.
>
> ***Research Question 3:*** Contemplates to evaluate, whether ESG investing is a temporary trend in today's world that all parties are following, or will it really result in a long-term sustainability and add financial value in the future.

[40] The Economist. *Triple Bottom Line*. < https://www.economist.com/news/2009/11/17/triple-bottom-line> accessed 14 April 2022.
[41] John Elkington., '*25 Years Ago, I Coined the Phrase Triple Bottom Line' (*Harvard Business Review, June 25, 2018) <https://hbr.org/2018/06/25-years-ago-i-coined-the-phrase-triple-bottom-line-heres-why-im-giving-up-on-it> accessed 14 April 2022.

This master's thesis intends to discuss the progress in the understanding of the importance of implementing ESG throughout the financial sector; and will elaborate consistent argumentation in support to the potential financial benefits of responsible investing for all stakeholders, as well as for the environment, society and companies in general.

1.4. Materials and Methodology

Sustainability in general and sustainable investing in particular are at the top of the agenda in the world. International organisations concentrate their resources to support development, promotion, enforcement and implementation of the new legislation, rules and reporting standards for the financial sector. The topic has a specific and unique nature. This fact does not allow application of purely doctrinal methodology with its narrow scope and less power to assist non-doctrinal questions.[42]

The study answers them by researching and analysing the international and regional (on an EU level) soft and hard law instruments, as well as EU policy documents and action plans. The dogmatic legal method, as a 'science concerned with the objective meaning of positive legal orders'[43] also known as a fundamental concept in legal science, is applied to analyse the relevant primary sources as the backbone of a legal research. Even though the core part of the research is based on the EU secondary legislation documents,[44] which are binding by their nature (except recommendations and opinions), the substantial part of the work overviews and analyses also the soft law documents.

Understandably, soft law texts are non-legal, rather they are of a political nature, but can serve as a ground for the law and thus cause political consequences and indeed change the behaviour of

[42] McConville. M, Chui. W. *Research Methods for Law* (second edition, Edinburgh University Press, 2017) 5.
[43] Radbruch, op. cit. supra n. 10, at 209. Seen in: Minemura. T. *Dogmatic legal Science and Sociology of Law.* (ARSP: Archiv für Rechts-und Sozialphilosophie / Archives for Philosophy of Law and Social Philosophy, 1970, Vol. 56, No. 3 1970) 351 – 366.
[44] European Union, *Consolidated version of the Treaty on the Functioning of the European Union*, 13 December 2007, 2008/C 115/01, art 288. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012E288> accessed 25 May 2022.

stakeholders.[45] However, also 'soft law can produce some legal effects.'[46] In some cases they have proven as effective as law to address international problems. Besides, 'soft law norms may harden, being frequently incorporated into subsequent treaties or becoming customary international law as a consequence of state practice'.[47] According to the same source, moreover, the norms, that are non-binding internationally, may become a model on a domestic level and become legally binding internally. Even though soft law instruments are not legally binding by their nature, it is important to distinguish them as having 'potential impact in practice'. Some scholars claim that soft law instruments may affect practice and policy development specifically due to their 'soft' informal influence.[48] Some measures under the soft law encourage opposing Member States to revise their considerations and eventually make changes in their policies and strategies 'that they would resist if forced to do so by law'.[49] Arguments support the idea that there is no relevant and/or logical explanation why should soft law be disparaged only because of its non-binding nature.

Sustainable investing is a relatively new arena in the financial sector. On the one hand, it comprises of interesting challenges, and on the other hand, suggests feasible chances for considerable increases in financial and reputational assets. In order to present the developing and diverse nature of ESG investing and its importance towards more sustainable future, the thesis uses secondary sources of law.

Formulation of precise legal or scientific definition of sustainable investing requires systemic study and thorough investigation of legal, social and financial concepts, principles, instruments and literature. Some authors argue that researchers can guide their work by legal discussion on the theoretical and conceptual framework when conducting interdisciplinary or socio-legal research. For more profound analysis, the thesis uses secondary sources. Even though there is no clear terminology or internationally recognised definition and standards of ESG, there is a general

[45] Raustiala, K. (2005), *Form and Substance in International Agreements* (99 An.J.Int'l L. 587. 2005) 5.
[46] European Observatory of Working Life (EurWork), *Soft Law* (2011). <https://www.eurofound.europa.eu/observatories/eurwork/industrial-relations-dictionary/soft-law> accessed 25 May 2022.
[47] Shelton. D.L., *Soft Law, Handbook of International Law* (Routledge Press, 2008) 1-2.
[48]European Observatory of Working Life (EurWork), *Soft Law* (2011). <https://www.eurofound.europa.eu/observatories/eurwork/industrial-relations-dictionary/soft-law> accessed 25 May 2022.
[49] ibid.

understanding of what it constitutes. We rely on this understanding in the light of secondary sources on law.

The unique nature of the topic also dictated to use the empirical method. It goes beyond traditional legal doctrine and legal analysis. There are methodologies supporting the generation of empirical evidences that back answers to the research questions. [50]

The thesis intends to analyse not only theoretical, but also practical part of the process analysis through interviews held according to the empirical method. Questionnaires for interviews were composed based on the selected criteria of stakeholders. By doing so, the thesis attempts to cover every dimension of the study field. Having into mind the rationale of this thesis, interviewees were selected from the financial sector (one of the biggest investment banks in Scandinavia), consultancy firm (one from the 'Big Four' consulting companies), and a research organisation specialised in the field of ESG.

The interviews were held according to informed consent from interviewees, in a semi-structured manner. This allowed both: interviewer to go beyond the preliminarily agreed questions, ask timely follow up questions, and interviewees to respond and cover all related issues. This made the research process deeper, detail-oriented and more insightful.

1.5. Delimitations

The limited scope, allocated time and nature of the thesis restricted to develop a comprehensive legal study of sustainable investing. It intends to cover particular major international legal instruments and at the same time delivers thorough overview and analysis of the EU's legal frameworks and policy development for sustainable finance development. Although initially the study intended to involve financial institutions, actually limit was brought down to private banks, investment banks, trust companies and investment dealers with primary focus on banks.

[50] McConville M. Chui. W *Research Methods for Law* (second edition, Edinburgh University Press, 2017) 5.

According to Waslander, the term private sector banks refers to for-profit institutions, i.e., commercial banks with publicly traded shares on a stock market. They cooperate with individual clients, small and medium enterprises, and big companies. The fact that banks provide a wide range of products such as 'loans, mortgages, deposit and savings facilities, and investment products', makes them of big interest for the presented research. Many Banks expand their services to 'capital-market transactions for governments and companies; underwriting, issuing, and trading securities; and facilitating derivatives transactions'.[51]

ESG and Corporate Social Responsibility (CSR)[52] are the two main terms used in discussions on social consciousness of certain businesses. There is an overlap between the two terms often leading to confusion, but there is also a substantial difference: ESG is an assessment tool while CSR is a model. More precisely, ESG is a criterion for investors to assess a company, determine its compatibility with their views and weighing worthiness to invest in; Corporate Social Responsibility is a business model used by individual companies. The presented thesis covers ESG topics and subjects of Corporate Sustainability related to ESG, but not the Corporate Social Responsibility itself. This is assumed to be another limitation of the study.

1.6. Structure

The master's thesis consists of five chapters. The first chapter presents the background, history, state of research, purpose and research questions, and methodology. It describes delimitations and sets the borders to its scope.

The second chapter provides analysis of several fundamentally important international legal frameworks, which are playing a major role in the developing process of sustainable finance. The UN Agenda 2030 – Sustainable Development Goals (SDGs), Paris Agreement under the United

[51] Waslander J. and others. *Banking Beyond Climate Commitments: Transforming Client Engagement and Products & Services for a net-zero Emissions Future.* (World Resources Institute, working paper) 4.
[52] The concept of Corporate Social Responsibility was first introduced in 1953 by the American Economist Howard R. Bowen in his publication 'Social Responsibilities of the Businessman.' However, the concept did not acquire a global recognition until the late 1990s. Nakajima. T and others, *ESG Investment in the Global Economy (*Springer. 2021) 3.

Nations Framework Convention on Climate Change, OECD Guidelines for Multinational Enterprises and UN Principles on responsible Banking are discussed and critically analysed.

The third chapter focuses on EU's policy towards sustainable finance. It overviews the definition and role of sustainable finance, the EU Green Deal with distributed subchapter of Circular Economy Action Plan. Every subchapter is coherent with sustainable finance and viewed as tools towards sustainable investing.

The fourth chapter summarises Sustainable Finance Disclosure Regulations as critical tools for encouragement of implementation and execution of ESG investing. Special focus is directed to the disclosures such as EU Taxonomy, Sustainable Finance Disclosure Regulation (SFDR) and Corporate Sustainability Reporting Directive (CSRD).

The fifth chapter summarises the document, makes legal analysis, condenses legal questions and provides conclusions according to the research and the interviews.

2. International Legal Instruments

The goal of sustainable development is well equipped with relevant legislation related to ESG investments on international and regional levels. In the past decade, the legal framework was further enriched with several important instruments in the area of hard and soft law. Before covering the legal basis and policy development on the EU level in the following parts, this chapter discusses fundamental international frameworks supporting and empowering the responsible investing development processes and highlights the overall significance of ESG investing.

