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The EU Sustainable Finance Framework in Light of International Standards

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ABSTRACT

This paper analyses the relationship between the EU sustainable finance legal framework and the most common international environmental, social, and governance standards. We find that standards included in the EU sustainable finance legal framework partly overlap with the international environmental, social and governance standards, while diverging as to the details. This overlap creates frictions, given that financial service providers need to decide which of the overlapping, yet partly diverging, standards they apply. The EU environmental taxonomy presents unique features and a higher level of sophistication when compared to the international environmental, social and governance standards. This may result in both upsides and downsides. On the upside, the EU sustainable finance legal framework could function as a pacemaker and facilitate impact measurement across the industry, while on the downside, we see additional costs for firms and resistance against the granular EU approach. At the same time, the EU sustainable finance legal framework lacks details on the social and governance dimensions. Here, reference to the international standards compensates for the lack of an EU social and governance taxonomy. While this allows for alignment of EU and international social and governance-oriented investors, a greater degree of sophistication at the EU level could enhance the potential for impact measurement—a particularly important aspect for socially sustainable investments.

I. INTRODUCTION

This paper investigates the relationship between the Taxonomy Regulation[1] as well as the Sustainable Finance Disclosure Regulation (SFDR)[2] (including the respective implementing rules) and the international environmental, social, and governance (ESG) standards.

The development of the EU sustainable finance legal framework[3] (EU SF framework), which also relies on several international standards, is expected to prompt a fundamental shift in the

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1 Regulation (EU) 2020/852 of the European Parliament and of the Council OJ 2020 L 198/13.

2 Regulation (EU) 2019/2088 of the European Parliament and of the Council OJ 2019 L 317/1.

3 We use the expression EU sustainable finance legal framework to refer to the legislative and regulatory initiatives adopted by the EU Institutions to favor the transition of both the economy and society towards sustainability.

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European economy towards sustainability.[4] In 2018, the European Commission (EC) published the Sustainable Finance Action Plan[5] that sets out a list of regulatory actions to ensure that the financial system supports the EU's transformation towards a climate neutral and sustainable economy. The most important legislative acts that have been adopted include the SFDR[6] and the Taxonomy Regulation; granular regulatory technical standards (RTSs)[7] have been adopted for each of these regulations. Thus, the Taxonomy-related Climate Delegated Act[8] comprises several hundred pages of definitions and classifications on climate-related economic activities. Other fields where EU regulators were and are active include sustainability indices and ratings,[9] banks' and asset managers' organization, investments and risk management, as well as financial product distributors' disclosure to clients. As one of the latest legislative initiatives, EU lawmakers reached a political compromise on a Corporate Sustainability Reporting Directive (CSRD)[10] in June 2022; the future CSRD will submit nearly 50,000 larger and listed EU companies to sustainability-related reporting obligations.

Sustainability is also the core of several standards and guidelines drafted by international organizations, industry networks, regulators, and supervisory authorities. The new EU provisions refer to a number of such international standards that have in this way become an integral part of the EU SF framework. Yet, these standards themselves are far from being uniform given their diverse origin. Against this background, this paper maps the ESG standards cited in the EU SF framework, identifies the relationship between the latter and those standards, and assesses to what extent the EU SF framework is building on, or contradicting, the global consensus reflected by these standards on what constitutes sustainability.

This paper is structured as follows: part II focusses on standards and standard setting in international banking and finance; part III analyses the EU SF framework with a focus on the references made to international standards on sustainability; part IV scrutinizes the international standards on sustainability cited in the EU SF framework against the background of the EU SF framework; part V lays out the major overlaps, differences, and commonalities across the main international standards on sustainability and the new provisions of the EU SF framework; part VI concludes.