2.1. Agenda 2030 – Sustainable Development Goals

In September 2015, UN member states adopted the UN Agenda 2030 – Sustainable Development Goals (SDGs)[53] which is an ambitious 'plan of action for people, planet and prosperity.'[54] The SDGs are presented as the group of 17 interconnected global goals[55] and 169 specific targets. They invite all actors, particularly private actors[56] to achieve the SDGs which are designed to be a 'blueprint to achieve a better and more sustainable future for all.'[57] The SDGs combine main social and environmental goals in order to achieve sustainable development and address environmental issues. They connect responsible production and consumption and promote economic growth at the same time.[58]

In the process of achieving SDGs, the role of financial institutions is vital. Driving transition towards more sustainable and resilient economy by 2030 requires massive capital. According to the UN Development Programme (UNDP), the value of global financial assets is estimated to be 200 trillion US dollars, which, channelled into sustainable development, could go a long way towards meeting the investment needs required to achieve the SDGs and goals of the Paris Agreement.[59] According to a plan, the majority has to come from private sector.[60] Over the last decade, financial institutions have seen that sustainability issues have become an important part of their activity. Therefore, banks are considering SDGs in achieving their targets and trying to identify the ways on how their activities can contribute to achieve the goals of 2030 agenda.

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[53] UN General Assembly, Transforming our world: the 2030 Agenda for Sustainable Development, 21 October 2015, A/RES/70/1 <https://www.un.org/ga/search/view_doc.asp?symbol=A/RES/70/1&Lang=E> accessed 27 April 2022.

[54] ibid, Preamble.

[55] GOAL 1: No Poverty; GOAL 2: Zero Hunger; GOAL 3: Good Health and Well-being; GOAL 4: Quality Education; GOAL 5: Gender Equality; GOAL 6: Clean Water and Sanitation; GOAL 7: Affordable and Clean Energy; GOAL 8: Decent Work and Economic Growth; GOAL 9: Industry, Innovation and Infrastructure; GOAL 10: Reduced Inequality' GOAL 11: Sustainable Cities and Communities; GOAL 12: Responsible Consumption and Production; GOAL 13: Climate Action; GOAL 14: Life Below Water; GOAL 15: Life on Land; GOAL 16: Peace and Justice Strong Institutions; GOAL 17: Partnerships to achieve the Goal <https://www.un.org/development/desa/disabilities/envision2030.html> accessed 27 April 2022.

[56] European Banking Federation (EBF), KPMG, *European Banking Practices in supporting and implementing the UN Sustainable Development Goals* (June 2021) 6.

[57] United Nations, Take Action for the Sustainable Development Goals <https://www.un.org/sustainabledevelopment/sustainable-development-goals/> accessed 27 April 2022.

[58] Weber.O *The financial Sector and the SDGs (Centre* for International Governance Innovation, Interconnections and Future Directions., CIGI Papers No. 201- November 2018) 2.

[59] United Nations Sustainable Development, *UN Secretary-General's Strategy for Financing the 2030 Agenda* (November 30, 2020) <https://www.un.org/sustainabledevelopment/sg-finance-strategy/> accessed 20 May 2022.

[60] One Stone Advisors., *The financial sector and the SDGs* (2017) 1.

Additionally, there are number of different regulations and initiatives that promote management of ESG issues at the European level. [61]

The major role, as well as the challenge for a financial institution to promote sustainable growth is to redirect funds toward more responsible investment practices, long-term thinking and a focus on positive impact in order to deliver SDGs.[62] Today the products offered by banks that are aligned with the SDGs, are mainly investment funds, created based on ESG criteria, thematic investments that impact the SDGs and sustainable bonds (green and social). At the same time, at retail level, banks are promoting those services and products, that are aligned with SDGs and promote transition towards low-carbon economy and are considering social challenges, like promoting and supporting gender equality.[63]

Banks are focusing on SDGs, over which their potential impact is very strong. According to the joint report by European Banking Federation (EBF) and KPMG the most significant SDGs for banks are those, which are related to economic growth and decent work (SDG 8), climate action (SDG 13), clean energy (SDG 7), sustainable cities and communities (SDG 11) and responsible consumption and production (SDG 12).[64]

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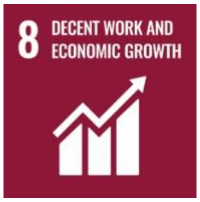
[61] European Banking Federation (EBF), KPMG, *European Banking Practices in supporting and implementing the UN Sustainable Development Goals* (June 2021) 6.
[62] One Stone Advisors., *The financial sector and the SDGs* (2017) 1.
[63] European Banking Federation (EBF), KPMG, *European Banking Practices in supporting and implementing the UN Sustainable Development Goals* (June 2021) 7-8.
[64]ibid 21.

Infographic 1. SDGs according to the level of relevance for the Banking sector



83%

Banks play a vital role in a process of promoting the use of savings account, increasing awareness for vulnerable customers, promoting small and medium enterprises (SMEs) entrepreneurship in order to rise employment in community.

75%

Banks can affect climate change in two streams: 1. by reducing banks internal environmental footprint itself, 2. by raising a capital and finance the projects that help to mitigate and adapt to climate change.

60%

In order to achieve a low-carbon economy, the capital needs to be allocated towards renewable energy projects (project finance), participating in sustainable and green bonds, and creating products and/or services for clean-energy minded customers.

52%

Banks are offering loans for renovation of buildings in order to become energy efficient, or for green vehicles; they also are offering green real estate products (green mortgages), and providing guidance for customers in order to increase their energy efficiency.

50%

Banks are increasing and allocating capital towards projects that support responsible and ethical production and consumption.

Source: EBF, KPMG, 2021.

2.2. Paris Agreement

The Paris Agreement,[65] also referred to as Paris Accords or the Paris Climate Accords, is a legally binding international treaty on climate change. The agreement was adopted in 2015 by 196 countries.[66]

The Paris Agreement has 'three long-term goals.'[67] According to article 2 of the Agreement, the first two goals focus on climate mitigation and adaptation, particularly to limit global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels,[68] while the third goal is 'making financial flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development.'[69] The third goal identifies the fundamental role of financial institutions, including private banks, in the process of realising goals set by the Paris Agreement.[70]

The financial sector has a key role in the ambitious agenda of Paris Agreement. Climate requires major investments. At the same time, it requires financial flows to shift away from climate-harmful activities.[71] 'The Paris Agreement sends a clear signal to capital markets and investors, public and private, that the global transition to clean energy is here to stay.'[72] According to the United Nations Framework Convention on Climate change Secretariat (UN Climate Change), 'Banks, assets managers, asset owners and insurers adjusted their business models, set and achieved their targets in support of the goals of the Paris Agreement. Flows of capital have been redirected to sustainable and climate resilient development.'[73] Obtaining financing in a correct

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[65] United Nations, Framework Convention on Climate Change, Adoption of the Paris Agreement, 21st Conference of the Parties, Paris, 2015. <https://unfccc.int/sites/default/files/english_paris_agreement.pdf> accessed 22 May 2022.
[66] Paris Agreement Signatories, <https://www.un.org/sustainabledevelopment/blog/2016/04/parisagreementsingatures/> accessed 22 May 2022.
[67] Bos. J., Wu. Y. *How Banks Can Accelerate Net-zero Emissions Commitments*. (October, 2021) <https://www.wri.org/insights/banks-paris-alignment-net-zero-finance> accessed 22 May 2022.
[68] United Nations, Framework Convention on Climate Change, Adoption of the Paris Agreement, 21st Conference of the Parties, Paris, 2015. Article 2 (1-a), (1-b) <https://unfccc.int/sites/default/files/english_paris_agreement.pdf> accessed 22 May 2022.
[69] ibid. Article 2 (c).
[70] Bos. J., Wu. Y. *How Banks Can Accelerate Net-zero Emissions Commitments.* (October, 2021) <https://www.wri.org/insights/banks-paris-alignment-net-zero-finance> accessed 22 May 2022.
[71] ibid.
[72] European Commission, *Putting the Financial Sector at the Service of the Climate (*November 2018) <https://ec.europa.eu/clima/system/files/2018-11/initiative_1_financial_sector_en.pdf> accessed 22 May 2022.
[73] UN Climate Change, Finance – *Climate Action Pathway., Greening the Sector, Attracting and Managing Finance to Operate a Sustainable Shift for the Planet.* <https://unfccc.int/climate-action/marrakech-partnership/reporting-tracking/pathways/finance-climate-action-pathway> accessed 22 May 2022.

way is vital because of that exceptional power banks and other financial institutions have on market participants throughout their lending, investment and advisory services.[74] 'Both an increase in private climate finance and a decrease in carbon-intensive financial transactions are required to limit global warming to 1.5°C.'[75]

Commitments of banks to achieve net-zero or Paris aligned emissions in their portfolio mean that they are taking responsibilities to eliminate financing projects that are associated with emission. 'Net-zero' will be achieved when all human-caused greenhouse gas (GHG) emissions will be removed from the atmosphere. This process is known as carbon removal.[76] In order to achieve this goal, there is a need to use 'Scope 3'[77] accounting, according to which actors take responsibility not only for their own operations and supply chains, but also for the business activities of the users of their products. For example, when banks are financing projects that are extensively utilizing fossil fuel, they share the responsibility for the emission that those projects cause.[78] In other words, banks together with their clients are expected to ensure measuring emission in every project that they finance.[79]

Indeed, the financial sector has to play tremendous role to reach the objectives of the Paris Agreement, although it still needs to be transformed in order to consider common goods and long-term public interests for sustainable development. Therefore, the financial system needs to become sustainable as a whole rather than adding a layer to sustainable finance.[80] The financial system requires an overarching strategy with built-in coordinated method and metrics, which will ensure risk assessment not only on a project or portfolio level, but also a clear roadmap for all counterparts

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[74] Bos. J., Wu. Y. *How Banks Can Accelerate Net-zero Emissions Commitments.* (October, 2021) 4. <https://www.wri.org/insights/banks-paris-alignment-net-zero-finance> accessed 22 May 2022.
[75] ibid.
[76] ibid 5.
[77]'The GHG Protocol identifies three scopes for GHG emissions for corporations as a basis for their accounting and reporting obligations. *Scope 1 emissions* refer to emissions from operations that are owned or controlled by the reporting company. *Scope 2 emissions* refer to the emissions from purchased or acquired electricity, steam, heating, or cooling consumed by the reporting company. *Scope 3 emissions* refer to all other indirect emissions (not included in Scope 2) that occur in the value chain, both upstream and downstream of the company. Scope 3 emissions are subdivided into specific categories, such as capital goods, waste generated in operations, business travel, and energy-related activities.' Waslander. J., Bos. J, Wu. Y. *Banking Beyond Climate Commitments: Transforming Client Engagement and Products & Services for a net-zero Emissions Future.* (World Resources Institute, working paper) 7.
[78] ibid.
[79] ibid.
[80] COP21 Ripples Consortium, *Finance after the Paris Agreement: The necessary transformation of the financial system* (Policy Brief, 2019) 1.

in the sector. The increased coordination will ensure a higher level of intra sectoral cooperation and application.[81]

2.3. UN Principles for Responsible Banking

In order to mobilise finance from a private sector for sustainable development, the UN established a partnership between its Environmental Programme and the global financial sector. This partnership is known under the name – United Nations Environment Programme Finance Initiative (UNEP FI), and unites more than 400 banks, insurers, investors and over 100 supporting institutions in order to help the financial sector deliver positive impacts and serve the people and the planet.[82]

The United Nations Environment Programme Finance Initiative has established UN Principles for Responsible Banking,[83] which comprises the unique framework to ensure that strategy and practice of signatory banks[84] are aligned with the vision that global society set out in SDGs and the Paris Climate Agreement. Currently (May 2022), the Principles for Responsible Banking has 280 signatories with total assets of US$ 81 trillion which amounts 45% of global banking assets.[85]

The framework consists of the six principles, which are designed to bring purpose, vision and ambition to sustainable finance. According to the framework, the signatory banks commit to embedding those principles across the entire business areas at the strategic, as well as portfolio and transnational levels.[86] The Principles and their instruments for implementation and

[81]Rydge J *Aligning finance with the Paris Agreement: An overview of concepts, approaches, progress and necessary action.* (London: Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science, 2020) 1.
[82] United Nations Environment Programme Finance Initiative (UNEP FI) <https://www.unepfi.org/about/> accessed 22 May 2022.
[83] UN Principles for Responsible Banking <https://www.unepfi.org/wordpress/wp-content/uploads/2019/07/PrinciplesOverview_Infographic.pdf> accessed 22 May 2022.
[84]Signatories of an UN Principles for Responsible Banking. <https://www.unepfi.org/banking/bankingprinciples/prbsignatories/> accessed 22 May 2022.
[85] ibid.
[86] United Nations Environment Programme Finance Initiative (UNEP FI). Creating the future of banking <https://www.unepfi.org/banking/bankingprinciples/more-about-the-principles/> accessed 22 May 2022.

accountability are seized in three primary documents: The Principles Signature Document,[87] the Key Steps to be Implemented by Signatories,[88] and the Reporting and Self-Assessment Template.[89]

<u>Infographic 2. The Six Principles of Responsible Banking</u>

Source: United Nations Environment Programme, 2019

Discussion on the Six Principles will allow to better understand the role of the UN Principles for Responsible Banking. The overview will be based on the 'Guidance Document or the Principles for Responsible Banking.'[90]

<u>Principle 1: Alignment</u> – bank's business strategy needs to be re-designed aiming at consistency with contributing to all guiding documents (SDGs, the Paris Climate Agreement, and other

[87]The Principles Signature Document. <https://www.unepfi.org/wordpress/wp-content/uploads/2019/07/FINAL-PRB-Signature-Document-2-Interactive-22-07-19.pdf > accessed 22 May 2022.

[88] Key Steps to be Implemented by Signatories <https://www.unepfi.org/wordpress/wp-content/uploads/2019/07/Key-Steps-to-be-Implemented-by-Signatories.pdf> accessed 22 May 2022.

[89]Reporting and Self-Assessment Template. < https://www.unepfi.org/wordpress/wp-content/uploads/2020/12/PRB-Reporting-Guidance-Document.pdf> accessed 22 May 2022.

[90] Guidance Document or the Principles for Responsible Banking. (November, 2021) <https://www.unepfi.org/publications/principles-for-responsible-banking-guidance-document/> accessed 22 May 2022.

relevant frameworks, including the UN Guiding Principles on Business and Human Rights).[91] This will ensure the support to future sustainability in line with achievement of business benefits in the long run.

Principle 2: Impact and Target Setting – If banks target on empowering people, developing sustainable economies and building better sustainable future, they need to identify, assess and improve the impact on people and environment. They shall assess risks and benefits of their activities, products and services; incorporate measures for the assessment, i.e., environmental, social and economic dimensions. As an outcome, they will be able to increase positive and decrease negative impact on people and environment. This will make bank's contributions to society's goals more feasible.

Principle 3: Clients and Customers – Achieving synergies with customers and clients and supporting them in transition towards more sustainable business models, technologies and lifestyles is another principle on the way to sustainability. Bank shall be able to evaluate its impacts, risks and opportunities. This principle is in compliance with the bank's efforts to develop trust in its clients as one of the most important determinants of its success.

Principle 4: Stakeholders – Collective action and partnerships is the basic set of measures for making the required changes. This set includes consulting, engagement, collaboration and/or partnering with stakeholders.[85]

Principle 5: Governance and Culture – All involved parties governing the changes (leadership, Board of Directors, the CEO, and senior and middle management) need to act in the same direction to respond efficiently to the global challenges. Corporate culture requires adjustments so that all employees understand assigned clear roles and responsibilities in achieving the bank's additional goals and 'integrate sustainability in their work and their decision-making'. Management systems including policies, structures, resource allocation and processes shall be effective.

Principle 6: Transparency and Accountability – disclosure and access to information, ensures trust among internal and external stakeholders and objective assessment of the bank's progress on its

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[91] United Nations, *Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework,* 2011 <https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf> accessed 22 May 2022.

efforts for sustainable development. Clear targets and reported progress display effectiveness of the choice and decisions, motivate employees, encourages innovative ideas, strengthens reputation and trust to the company.

In case if regulatory bodies will elaborate on the managing guidelines for financial institutions and administer to follow those principles and implement them in their organizational frameworks, they will be able to speed up changes that address currently existing challenges in sustainable financing.

2.4. OECD Guidelines for Multinational Enterprises

The Organisation for Economic Co-operation and Development (OECD) elaborated on the Guidelines for Multinational Enterprises.[92] These are recommendations on responsible business conduct addressed by governments to multinational enterprises operating in or from the adhering[93] countries.[94] The aim of the guidelines is the promotion of positive inputs by enterprises to environmental and social progress worldwide.[95] Guidelines also recognise, that 'business activities can result in adverse impacts related to workers, human rights, the environment, corruption, consumers and corporate governance.'[96]

The previous chapter discussed how financial institutions can play a key role in the development process of sustainable future. This vital role can be pursued through promoting responsible business conduct (RBC) between their clients and financing projects that can have positive sustainable influences. Directing and scaling up the financial flows will be critical in order to

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[92]OECD Guidelines for Multinational Enterprises (OECD Publishing 2011) <https://www.oecd.org/daf/inv/mne/48004323.pdf> accessed 20 May 2022. The Guidelines were adopted in 1976, but in order to ensure, that in the changing landscape of the global economy, they still remain leading and reliable tool to promote responsible business conduct, the Guidelines have been reviewed several times (the most recent update is from 2011).

[93] The list of adhering countries <https://www.oecd.org/investment/mne/oecddeclarationanddecisions.htm> accessed 20 May 2022.

[94] OECD Guidelines for Multinational Enterprises (OECD Publishing 2011) <https://www.oecd.org/daf/inv/mne/48004323.pdf> accessed 20 May 2022.

[95] ibid.

[96] OECD, *Due Diligence for Responsible Corporate Lending and Securities Underwriting: Key considerations for banks implementing the OECD Guidelines for Multinational Enterprises* (2019) 8. < http://mneguidelines.oecd.org/due-diligence-for-responsible-corporate-lending-and-securities-underwriting.pdf > accessed 20 May 2022.

achieve SDGs and goals set out by the Paris Agreement. In order to contribute to sustainability goals, businesses need to embed responsible business conduct in their activities and across their value chains through strong due diligence process. In that case, banks can ensure that their financial flows are ultimately benefiting the people and the planet. [97]

The concept and definition of due diligence can be interpreted variously, but according to the OECD Guidelines for Multinational Enterprises, due diligence for responsible business conduct, in the context of banking is a process led prior[98] to offering financing or services to a client with the purpose of identifying and assessing financial, legal or reputational risks to the bank rather than preventing an impact on client's operations. In this context, the term 'environmental and social risk' refers to describing of how responsible business conduct issues may impact banks, its clients and shareholders. Due diligence for responsible business conduct should also prevent and anticipate adverse impacts which may help banks protect their reputation, improve stakeholder relationships, create more value for their clients and contribute to the society. It also helps to meet legal requirements such as local labour and environmental laws. In case of corporate lending and securities underwriting, it is important to have ex-ante due diligence process ready to prevent and avoid financing or even securities underwriting services to the clients that cause, contribute or are linked to substantial adverse responsible business conduct impacts. Based on the above mentioned, it is important to stress on the fact that due diligence should be ingrained in banks' risk management and decision-making process.[99]

The OECD Guidelines for Multinational Enterprises is an important document among others addressing the need for complex approach to the banks, its clients and shareholders for long-term sustainable development.