II. STANDARDS IN INTERNATIONAL BANKING AND FINANCE

Over the last four decades, standard setting (as opposed to law making) has become increasingly important in the realm of international banking and finance. While a view in the literature reveals some divergence as to its meaning,[11] a standard may be best defined as 'a rule, princi-

[4] For an overview see Danny Busch, Guido Ferrarini and Seraina Grünewald, *Sustainable Finance in Europe: Corporate Governance, Financial Stability and Financial Markets, EBI Studies in Banking and Capital Markets Law*, 1st ed. (Frankfurt: Springer International Publishing, 2021); Dirk A. Zetzsche and Linn Anker-Sørensen, 'Regulating Sustainable Finance in the Dark', 23 European Business Organization Law Review 47 (2022), at 85. *passim*.

[5] European Commission, Action Plan: Financing Sustainable Growth COM (2018) 97 final.

[6] The SFDR is supplemented by the RTS embedded in the Commission Delegated Regulation (EU) 2022/1288 of 6 April 2022 (…) [on] the content and presentation of the information in relation to the principle of 'do no significant harm', specifying the content, methodologies and presentation of information in relation to sustainability indicators and adverse sustainability impacts, and the content and presentation of the information in relation to the promotion of environmental or social characteristics and sustainable investment objectives in pre-contractual documents, on websites and in periodic reports OJ 2022 L 196/1.

[7] Regulatory Technical Standards (RTS) are technical rules drafted by one of the European Supervisory Authorities (ESAs) that further develop, specify and determine the conditions for consistent harmonisation of the rules included in a legislative act.

[8] Commission Delegated Regulation (EU) 2021/2139 of 4 June 2021 supplementing Regulation (EU) 2020/852 of the European Parliament and of the Council by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives OJ 2021 L 442/1.

[9] Climate Benchmarks Regulation (EU) 2019/2089 of the European Parliament and of the Council OJ 2019 L 317/17.

[10] Proposal for a Directive of the European Parliament and of the Council (…) as regards corporate sustainability reporting (COM (2021) 189 final.

[11] See Eibe Riedel, 'Standards and Sources. Farewell to the Exclusivity of the Sources Triad in International Law?', 2 European Journal of International Law 58 (1991), at 84.

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ple, or means of judgment or estimation; a criterion, measure'.[12] An ever-growing host of such 'standards' (in particular, principles and guidelines) have been drafted by a plethora of non-state actors.[13] Some of these standards 'regulate' where gaps are present in legislation, while others accompany, and further define, binding law provisions.[14]

The trend towards standard setting has been driven by globalization as well as the liberalizations and privatizations which have occurred in many countries around the world since 1980s.[15] At the same time, the trend towards standard setting highlights the limited effectiveness of national regulation where global and cross-border matters are concerned. Furthermore, it has blurred the dividing lines between the private and public sectors.[16]

In this context, the main issues relate to the impact on the legislative authority of the state,[17] the quasi-regulatory impact of such standards, their effectiveness,[18] and the legitimacy and governance of both the standards and the bodies drafting them.[19] The category of standards is broader than the one of the laws;[20] on these grounds, it has been argued that standards stand between the state and the market, blurring the distinction between legal and social norms.[21]

The issue of legitimacy of such standards and of the actors drafting them has several dimensions. While social legitimacy is a matter of fact that concerns the social acceptance by the entities submitted to them, from a legal perspective, a standard would be considered legitimate insofar as it is created by the competent actor in compliance with the appropriate procedure.[22]

Standards create the desired order as far as they are complied with; only to this extent, they are 'effective'. To a large extent, the effectiveness of international financial standards depends both on the market power of the institution formulating them and on the capacity of the competent actors to ensure compliance.[23] The most influential non-state standard setters are international organizations.[24]

In the field of international banking and finance, the capital requirements drafted for banks by the Basel Committee on Banking Supervision are often regarded as one of the most prominent examples of 'de-formalization' of international law.[25] Although they do not qualify as legal

[12] See the Oxford English Dictionary, at 504, 505.