[97] ibid 7.

[98] 'Due diligence is preventative – The purpose of due diligence is first and foremost to avoid causing or contributing to adverse impacts on people, the environment and society, and to seek to prevent adverse impacts directly linked to operations, products or services through business relationships. When involvement in adverse impacts cannot be avoided, due diligence should enable enterprises to mitigate them, prevent their recurrence and, where relevant, remediate them.' ibid 8.

[99] ibid 14-17.

3. Sustainable Finance in Europe - ESG Regulations and Instruments

'Climate change and environmental degradation are an existential threat to Europe and the world.'[100] Furthermore, social and governance factors are becoming more prominent in the financial sector. The EU stands at the frontline of rapid development of ESG measures, which will be fully ingrained into business operations across the entire financial market. This chapter discusses the aim of sustainable finance, all important legal frameworks and instruments within the EU and overviews the EU's ambitions and steps towards sustainable financial institutions.

3.1. Sustainable Finance

The concept of sustainable finance gained its recognition in the last decade, embedding sustainability at different levels of both the society and the financial system.[101] It is acknowledged as a process, which encourages investors to make investment decisions according to ESG considerations leading to even longer-term investments.[102] The EU policy assumes that sustainable finance simultaneously aids economic growth through activation of social and governance factors and decreasing the environmental impact. ESG related risks are covered by the transparency requirements of sustainable finance. [103]

One of the most important lessons learnt from the 2007-2009 financial crisis is that the financial markets lacked transparency and long-term sustainability as well as proper regulation. This finding together with the final report of the High-Level Expert Group on Sustainable Finance,[104] has

[100] European Commission, Consolidated Version of the *European Green Deal. Striving to be the first climate-neutral continent*, COM (2019) 640 final, 11 December 2019 <https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en> accessed 1 May 2022.
[101] Flammer, C. (2021). Corporate green bonds. *Journal of Financial Economics* (May 14, 2021) < https://doi.org/10.1016/j.gfj.2013.07.006 > accessed 1 May 2022.
[102] European Commission, *Overview of Sustainable Finance* < https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en > accessed 1 May 2022.
[103] ibid.
[104] A technical expert group (TEG) on sustainable finance was set up by the Commission to aid it in the elaboration of a unified classification system for sustainable economic activities and low-carbon index methodologies, but also on an EU green bond standard (Action 2 of the Action Plan) and on climate-related disclosure metrics (Action 9 of

resulted in more appropriate regulation and served as a foundation for the EU Action Plan on Sustainable Finance.[105]

Sustainable finance plays an important role in the process of delivering policy objectives under the EU Green Deal, EU's commitments on climate change and sustainability objectives on an international level. 'It does this by channelling private investment into the transition to a climate-neutral, climate-resilient, resource-efficient and fair economy, as a complement to public money.'[106]

In 2018, the European Commission adopted its first action plan on sustainable finance.[107] It served as a first major step to direct private financial flows for investments that support the target of the Paris Agreement of a carbon-neutral economy by 2050. Since then, the EU has taken several steps towards a sustainable finance system, which includes but is not limited to: the EU Taxonomy,[108] the Sustainable Finance Disclosure Regulation (SFDR),[109] the Corporate Sustainability Reporting Directive (CSRD)[110] and the European Green Bond Standard.[111]In July 2021 the EU Commission adopted the new sustainable finance strategy within the framework of the EU Green Deal.[112] It follows the Commissions 2018 Sustainable Finance Action Plan and sets out a number of legislative and regulatory initiatives. The aim of the new regulatory initiative is to support the

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the Action Plan). <https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en> accessed 6 May 2022.

[105] KPMG, *EU Sustainable Finance Explained: An overview. How to navigate within new legislative proposals for Sustainable Finance set up by European Commission?* <https://home.kpmg/se/sv/home/campaigns/2020/06/eu-sustainable-finance-explained-an-overview.html> accessed 6 May 2022.

[106]EU Commission, *Overview of Sustainable Finance* <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en> accessed 6 May 2022.

[107] European Union, Action Plan of the Commission for Financing Sustainable Growth, COM/2018/097, 3 March 2018 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097> accessed 6 May 2022.

[108] Council Regulation (EC) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L198/13 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&qid=1647792943731&from=EN> accessed 6 May 2022.

[109] Council Regulation (EC) 2019/2088 of 27 November 2019 on Sustainability-related disclosures in the financial services sector, OJ L317/1 < https://eur-lex.europa.eu/eli/reg/2019/2088/oj> accessed 6 May 2022.

[110] Proposal for a Directive of the European Parliament and of the Council, amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM/2021/189 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0189> accessed 6 May 2022.

[111] Proposal for a Council Regulation (EC) on European Green Bonds. {SEC(2021) 390 final} - {SWD(2021) 181 final} - {SWD(2021) 182 final} 6 July 2021. COM (2021) 391 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0391> accessed 6 May 2022.

[112] EU Commission. Strategy for financing the transition to a sustainable economy. <https://ec.europa.eu/info/publications/210706-sustainable-finance-strategy_en> accessed 6 May 2022.

financing of sustainable economic activities. To fulfil this goal, the Commission proposes initiatives in four different areas: 1. Financing the path of the real economy towards sustainability; 2. Supporting a green recovery towards more inclusive sustainable finance; 3. Improving the financial sector's resilience and contribution to sustainability; 4. Fostering global ambition.[113]

3.2. The EU Green Deal

At the end of 2019, the European Union announced its EU Green Deal,[114] referred as 'man on the moon' moment by the president of the EU Commission, Von der Leyen.[115] The overarching aim of the EU Green Deal is to transform the region into a 'modern, resource-efficient and competitive economy.'[116] The EU pursues an ambition 'to becoming the first climate-neutral bloc in the world.'[117] One cannot expect that EU's transition to sustainable economy will take place in a short-term period, rather, it requires time and significant investment efforts from the EU, its members and private actors – especially the financial institutions. The European Green Deal's Investment Plan applies efforts to attract private investments, mobilise green investments, and extend its goals to various sectors – including energy, transport, food, biodiversity and construction.[118] In order to reach no net emission of greenhouse gases by 2050 and transform the bloc into green economy,

[113] ibid.
[114] European Commission, Consolidated Version of the *European Green Deal. Striving to be the first climate-neutral continent*, COM (2019) 640 final, 11 December 2019 <https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en> accessed 1 May 2022.
[115] Press remarks by President Von der Leyen on the occasion of the adoption of the European Green Deal Communication. 11 December 2019. Brussels. <https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_19_6749> accessed 1 May 2022.
[116] European Commission, Consolidated Version of the *European Green Deal. Striving to be the first climate-neutral continent*, COM (2019) 640 final, 11 December 2019 <https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en> accessed 1 May 2022.
[117] European Commission. Financing the green transition: *The European Green Deal Investment Plan and Just Transition Mechanism*, 14 January 2020, Brussels <https://ec.europa.eu/commission/presscorner/detail/en/ip_20_17> accessed 1 May 2022.
[118] ibid.

the Commission intends to invest €1 trillion by 2030 and expects that over the next 10 year period the number of private sector investments will reach €2.5 trillion in total.[119]

3.3. Circular Economy Action Plan

In March 2020, the European Commission adopted a new circular economy action plan[120] which, in fact, is one of the key parts of the EU Green Deal. The main goal of the circular economy action plan is to reduce pressure on natural resources to support sustainable growth and more job opportunities.

The action plan is focused to ensure that resources used for production will remain in the EU economy for as long as possible. It also targets at decreasing the EU's consumption footprint by increasing its circular material usage. At the same time, governments tend to popularise circular economy and inspire the 3Rs approach - Reduce, Reuse and Recycle - in the waste management system.[121]

The circular economy action plan aims to promote circularity in production process and generate stimuli for the whole Europe, ensure lower levels of waste and make sustainable product a standard for the EU. This approach will empower consumers with the possibility to access reliable information about products, including their life span. The plan focuses on the sectors that are using most resources but at the same time have potential for circularity and implementation of the 3Rs approach, like electronics, batteries and vehicles, plastics, packaging, textiles, food, water, nutrients, construction and buildings and finally it aims to create a well-functioning EU market for secondary raw materials.[122]

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[119] Brül. V. *Green Finance in Europe – Strategy, Regulation and Instruments (*Intereconomics, Volume 56, 2021. Number 6) 323-330. < https://www.intereconomics.eu/contents/year/2021/number/6/article/green-finance-in-europe-strategy-regulation-and-instruments.html> accessed 2 May 2022.

[120] EU Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions *a new Circular Economy Action Plan For a cleaner and more competitive Europe*, 11 March 2020**,** COM/2020/98 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1583933814386&uri=COM:2020:98:FIN> accessed 6 May 2022.