[13] See Tim Büthe and Walter Mattli, *The New Global Rulers: The Privatization of Regulation in the World Economy* (Princeton: Princeton University Press, 2011), *passim*; Dieter Kerwer, 'Banking on Private Actors. Financial Market Regulation and the Limits of Transnational Governance', in Adrienne Héritier, Michael Stolleis and Fritz Scharpf (eds), *European and International Regulation after the Nation State* (Baden-Baden: Nomos, 2004) 205; Janet Koven Levit, 'A Bottom-Up Approach to International Law-Making: The Tale of Three Trade Finance Instruments', 30 Yale Journal of International Law 125 (2005).

[14] See Anne Peters, 'Lucy Koechlin and Gretta Fenner Zinkernagel, Non-State Actors as Standard Setters: Framing the Issue in an Interdisciplinary Fashion', in Anne Peters, Lucy Koechlin, Till Förster and Gretta Fenner Zinkernagel (eds), *Non-State Actors as Standard Setters* (Cambridge: Cambridge University Press, 2009) 13.

[15] Ibid, at 1.

[16] See Joseph Nye and John Donahue, *Governance in a Globalizing World* (Washington: Brookings Institution Press, 2000) *passim*.

[17] See Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996) *passim*.

[18] See Peters, Förster and Koechlin, above n 14, at 3.

[19] See Steven Wheatley, 'Democratic governance beyond the state: the legitimacy of non-state actors as standard setters', in Anne Peters, Lucy Koechlin, Till Förster and Gretta Fenner Zinkernagel (eds), *Non-state Actors as Standard Setters* (Cambridge: Cambridge University Press, 2009) 215; Julia Black, 'Legitimacy, Accountability and Polycentric Regulation: Dilemmas, Trilemmas and Organisational Response', in Anne Peters, Lucy Koechlin, Till Förster and Gretta Fenner Zinkernagel (eds), *Non-State Actors as Standard Setters* (Cambridge: Cambridge University Press, 2009) 241.

[20] See Peters, Koechlin and Fenner Zinkernagel, above n 14, at 12.

[21] See Harm Schepel, *The Constitution of Private Governance, Product Standards in the Regulation of Integrating Markets*, 1st ed. (Oxford: Hart Publishing, 2005) 3.

[22] See Peters, Koechlin and Fenner Zinkernagel, above n 14, at 18.

[23] See Marcus Schaper, 'Non-state environmental standards as a substitute for state regulation?', in Anne Peters, Lucy Koechlin, Till Förster and Gretta Fenner Zinkernagel (eds), *Non-State Actors as Standard Setters* (Cambridge: Cambridge University Press, 2009) 304.

[24] According to the International Law Commission, these are as organisations 'established by treaty or other instrument governed by international law and possessing [their] own international legal personality'. See Art. 2 of the Draft Articles on the Responsibility of International Organizations, Report of the International Law Commission, Fifty-fifth session, 2003 (UN Doc A/58/10, 38).

[25] See Enrico Milano and Niccolò Zugliani, 'Capturing Commitment in Informal, Soft Law Instruments: A Case Study on the Basel Committee', 22 (2) Journal of International Economic Law 163 (2019), at 176.

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acts under international law, the lack of such a formal status, irrespective of some concerns about legitimacy[26] and accountability,[27] has by no means affected their effectiveness.[28] On these grounds, the Basel Accords have been described as informal standards developed by domestic regulators at the international level, with a view to inducing compliance by national legislators and stakeholders at domestic level.[29] The most important factors that explain the effectiveness of the Basel standards are reputational costs and benefits as well as market incentives in that compliance with more reliable and transparent practices in turn increases credibility.[30] Their very legitimacy also derives from the fact that banking is both complex and global, thus regulating requires highly competent bodies and cross-border coordination, which can be achieved through standard setting.[31]

Sustainability, with its environmental and social dimensions, is much like banking and finance: it is complex and global. This may explain why not only international organizations like the United Nations (UN) and its sub-organizations, the Organisation for Economic Co-operation and Development (OECD), multilateral development banks, but also new entrants like the Alliance for Financial Inclusion (an organization of central banks of emerging and developing economies focusing on peer learning),[32] are particularly active in setting sustainability standards.

This article deals with sustainable finance where the complexity and global dimension of finance and sustainability overlap. Such second degree of complexity explains not only the great number of technical bodies engaging in standard setting but also the EU's legislative preference to incorporate international sustainability standards in its SF framework by reference. Yet, as we will show in the remainder of the article, the EU SF framework may also function as a particularly good example for the challenges associated with lawmakers' piggybacking on international standards.

Prior to analysing these challenges, an overview of the EU SF framework and its *modus operandi* may provide context.

III. THE EU SF FRAMEWORK

The two major legislative acts on sustainable finance in the EU are the SFDR and Taxonomy Regulation.

A. SFDR's double materiality disclosures

SFDR sets sustainability-related disclosure obligations for financial market participants, such as financial institutions and financial advisers. The SFDR disclosure rules provide transparency with regard to (i) the integration of sustainability risks in the financial market participants operations and investments and (ii) the impact of the financial market participants' operations and investments on sustainability factors. Together, they establish what is dubbed a 'double

[26] See Jose Gustavo Prieto Muñoz, 'Governance of the Global Financial System: The Legitimacy of the BCBS 10 years after the 2008 Crisis', 22 (2) Journal of International Economic Law 247 (2019), at 260.

[27] See Jan Riepe, Basel and the IASB: Accountability Interdependencies and Consequences for Prudential Regulation, 22 (2) Journal of International Economic Law, (2019), at 261–283.

[28] Accordingly see Kern Alexander, Rahul Dhumale, and John Eatwell, *Global Governance and International Standard Setting* (Oxford: Oxford University Press, 2005) at 37; Marc Jacob, 'Bank for International Settlements (BIS)', in Max Planck Encyclopedia of Public International Law (2013) http://opil.ouplaw.com/view/10.1093/law:epil/9780199231690/law-9780199231690-e453 (visited 2 November 2022).

[29] See Milano and Zugliani, above n 25, at 163–176.

[30] See Chris Brummer, *Soft Law and the Global Financial System: Rule Making in the Twenty-First Century*, 2nd ed. (Cambridge: Cambridge University Press, 2011) *passim*.

[31] See Matteo Ortino, 'The Governance of Global Banking in the Face of Complexity', 22 (2) Journal of International Economic Law 177 (2019), at 204.

[32] https://www.afi-global.org/(visited 2 November 2022).

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materiality' standard.[33] Accordingly, the first set of disclosures on sustainability risks focus on the aspects of sustainability that directly influence the firm and portfolio value (e.g. the impact of a rising sea level on housing prices); this is the sustainability dimension that each actor internalizes. The second set of disclosures focus on the impact of the firm's activities on sustainability factors; these are the externalities the firm's economic activity creates (e.g. the firm's greenhouse gas emissions let the sea level rise). On these grounds, the SFDR's double materiality approach requires disclosures on both the impacts of sustainability on the firm (inward dimension) and the impacts of the firm's operations on sustainability (outward dimension).[34]

Further disclosures must be made if a financial market participant claims to further environmental or social good. In this case, the SFDR requires an explanation of how this may come about, of which methodology this assessment rests upon and of how it is ensured throughout the investment process that these promises come true. Obviously, the latter is a regulatory response to greenwashing.[35]

Given the ambivalence of the respective terms used in the economic world, the SFDR disclosures would have little effect in the absence of precise definitions and classifications. Thus, the latter have been provided by lengthy RTSs and the EU Taxonomy Regulation.

B. The EU Taxonomy's classification system

The Taxonomy Regulation has introduced a classification system for the distinction between environmentally sustainable economic activities and other, non-sustainable, economic activities.