[121] Jones. S. *Advancing a Circular Economy, A Future Without Waste?* (Springer 2021) 4.

[122] EU Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions *a new Circular Economy Action Plan For a*

According to the EU Commission, application of measures for circular economy in Europe can result in significant improvements in the economy – increase the gross domestic product (GDP) by an additional 0.5% by 2030 and create around 700 000 new jobs.[123]

According to the Digest prepared by Platform voor Duurzame Financiering, 'the financial sector, as a financier of circular companies, can play an important role in accelerating the transition to a circular economy'. Based on the example of the De Nederlandsche Bank, the same source informs: 'The working group believes that by 2030 circular considerations should be an integral part of the assessment of funding applications and investment decisions. To achieve this, the working group proposes four concrete actions for the financial sector in its roadmap to a circular economy in 2030'.[124] The actions are discussed below:

- Consider linear and circular risks into financing decisions. Linear risk is defined as the risk of interruption of operations if companies follow the assumption of infinite resources. This risk shall be unambiguously considered in financing decisions. Realistic approach to assessing the circular risks can be ensured by focusing models on the future aiming at clarities of the future cash flows, long-term stability goals and accurate chain contracts. Weigh circular metrics in financing by the inclusion of circular metrics in financing to make the processes more transparent, allow for verification by outside parties, proper benchmarking, and reduction of the risk of greenwashing.
- Build up experience by closing landmark deals and opening-up more opportunities for financing of circular-type business plans with at least one new element of circular finance. New endeavours will be based on the shared experience of circularity matrices, assessment of risks and opportunities provided by circularity, as well as existing practices of how financial institutions will be using this information. This will create the ground for standardized and publicly available documentation and stimulate future deals.
- Optimise and further broaden the range of financing instruments will ensure quick progress in achieving the state in the business when circular financing becomes a standard. This means

cleaner and more competitive Europe, 11 March 2020, COM/2020/98 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1583933814386&uri=COM:2020:98:FIN> accessed 6 May 2022.

[123]EU commission *Changing how we produce and consume: New Circular Economy Action Plan shows the way to a climate-neutral, competitive economy of empowered consumers* (Press release, 11 March 2020, Brussels) < https://ec.europa.eu/commission/presscorner/detail/en/ip_20_420> accessed 6 May 2022.

[124] Platform voor Duurzame Financiering. *The Financial Sector as a driver of Circular Economy* <https://www.dnb.nl/media/jn5jlebg/20220202-pdf-finance-roadmap-digest-en.pdf> accessed 25 May 2022.

development of appropriate financing with more risk capital for early-stage circular companies. ‘Blended finance, government funding and financial innovation also all play an important role in accelerating the timeframe within which this shift can happen’.[125]

4. Sustainable Finance Disclosure tools

4.1. EU Taxonomy

The EU sets and leads ambitious agenda towards sustainability. High-Level Expert Group on Sustainable Finance recommended the EU Taxonomy[126] as a tool to elevate finance to sustainability. The EU Commission responded with a 10-step action plan to reform the financial system, of which the EU Taxonomy was the key legal proposal.[127]

In its simplest understanding, ‘the EU Taxonomy is a green classification system that translates the EU’s climate and environmental objectives into criteria for specific economic activities for investment purposes.’[128] It ‘provides clarity via a common language for investors, issuers, policymakers and regulators’ and plays a vital role in the development of sustainable finance.[129]

The EU Taxonomy can be considered as an assistance tool for stakeholders in making the informed decision about environmentally friendly economic activities. Well-informed decisions, in their

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[125] ibid

[126] Regulation (EU) 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 (Text with EEA relevance), OJ L198/13 < https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852 > accessed 7 May 2022.

[127] EU Technical Expert Group on Sustainable Finance *Financing a Sustainable European Economy Using the Taxonomy (*Supplementary Report 2019) 4.

[128] European Commission *What is EU Taxonomy and How Will it Work in Practice?* 1.

[129] Principles for Responsible Investment, *Investor briefing EU Taxonomy* (updated April 2022) 12.

turn, help stakeholders to significantly influence the environmental objectives and create better motivation for transition process towards a more sustainable economy.[130]

The objective of the EU Taxonomy is to meet Sustainable Development Goals, as well as commitments according to the Paris Agreement and other environmental goals. Involvement of private stakeholders and re-directing capital into environmental and sustainable areas will make those processes realistic and smooth. Development of classification is based on technical and scientific definitions,[131] promotes transparency, long-term vision, and prevents 'greenwashing.'[132] It is important that the EU Taxonomy does not prohibit investment in any activity, and 'investors are free to choose what to invest in.'[133]

Indeed, the EU Taxonomy is a centrepiece of the EU Action Plan on Sustainable Finance. It is a legislative proposal, which forms the foundation of EU objectives, like possible changes to central bank policies, the EU Green Bond Standard and the EU Ecolabel.[134]

In order for an economic activity to be considered as sustainable, it must contribute to at least one from six environmental objectives. According to the regulation, the six environmental objectives are: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; prevention and control of pollution; and protection and restoration of biodiversity and ecosystems.[135] At the same time, economic activity should not only contribute to one of those six environmental objectives, but also it cannot harm any of the remaining objectives significantly. Except the above-mentioned criteria, it is also important that an economic activity meets the 'minimum safeguards' such as the OECD Guidelines

[130] Morningstar, *The EU Sustainable Finance Taxonomy Explained* (202) 2.
[131] Birindelli. B. and others, *Climate Change: EU taxonomy and forward-looking analysis in the context of emerging climate related and environmental risks (*Risk Management Magazine, Vol. 15, Number 3, September-December 2020) 49.
[132] In the context of Regulation (EU) 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 (Text with EEA relevance), OJ L198/13, greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852> accessed 7 May 2022.
[133] European Commission, *What is the EU Taxonomy and how will it work in practice?* 1.
[134] ibid.
[135] Regulation (EU) 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 (Text with EEA relevance), OJ L198/13, para. 23. < https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852 > accessed 7 May 2022.

for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights and the core Labour Organisation Conventions not to have a negative social impact.[136]

The EU Taxonomy envisions economic activities as contributors to one of the six environmental objectives and are distinguished between three different types. First type is an economic activity that makes 'substantial contribution'[137] based on its own performance. The second type – 'Enabling economic activity'[138] is an economic activity, that stimulates and enables other activities to make a significant contribution through their products or services. And the third type of economic activity is 'transitional'[139] economic activity, under which fall businesses for which low-carbon alternatives are not yet available and which in fact have greenhouse gas emission levels that correspond to the best environmental performance in the sector.

In order to determine economic activities contributing significantly to one of the environmental objectives and not harming any other objectives, the EU Taxonomy obliges the European Commission to develop delegate acts[140] which will set the 'technical screening criteria'. The first delegate act – the Taxonomy Climate Delegate Act[141] sets criteria for the sectors, whose activities are most relevant in the process of achieving climate neutrality. This involves sectors like energy, forestry, manufacturing, transport and buildings.[142] The Climate Delegate Act contains technical screening criteria for almost 80 climate change mitigation activities and up to 100 climate change adaptation activities. It also sets the criteria to assess whether or not certain economic activities have caused no significant harm to any other environmental objectives.[143]

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[136] Principles for Responsible Investment, *Investor briefing EU Taxonomy* (updated April 2022) 8.

[137] Regulation (EU) 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 (Text with EEA relevance), OJ L198/13, article 15 < https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852 > accessed 7 May 2022.

[138] ibid, article 16.

[139] ibid, article 10 (2).

[140] Delegate Acts will be living documents that will be added to over time and updated as necessary. European Commission, *What is EU Taxonomy and How Will it Work in Practice?* 1.

[141] Commission Delegated Regulation (EU), C/2021/2800 final, 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, C/2021/2800 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=PI_COM:C(2021)2800> accessed 14 May 2022.

[142] ibid.

[143] Principles for Responsible Investment, *Investor briefing EU Taxonomy* (updated April 2022) 11.

The Disclosure Delegate Act,[144] points out an entry-level reporting requirement for undertakings covered by Article 8 of the EU Taxonomy Regulation. To be more specific, it means that undertakings, that fall under the Non-Financial Reporting Directive are set to be adjusted by the Corporate Sustainability Reporting Directive.[145]

The Disclosure Delegate Act differentiates 'taxonomy-eligible' and 'taxonomy-aligned' economic activities. According to Article 1(5), 'taxonomy-eligible activity is an activity […] irrespective of whether that economic activity meets any or all of the technical screening criteria laid down in those delegated acts.' In contrast, 'Taxonomy-aligned' economic activities meet said technical screening criteria.

The Disclosure Delegate Act has introduced reporting requirements. According to the act, from January 1st, 2022, all undertakings must disclose what share from their total economic activity is taxonomy-eligible.[146] From January 1st, 2023, non-financial undertakings will have to report what is the share of taxonomy-aligned economic activity and the report has to cover all of the six environmental objectives. Starting from January 1st, 2024, all of the financial undertakings have to perform the same.[147] The Key Performance Indicators (KPIs)[148] require that non-financial undertakings must be disclosed if they are related to capital expenditure, operating expenditure and turnover. Those are specified under the article 8 of the EU Taxonomy Regulation. Therefore, the Disclosure Delegate Act explains that financial institutions must disclose KPIs which relate to the proportion of taxonomy-aligned activities in their financial activities and provide comprehensive requirements for investment firms, asset managers and insurers and reinsurers.[149] Under the EU Taxonomy, asset managers, as well as institutional investors are required to explain

[144] Commission Delegated Regulation (EU) 2021/2178 of 6 July 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by specifying the content and presentation of information to be disclosed by undertakings subject to Articles 19a or 29a of Directive 2013/34/EU concerning environmentally sustainable economic activities, and specifying the methodology to comply with that disclosure obligation (Text with EEA relevance) OJ L443/9 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2021.443.01.0009.01.ENG> accessed 12 May 2022.
[145] Principles for Responsible Investment, *Investor briefing EU Taxonomy* (updated April 2022) 14.
[146] Reporting is limited to EU Taxonomy's climate objectives, since the other four environmental objectives have not yet been covered in a delegate act.
[147] ibid.
[148] These indicators are not appropriate for demonstrating to what extent the economic activities of financial undertakings that fall under the scope of Article 8 are taxonomy-aligned.
[149] ibid.

whether and how they have used the Taxonomy criteria when marketing their products as environmentally sustainable.[150]

The EU Taxonomy applies to financial market participants who are offering financial products in the EU. According to the Sustainable Finance Disclosure Regulation (SFRD),[151] financial products, that are subject of the EU Taxonomy are defined as portfolio managed, an alternative investment fund, an insurance-based investment product, a pension product and a pension scheme, an Undertakings for Collective Investment in Transferable Securities (UCITS) fund, or a Pan-European Personal Pension Product.[152] It also applies to large financial and non-financial undertakings[153] that are already required to provide a non-financial statement under Non-Financial Disclosure Regulation (NFDR). The number of companies might extend after the European Council and the Parliament will approve proposed Corporate Sustainability Reporting Directive (CSRD).[154] The EU Taxonomy also applies to the EU member states that are required to set out requirements for financial market participants or issuers in respect of environmentally sustainable financial products or corporate bonds.[155]

4.2. Sustainable Finance Disclosure Regulation (SFDR)

The EU's Sustainable Finance Disclosure Regulation (SFDR) entered into force in March 2021. It creates a comprehensive reporting framework for financial products and financial entities[156] and 'stresses social and environmental compliance disclosure and reporting obligations for financial

[150] EU Technical Expert Group on Sustainable Finance, *Financing a Sustainable European Economy Using the Taxonomy (*Supplementary Report 2019) 3.
[151] 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 (Text with EEA relevance), OJ L317/1 <https://eur-lex.europa.eu/eli/reg/2019/2088/oj> accessed 12 May 2022.
[152] Principles for Responsible Investment, *Investor briefing EU Taxonomy* (updated April 2022) 7.
[153] Reporting requirements for financial market participants and large companies have applied since 1 January 2022.
[154] Proposal for a Directive of the European Parliament and of the Council, amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM (2021) 189 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189> accessed 12 May 2022.
[155] Principles for Responsible Investment, *Investor briefing EU Taxonomy* (updated April 2022) 7.
[156] European Commission *What is the EU Taxonomy and how will it work in practice?* 3.

services participants.'[157] The aim of SFDR is to direct capital into more sustainable investments and increase transparency, which is directed to preventing the greenwashing.

The SFDR is a 'Level 1' regulation, pointing to the fact that it sets out high level detailed obligations and rules to the firms. Those rules are being published as 'Level 2'[158] or as part of the Regulatory Technical Standards (RTS).[159] According to the SFDR Level 1 rules, financial market participants are required to publish information on their websites about:

- Their policies on the integration of 'sustainability risks' in the investment decision making process;[160]
- Their due diligence policies with respect to 'principal adverse impacts' of investment decisions on sustainability factors - or reasons why they don't consider such impacts;[161]
- How sustainability risks are integrated in their remuneration policy.[162]

According to article 2 of the SFDR,[163] the regulation sets disclosure requirements for financial market participants (FMPs) and financial advisors (FAs) operating or advertising themselves in the EU, as well as market participants with EU shareholders. Financial Market Participants include:

- An insurance company that makes available an insurance-based investment product (IBIP);
- Investment firms that provide portfolio management;
- An institution for occupational retirement provision (IORP);
- A manufacturer of pension products;

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[157] Bengo, I., Boni, L., & Sancino, A. (2022). *EU financial regulations and social impact measurement practices: A comprehensive framework on finance for sustainable development.* Corporate Social Responsibility and Environmental Management. 1.
[158] John Berrigan, deputy director-general for financial stability, financial services and capital markets union at the European Commission, wrote, 'Due to the length and technical detail of those 13 regulatory technical standards, the time of the submissions to the Commission, and to facilitate the smooth implementation of the delegated act by product manufacturers, financial advisers and supervisors, we would defer the date of application of the delegated act to 1 January 2023.' <https://www.esma.europa.eu/sites/default/files/library/com_letter_to_ep_and_council_sfdr_rts-j.berrigan.pdf> accessed 16 May 2022.
[159] Lysak. O. Houston. C, Juwadi. R. *EU SFDR – What's Happening in the market?* Wolters Kluwer Legal & Regulatory (VOL. 28, NO. 12 December 2021) 17.
[160] Council Regulation (EC) 2019/2088 of 27 November 2019 on Sustainability-related disclosures in the financial services sector, OJ L317/1, *Article 3* < https://eur-lex.europa.eu/eli/reg/2019/2088/oj> accessed 6 May 2022.
[161] ibid *article 4.*
[162] ibid *article 5.*
[163] ibid article 2.

- An alternative investment fund manager (AIFM);
- A pan-European personal pension product provider (PEPP);
- Manager of a qualifying venture capital fund;[164]
- Manager of a qualifying social entrepreneurship fund;[165]
- A management company for Undertakings for the Collective Investments in Transferable Securities (UCITS).
- A credit institution that provides portfolio management.

According to article 1 of the Regulation (EU) 2019/2088 (SFDR),[166] disclosure obligations are divided into three categories:

1. The adverse impacts of investment decisions on sustainability factors;
2. Considering sustainability (ESG) risk in investment processes;
3. Provision of sustainability information with respect to financial products.

Adverse impact of sustainable finance means that required firms, have to disclose all of the potential negative consequences on sustainability factors prior to making an investment decision. Environmental aspects of sustainability factors may include water consumption, energy performance, while social aspects of sustainability factors include but are not limited to the respect for human rights, labour rights and other social issues.

As firms need to consider sustainability risks into investment process by disclosing all ESG events, this could negatively impact material investment and bring their remuneration policies in line with sustainability risk management.

Financial market participants have to distinguish their funds in relation to sustainability risks in one of the three categories which are laid out in Articles 6, 8 and 9 and describe type of all possible funds.

[164] Registered in accordance with Article 14 of Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds Text with EEA relevance, OJ L115 <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:115:0001:0017:EN:PDF > accessed 16 May 2022.
[165] ibid, Article 15.
[166] Council Regulation (EC) 2019/2088 of 27 November 2019 on Sustainability-related disclosures in the financial services sector, OJ L317/1, *Article 1* < https://eur-lex.europa.eu/eli/reg/2019/2088/oj> accessed 16 May 2022.

Article 6 covers funds, 'that do not deem sustainability risks to be relevant'[167] and do not integrate ESG considerations into the investment decision making process, or explain where integration is not relevant, where products do not meet the criteria of article 8 or 9. It could include stocks, which at the moment are excluded by ESG funds, for example, coal producers. As the thesis already acknowledged, investors are free to invest where they plan to, but it is predictable that in today's world, non-sustainable funds can face substantial marketing difficulties against more sustainable funds.

There are two categories of ESG friendly funds: those that support environmental and social sustainability (covered by the article 8 of the SFDR), or funds, that have sustainable investment as an objective (covered by the article 9 of the SFDR).[168]

Article 8 under the 'EU taxonomy' chapter includes products promoting social or environmental characteristics. Although, they may not fall under any sustainable investments, sometimes pointed as 'light green products' on the market, or may make up some amount of portfolio investing in sustainable investments, referred as 'mid green' funds.[169] This article states, that the description of a financial product must include information about how environmental and social features are addressed and what methodology was applied for the measurement of those features.[170] When considering the eligibility for financial products, investments in pre-selected sectors will benefit from an advantage in sustainability criteria compared to their peers. This factor leads to the fact that investment solutions that are offering better ESG performances, have better chances to generate enhanced financial returns.[171]

A financial product under the Article 9 (1), (2), (3) of the SFDR applies to a wide range of underlying assets, which are qualified as 'sustainable investments' according to article 2 (17). Moreover, article 5 and Recital 19 to the Regulation (EU) 2020/852[172] additionally clarify that

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[167] Lysak. O. Houston. C, Juwadi. R. *EU SFDR – What's Happening in the market?* Wolters Kluwer Legal & Regulatory (VOL. 28, NO. 12 December 2021) 7.
[168] ibid 8.
[169] ibid 18.
[170] Bengo, I., Boni, L., & Sancino, A. *EU financial regulations and social impact measurement practices: A comprehensive framework on finance for sustainable development.* Corporate Social Responsibility and Environmental Management (2022) 7.
[171] ibid.
[172] Regulation (EU) 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 (Text with EEA relevance), OJ L198/13 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32020R0852> accessed 16 May 2022.

‘sustainable investments’ include investments into ‘environmentally sustainable economic activities.[173] Sometimes article 9 products are referred as ‘dark green’ products.