The Taxonomy Regulation defines six desirable environmental objectives to be achieved by economic activities. These objectives include (i) mitigation of climate change, (ii) adaptation to climate change, (iii) the sustainable use and protection of water and marine resources, (iv) the transition to a circular economy, (v) pollution prevention and control, and (vi) protection and restoration of biodiversity and ecosystems.[36]

An economic activity is sustainable according to Article 3 of the Taxonomy Regulation if: (i) it substantially contributes to an environmental objective, while, (ii) at the same time, it does not significantly harm another environmental objective, and (iii) it complies with minimum safeguards concerning labour and social rights.[37]

Details of the broad expressions used have been specified for every economic sector and activity over several hundred pages of technical screening criteria. These criteria define, for instance, what mitigation of climate change means when building a new house or renovating an old one. While, on the paper, these rules apply to both the actors that build the house and the financial institutions financing the construction, as of now financial institutions are the main recipient of the new provisions, given that most construction firms are small and medium enterprises which still fall outside the scope of application of the taxonomy.

[33] See Linn M. LoPucki, 'Corporate Greenhouse Gas Disclosures', 56 (1) UC Davis Law Review (Forthcoming November 2022).

[34] See Hans B. Christensen, Luzi Hail and Christian Leuz, 'Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review', 26 Review of Accounting Studies 1176 (2021), at 1178.

[35] On greenwashing see Wahida Shahan Tinne, 'Green Washing: An Alarming Issue', 7 ASA University Review 81 (2013), at 88; Desirèe Schmuck, Jorg Matthes and Brigitte Naderer, 'Misleading Consumers with Green Advertising? An Affect–Reason–Involvement Account of Greenwashing Effects in Environmental Advertising', 47 (2) Journal of Advertising 127 (2018), at 145.

[36] Art. 9 Taxonomy Regulation (EU) 2020/852 of the European Parliament and of the Council OJ 2020 L 198/13.

[37] See Franziska Schütze and Jan Stede, 'The EU Sustainable Finance Taxonomy and its Contribution to Climate Neutrality', Journal of Sustainable Finance & Investment (2021), 1–34.

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IV. INTERNATIONAL STANDARDS ON SUSTAINABILITY

International organizations have developed a number of standards and guidelines in the field of sustainability (hereafter ESG standards).

A. The global landscape of ESG standards

With a view to the ESG standards listed in Appendixes, we noted significant divergence in terms of scope and content in three main respects.

The first difference relates to the sector covered: a set of ESG standards may target corporations operating in any sector, while others focus only on specific sectors. Notably, the OECD Guidelines for multinational enterprises (MNEs) are accompanied by a general Due Diligence Guidance for Responsible Business Conduct as well as different sectorial due diligence guidelines,[38] such as the Due Diligence for Responsible Corporate Lending and Securities Underwriting,[39] which is a supporting guidance dedicated to banks implementing the OECD Guidelines for MNEs. On the other hand, the International Finance Corporation (IFC) Performance Standards are supported by elaborate guidelines designed to help borrowers implement the requirements contained in the standards.[40]

The second difference relates to the ESG dimension covered: some standards provide guidance on one of the three ESG considerations, while others deal with all of them. Only one of the three ESG dimensions is addressed by the following instruments: the UN Guiding Principles on Business and Human Rights Implementing the UN 'Protect, Respect and Remedy' Framework focus on the social dimension while the OECD Guidelines on Corporate Governance of State-owned Enterprises deal with the governance dimension. Examples of standards addressing all the three ESG considerations include the OECD Guidelines for MNEs and the IFC Performance Standards on Environmental and Social Sustainability.[41]

The third difference relates to the inclusion (or lack thereof) of operational and/or disclosure guidelines. Disclosure and operational guidelines might be provided together (as part of the same set of standards[42] or as a separate but complementary document)[43] or separately.

Importantly, some institutions have developed non-financial reporting standards linked to a rating system, including the Global Initiative for Sustainability Ratings (GISR),[44] Global Reporting Initiative (GRI),[45] the International Integrated Reporting Council (IIRC),[46] and the Sustainability Accounting Standards Board (SASB).[47]

Even though the ultimate objective of such disclosure standards is roughly the same (i.e. enhancing transparency and producing more comparable data on ESG performance), there

[38] Organisation for Economic Cooperation and Development, 'Due Diligence Guidance by Sector', http://mneguidelines.oecd.org/guidelines/ (visited 2 November 2022).
[39] Organisation for Economic Cooperation and Development, 'Due Diligence for Responsible Corporate Lending and Securities Underwriting', https://mneguidelines.oecd.org/due-diligence-for-responsible-corporate-lending-and-securities-underwriting.pdf (visited 2 November 2022).
[40] International Finance Corporation, Guidance Notes to Performance Standards on Environmental and Social Sustainability, 1 January 2012.
[41] International Finance Corporation, Performance Standards on Environmental and Social Sustainability, 1 January 2012. See also World Bank, 'Environmental and Social Standards (ESS)', https://www.worldbank.org/en/projects-operations/environmental-and-social-framework/brief/environmental-and-social-standards (visited 2 November 2022).
[42] OECD Guidelines for MNEs and the IFC Performance Standards on Environmental and Social Sustainability.
[43] Organisation for Economic Cooperation and Development, 'Due Diligence Guidance for Responsible Business Conduct', https://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf (visited 2 November 2022).
[44] Global Initiative for Sustainability Standards (GISR), 'Sustainability rating standards. Component 1: Principles', http://www.truevaluemetrics.org/DBpdfs/Initiatives/GISR/GISR-Principles-Version-1-1.pdf (visited 2 November 2022).
[45] GRI, 'Consolidated set of GRI Sustainability Reporting Standards 2016', https://www.globalreporting.org/standards/gri-standards-download-center/consolidated-set-of-gri-standards/ (visited 2 November 2022).
[46] International Integrated Reporting Council, IIRC, 'International <IR> Framework January 2021', https://integratedreporting.org/wp-content/uploads/2021/01/InternationalIntegratedReportingFramework.pdf (visited 2 November 2022).
[47] SASB Standards, https://www.sasb.org/standards/download/ (visited 2 November 2022).

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Table 1. SFDR Articles Per Type of Disclosure

Information to disclose	Websites		Pre-contractual disclosure		Periodic reports	
	Entity level	Product level	Entity level	Product level	Entity level	Product level
Sustainability risks	Art. 3, 6	–	Art. 6	Art. 6	–	–
Principal adverse impact on sustainability factors	Art. 4	Art. 7	–	–	–	–
Promotion of environmental and social characteristics	–	Art. 10	–	Art. 8	–	Art. 11
Sustainable investments	–	Art. 10	–	Art. 9	–	Art. 11

are divergences, which relate mainly to the concept of financial materiality and 'stakeholders' relations'. For instance, IIRC and SASB emphasize that disclosure should concern only ESG aspects that are relevant in terms of financial materiality, whereas GRI and GISR, 'while employing the language of materiality… emphasize firms' social and environmental responsibilities, including firms required engagement with and treatment of all stakeholders, regardless of their economic value'.[48]

Recently, standards supporting the narrow view of financial materiality versus those promoting the broader view of double materiality have come under heavy criticism because considered too much focussed on 'very specific and compliance-focussed dimensions'.[49] In this respect, the EU framework is rather demanding as it has embraced double materiality as further discussed in section V.

B. Standards referred to in the EU SF framework

The EU SF framework draws on standards for filling the gaps that exist despite lengthy regulatory text. In the EU Taxonomy, references to international standards shall ensure that economic activities comply with social minimum safeguards to be classified as environmentally sustainable. In the SFDR and the related RTSs, references to international standards help understand which investments are environmentally and socially sustainable where the EU Taxonomy does not apply.

According to the Taxonomy Regulation, in order for an economic activity to qualify as environmentally sustainable, the latter has to comply with minimum standards concerning human and labour rights. Under Article 18 Taxonomy Regulation (Art. 18 TR), minimum safeguards are defined as procedures applied during the course of an undertaking to ensure the compliance with selected ESG international standards, in particular, the OECD Guidelines for MNEs and the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the eight fundamental conventions identified in the International Labor Organisation (ILO) Declaration on Fundamental Principles and Rights at Work and the International Bill of Human Rights.