Summarising the above part of the paper leads to the idea that the SFDR helps organisations to focus on ESG risks during the investment decision-making process and reduce/prevent greenwashing. The SFDR is acknowledged as a complement to the EU taxonomy, which establishes the understanding about whether an economic activity is environmentally sustainable. When fulfilling the obligations under the SFDR, it also discloses requirements from the taxonomy and vice-versa – firms have to follow the EU Taxonomy in order to comply with the SFDR.

4.3. Corporate Sustainability Reporting Directive (CSRD)

Investors and stakeholders are increasingly asking for sustainability standards in order to invest in a more responsible, sustainable way. Hence, because the Non-Financial Reporting Directive (NFRD) [174] appeared unable to respond to stakeholders’ demands, the EU faced the reality and need for elaborating a new reporting directive to respond to the new demands towards sustainable finance.

In April 2021, the European Commission published a proposal for Corporate Sustainability Reporting Directive (CSRD)[175] in order to revise and strengthen rules introduced by the NFRD.

The reporting rules according to NFRD recognised some key principles for ‘public interest entities’ with more than 500 employees on annual basis and introduced a ‘double materiality perspective’ which means that companies have to report about sustainability issues that affect their businesses and the ways they are affected. They also are required to report about their own impact on the

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[173] ibid.

[174] Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups Text with EEA relevance, *OJ L 330/1* <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095> accessed 16 May 2022.

[175] Proposal for a Directive of the European Parliament and of the Council, amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM/2021/189 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189> accessed 16 May 2022.

people and the environment.[176] However, the information that companies reported under the NFRD was not enough, was hardly comparable to other companies and was almost impossible to assess the level of reliability of that information. Considering these shortfalls, investors lacked a trustful sustainability-related overview of risks to the companies they were interested to invest in.[177]

The CSRD aims to ensure that the information disclosed by the companies will be adequate. It will require reported information to be consistent with the EU regulations and reliable, comparable and easy to understand. It also aims to reduce unnecessary costs and make it cost-efficient for the companies to report.[178]

The proposal will apply to all of the large companies,[179] listed on the EU regulated markets. From January 2026, the reporting requirements will also cover all listed small and medium-sized enterprises (SMEs).[180] It will also apply to a 'large undertakings'[181], credit institutions and insurance undertakings regardless of their legal form.[182] The companies under the CSRD would

[176] European Commission, *Questions and Answers: Corporate Sustainability Reporting Directive Proposal.* < https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_1806> accessed 16 May 2022.

[177] ibid.

[178]E&Y, *How the EU's new sustainability directive will be a game changer* (July, 2021) <https://www.ey.com/en_no/assurance/how-the-eu-s-new-sustainability-directive-will-be-a-game-changer> accessed 16 May 2022.

[179] It is expected that 49 000 companies will be required to report under CSRD, compared to 11 600 companies at present.

[180] The directive provides simplified reporting obligations for listed SMEs.

[181] According to Accounting Directive an entity that meets two of the following three criteria: a net turnover of more than €40 million; balance sheet assets greater than €20 million; more than 250 employees.

[182] E&Y, *How the EU's new sustainability directive will be a game changer* (July, 2021).

have to report sustainability issues not only on environmental factors, but also social[183] and governance[184] factors.[185]

The standards for the new reporting are to be developed by the European Financial Reporting Advisory Group (EFRAG), aiming to meet stakeholders' comprehensive requirements. They will follow the 'double materiality' concept, meaning that both, 'impact materiality' and 'financial materiality' perspectives will be applied in their own right.[186] The Commission also targets to adopt additional, second set of reporting standards[187] by October 2023, which will specify corresponding sustainability information, including sector-specific considerations that companies should report about.[188]

According to the proposal, one of the most important innovations is the fact that the Commission is providing sustainability reporting status which will be equally important as financial reporting. Companies will be responsible for integrating sustainability reports in their management reports. Additional significant change is that the company's management becomes liable for sustainable reporting. Therefore, understandably, the Commission intends to audit the content of the report.

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[183] 'Social factors would include: equal opportunities for all, including gender equality and equal pay for equal work, training and skills development, and employment and inclusion of people with disabilities; working conditions, including secure and adaptable employment, wages, social dialogue, collective bargaining and the involvement of workers, work-life balance, and a healthy, safe and well-adapted work environment; respect for the human rights, fundamental freedoms, democratic principles and standards established in the International Bill of Human Rights and other core UN human rights conventions, the International Labour Organization's Declaration on Fundamental Principles and Rights at Work and the ILO fundamental conventions and the Charter of Fundamental Rights of the European Union.' Simmons + Simmons, EU Proposal for Corporate Sustainability Reporting Directive (CSRD), EU's proposal to widen the scope and ESG disclosure requirements on the NFRD. June, 2021. <https://www.simmons-simmons.com/en/publications/ckq2dt9nx1jdk0957na53e2j3/eu-proposal-for-a-corporate-sustainability-reporting-directive-csrd->accessed 16 May 2022.

[184] 'Governance factors would include: the role of the undertaking's administrative, management and supervisory bodies, including with regard to sustainability matters, and their composition; business ethics and corporate culture, including anti-corruption and anti-bribery; the undertaking's political engagements, including its lobbying activities; the management and quality of relationships with business partners, including payment practices; and the undertaking's internal control and risk management systems, including for the reporting process.' ibid.

[185] ibid.

[186] E&Y, *How the EU's new sustainability directive will be a game changer* (July, 2021) <https://www.ey.com/en_no/assurance/how-the-eu-s-new-sustainability-directive-will-be-a-game-changer> accessed 16 May 2022.

[187] The Commission will review the standards every three years after the directive has been applied to take into account new developments.

[188]E&Y, *How the EU's new sustainability directive will be a game changer* (July, 2021) <https://www.ey.com/en_no/assurance/how-the-eu-s-new-sustainability-directive-will-be-a-game-changer> accessed 16 May 2022.

According to the proposal, the EU member states should transpose the new directive into their national law by the end of 2022. Hence, from January 2023, all companies need to comply with the new rules.[189]

To summarise, the new proposal is aiming to adequately respond to stakeholders' expectations and demands. Companies will have to disclose all necessary information about sustainability issues and risks that they are facing in order to provide an investor a reliable big picture to encourage and ensure much more sustainable investing.

5. Conclusion

The thesis considers research of practical implications of sustainability regulatory framework as a significant contribution to the on-going processes. All parts of the paper prove that sustainable finance in general, and sustainable investing in particular, leads the processes in financial services and is at the top of the world's agenda. The growing interest of stakeholders in sustainable investment indicates that investors started extensively incorporating long-term financial risk and opportunities assessment into their decision-making processes in order to reasonably influence financial and overall performance and generate sustainability.[190] This path is clearly seen and supported in the interviews conducted under the research. Different representatives of the sector provided their insights on the current and potential developments.

Henrik Immelborn, Managing Director, Debt Solutions and Loans, Nordea[191] points out, that investors are focused on different ESG components, and at different degrees. Some are focused on 'E', some on 'S'. Most of them are concentrated on 'G' because everybody expects that at least large listed corporations have good governance in place.

Hans-Ulrich Beck, Global Head of ESG Products from Morningstar-Sustainalytics[192] shares his opinion that there is a growing desire to align investment decisions with sustainability objectives

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[189] ibid.
[190] See p. 16.
[191] The largest financial group in the Nordics;
[192] Sustainalytics, a Morningstar Company, provides high-quality, analytical environmental, social and governance (ESG) research, ratings and data to institutional investors and companies. Sustainalytics' Corporate Solutions unit

through sustainable investments. This trend starts actively penetrating in the retail investor market. A growing realisation of the materiality of certain ESG factors is also observed which results in plans for integration of ESG into portfolio risk management processes. This starts characterising the institutional market.

Partner of one of the 'Big Four' consulting companies (decided to remain anonymous) highlighted that investor sees that if ESG risks are not managed properly, it can threaten their portfolio which logically will affect their finances, so 'if you are on the right side of an investment, it will benefit you.'[193]

The sustainable finance needs to be framed with systematic, influential and powerful legislation. This may happen when it falls in the centre of policymakers' attention.

Research Questions stated in the thesis are designed to study and analyse the international and regional (on the EU level) legal instruments for sustainable investing, its capabilities and potential strengths for sustainable future.

5.1. *Research Question 1*

Legal Instruments Designed for Sustainable Investing in the EU and Globally

The study found that the goal of sustainable development of financial sector is well equipped with relevant legislation related to ESG investments on international and regional levels.[194] The Paris Agreement, Agenda 2030, the UN Principles for Responsible Banking, as well as the OECD guidelines for Multinational Enterprises, together with the EU Green Deal, the Sustainable Finance action plan, the Sustainable Finance Disclosure Regulations (SFDR, CSRD) and other important international instruments (which the thesis is not covering due to its limited scope and the nature), highlight that the ground for sustainable finance and general sustainability is emerging and the financial sector plays a major role in this process. Are those tools and instruments sufficient? Does

works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices and capital projects. For more information <https://www.sustainalytics.com> accessed 25 May 2022.

[193] The Big four firms in management consulting are Deloitte Touche Tohmatsu (Deloitte), KPMG International (KPMG), PricewaterhouseCoopers (PwC), and Ernst & Young (EY).

[194] See page 25.

this set of frameworks realistically support the livelihood of the idea of sustainable future? Analysis leads to the second Research Question.

5.2. *Research Question 2*

To what extent the legal instruments designed for sustainable investing are realistically supporting and ensuring financial institutions in setting and achieving ESG goals

The discussed instruments play a major role in transitioning to a more sustainable future. The problem is that they alone cannot respond to the existing challenges, such as those related to climate change. For example, the Paris Agreement, as the most significant global climate agreement, is mandatory by its nature and requires countries to assess their progress towards implementation of the agreement every five years through a process known as stocktake.

Some scholars argue, that even though the UN Framework Convention on Climate Change[195] views the Paris Agreement as legally binding, it does not envisage imposing penalties or fees for parties that violate its terms and there is no enforcement body or court responsible and ready to assess and administer compliance. There are some counter arguments to this opinion but the fact is that the agreement still leaves space for ambiguity and even more questions for financial institutions as they move forward in this direction.

There still is a pending question about why should states follow the Paris Agreement, if there is no mechanism in place for enforcement. Nevertheless, SFDR and CSRD do not face the same enforcement related challenges, i.e., in case of non-compliance national administrative authorities appointed by the EU Member States may impose fines but still there are some loopholes. The SFDR also comprises challenges: the system of implementation is weakened by the lack of data. It is almost impossible to calculate social and governance related indicators due to the lack or even absence of reliable sources. The issue with the data and its transparency will negatively impact on

[195] UN General Assembly, *United Nations Framework Convention on Climate Change*, 20 January 1994, A/RES/48/189 <https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement> accessed 25 May 2022.

the level of confidence of asset owners and asset managers 'when defining the ESG policy and strategy'.[196]

This opinion is completely supported by Hans-Ulrich Beck, indicating that even though disclosure regulations play a major role in transitioning to a more sustainable future, they alone cannot solve important challenges like climate change. Disclosure regulations should be seen as 'one element from a toolbox' that should be used as part of a broader set of policy tools. Disclosure mechanisms are used by policy makers to increase transparency. To a certain degree, increased disclosure will incentivize corporates to align with the sustainable agenda. But real change will require a transition to a corporate operating environment in which the right behaviour is also the more profitable behaviour. Unless the economics of business models change, our economies will not move to a more sustainable model. Transparency is 'oiling the machine' but the direction of where we are travelling is provided by the broader policy context and the operating environment for economic actors that it creates. For real change, the transparency regulations of the EU will need to be complemented by economic policies that are aligned with the broader sustainability agenda.

5.3. *Research Question 3*

Is ESG a temporary trend or will it result in a long-term sustainability and financial value?

Today's world is looking for solution to the sustainability related issues, such as climate change, gender inequality on workplace, labour rights and biodiversity. This thesis views ESG as a criterion to assess the risks related to the investments. It cannot be assumed as some temporary short-term trend due to its vital role in the risk assessment process. As time goes more and more companies will be using ESG data for their value analysis aiming at providing investors necessary visions on sustainability. Investors will evaluate Companies' portfolios primarily by considering their ESGs. There will be a trade-off between capitalizing on short-term performance and longer-

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[196] Invest ESG.eu, *SFDR aims at preventing greenwashing and ensuring data comparability* (March, 2021). <https://investesg.eu/2021/03/09/sfdr-aims-at-preventing-greenwashing-and-ensuring-data-comparability/> accessed 25 May 2022.

term impact of their financial activities. Businesses 'are going to be held responsible for the choices.'[197]

According to Hans-Ulrich Beck, it is expected that over time ESG ratings and data will become one standard data set amongst others that is used to analyse and evaluate companies. The market interest is driven by an increased awareness of important sustainability challenges that our societies face, and the desire to address them amongst others by channelling capital flows to more sustainable companies. Given that the challenges that our societies will face as a result of climate change, biodiversity loss, access to freshwater resources, etc. are likely to become more severe. Understandably, it is expected that motivation for and interest in sustainable investing will grow further.

5.4. Path forward to the long-term Sustainable Investing

It is quite evident that the demand for sustainable investing is increasing, more stakeholders are asking for ESG reporting in the decision-making process and legislative bodies are trying to develop sustainable finance to meet the SDGs or the Paris Agreement targets but the processes still face challenges that need to be addressed. Success of this story will become feasible when the theory will transform into practice. This was the main highlight during the interview processes. Interviewees indicated that there is a significant interest from the investment community in understanding the ESG practices of the companies. The companies can demonstrate their ESG strategy, management practices and performance through ESG reporting. However, the absence of a globally accepted reporting standard remains as one of the major challenges for ESG reporting. The abundance of different standards put companies in complicated situations when deciding about the ESG reporting. It also results in the continuous requests for additional information and clarification from ESG rating agencies and investors who ask for consistent and comparable

[197] Datarade, *Best ESG Datasets, Databases & APIs*. <https://datarade.ai/data-categories/esg-data> accessed 25 May 2022.

reporting across companies. On the other side, requests for the additional data are coming from ESG rating agencies and investors to the companies.

The partner from one of the ‘Big Four’ companies (anonymous interviewee) notes that the challenges faced by the companies, also impact the investors. Even though information about companies is somewhat standardised, when it comes to comparability, quality or availability of the data, it leaves feasible space for interpretation and makes analysis challenging from the stakeholder’s standpoint.

Another challenge that financial institutions are facing is ‘greenwashing’. There are many cases, when investors used ESG label carelessly. Henrik Immelborn indicates that ‘greenwashing’ is a considerable challenge that goes back to data standards and data availability. Ensuring data transparency might be a solution for the challenge and regulators can significantly support the financial sector in this area.

Even though ESG investing is relatively new and emerging process with many challenges, it still remains as one of the promising ways towards more sustainable future. The Managing Director of Debt Solutions and Loans, of one of the biggest Nordic banks stated that ESG is an area where banks started investing heavily; Partner from one of the ‘Big Four’ companies agrees to the idea that the number of companies who are asking for ESG reporting is rising; and an expert and the Global Head of ESG Products from one of the biggest research and analytical company in the field predicts that ESG will be ingrained into evaluation process of the companies. This gives us a solid ground for a positive assumption that the contemporary financial system is going towards a more sustainable future, which in return will play a major role on a more global scale.

Appendix A

Interview for master’s thesis	
Interviewee:	Henrik Immelborn - Managing Director, Debt Solutions and Loans, Nordea.
Interviewer:	Ana Osadze, master’s student at Lund University School of Economics and Management (LL.M. in European and International Trade Law)
Date and time:	05/05/2022, 12:45 PM
Location:	Sweden, Lund
Interview Setting:	Zoom

Question 1: What is the reason behind the increasing number of ESG oriented investors?

Question 2: What are the quantifiable as well as non-quantifiable benefits of ESG investments? Are they expected to be realized in the short-term or in the medium to long-term period?

Question 3: Please describe the widely adapted investment instruments to move capital into sustainable investment.

Question 4: From your perspective, how can these instruments become more accessible to individual and institutional investors? What are the stepping stones for investment banks of emerging markets to popularise ethical investment?

Question 5: How big of an impact do ESG risks have in the general risk assessment of a corporate loan issuing process?

Follow up question: would you refuse lending to a company whose business conduct is not environmentally friendly? (E.g., coal mining, etc.)

Question 6: What challenges do you see for ESG investing to become mainstream globally?

Question 7: Follow up question: Since you mentioned greenwashing there are lots of articles about it, are there regulators actins efficiently to regulate greenwashing?

Appendix B

Interview for master's thesis	
Interviewee:	Hans-Ulrich Beck. Global Head of ESG Products. Product Strategy and Development
Interviewer:	Ana Osadze, master's student at Lund University School of Economics and Management (LL.M. in European and International Trade Law)
Date and time:	20/05/2022, 12:30 PM
Location:	Sweden, Lund
Interview Setting:	Zoom

Question 1: Increasing demand for risk management and resilience has drawn attention of decision makers to the larger ESG agenda. As a result, the number of ESG oriented investors is increasing. What reasons could you highlight behind this turn of events?

Question 2: Why is ESG reporting important for companies and what major challenges are they facing?

Question 3: From your perspective, what are the main ESG risks in the financial sector?

Question 4: Sceptics of sustainable investing think that ESG investing is a trend in today's world that everyone is following. What would you tell them? will it really bring a long-term sustainability and financial value in the foreseeable future?

Question 5: There are three disclosure tools that create one coherent framework in the EU. the EU's Sustainable Finance Disclosure Regulation (SFDR), the EU Taxonomy and the Non-Financial Reporting Directive (NFRD → CSRD). How do you think, as an experienced professional, whether, and if so, to what extent has above mentioned disclosures a promising future in the financial sector towards sustainable development? Are they sufficient to fulfil EU's ambitious agenda towards sustainable finance?

Appendix C

Interview for master's thesis

Interviewee:	Unanimous (Partner in one of the 'Big Four' companies)
Interviewer:	Ana Osadze, master's student at Lund University School of Economics and Management (LL.M. in European and International Trade Law)
Date and time:	19/05/2022, 11:00 AM
Location:	Sweden, Lund
Interview Setting:	Zoom

Question 1: Increasing demand for risk management and resilience has drawn attention of decision makers to the larger ESG agenda. As a result, the number of ESG oriented investors is increasing. What reasons could you highlight behind this turn of events?

Question 2: Why is ESG reporting important for companies and what major challenges are they facing?

Question 3: What challenges do you envision for promoting the development of ESG investing and becoming it mainstream globally?

Question 4: What is your role in promotion and development of ESG investing as one of the biggest and influential consulting company?

Question 5: From your perspective, what are the main ESG risks in the financial sector?

Question 6: How do you envision financial sector's concentration in sustainable investments in the foreseeable future?

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