[48] See Emily Barman, 'Doing Well by Doing Good: A Comparative Analysis of ESG Standards for Responsible Investment, Advances in Strategic Management', 38 Emerald Publishing Limited, Bingley 289 (2018), at 311.

[49] See Tom Adams, 'Lindsay Smalling and Sasha Dichter, ESG Investing Needs to Expand Its Definition of Materiality', Stanford Social Innovation Review, 23 February 2022, https://ssir.org/articles/entry/esg_investing_needs_to_expand_its_definition_of_materiality (visited 2 November 2022).

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Table 2. Items to be disclosed under SFDR RTS Annex 1 versus International Standards recalled by Art. 18 TR

SFDR RTS items	Framework mentioned in Art. 18 TR
1. Investments in companies without workplace accident prevention policies	OECD V, UNGC 3–6
2. Rate of accidents	OECD V, UNGC 3–6
3. Number of days lost to injuries, accidents, fatalities, or illness	OECD V, UNGC 3–6
4. Lack of a supplier code of conduct	OECD VI
5. Lack of grievance/complaints handling mechanism related to employee matters	OECD VI, UNGC 3–6
6. Insufficient whistle-blower protection	OECD VI, UNGC 3–6
7. Incidents of discrimination	OECD IV, UNGC 1–2
8. Excessive CEO pay ratio	OECD VI, III, UNGC 3–6
9. Lack of a human rights policy	OECD IV, III, UNGC 1–2
10. Lack of due diligence	OECD IV, III, UNGC 1–2
11. Lack of processes and measures for preventing trafficking in human beings	OECD III, IV, UNGC 1–2
12. Operations and suppliers at significant risk of incidents of child labour	OECD III, IV, V, UNGC 1–6
13. Operations and suppliers at significant risk of incidents of forced/ compulsory labour	OECD III, IV, V, UNGC 1–6
14. Number of identified cases of severe human rights issues and incidents	OECD III, IV, UNGC 1–2
15. Lack of anti-corruption and anti-bribery policies	OECD III, VII, UNGC 10
16. Cases of insufficient action taken to address breaches of anti-corruption/-bribery laws	OECD III, VII, UNGC 10
17. Convictions/fines for violations of anti-corruption and anti-bribery laws	OECD III, VII, UNGC 10

Moreover, under the SFDR financial institutions that consider the principal adverse impacts of their investment decisions on sustainability factors should take into account the Due Diligence Guidance for Responsible Business Conduct developed by the OECD[50] and the UN-supported Principles for Responsible Investment.[51] Further references to international standards are made in the SFDR RTS. Accordingly, the disclosures on principal adverse impacts must contain a section describing principal adverse-sustainability impacts. Thereon, two numerical adverse-sustainability indicators are to be disclosed which ask for compliance with the UN Global Compact (UNGC) principles and the OECD Guidelines for MNEs. The first is indicator 10 'violations of UNGC principles and OECD Guidelines for MNEs' linked to the metric 'share of investments in investee companies that have been involved in violations of the UNGC principles or OECD Guidelines for MNEs'. The second one is indicator 11 'lack of processes and compliance mechanisms to monitor compliance with UNGC principles and OECD Guidelines for MNEs', linked to the metric share of investments in investee

50 Organisation for Economic Cooperation and Development, Due Diligence Guidance for Responsible Business Conduct (May 2018).
51 PRI, What are the Principles for Responsible Investment?

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companies without policies to monitor compliance with the UNGC principles or OECD Guidelines for MNEs or grievance/complaints handling mechanisms to address violations of such standards.

Table 2 shows a comparison between items to be disclosed under Annex 1 of the SFDR RTS and the international standards recalled by Article 18 of Taxonomy Regulation.

1. Incorporation of standards 'by reference'

The standards referred to in the EU SF framework are depicted in Table 3.

By mentioning these standards in the legal text of the EU SF framework, they underwent a fundamental change: while such standards were initially conceived as non-binding international principles (OECD Guidelines for MNEs), or project-based environmental and social performance standards (IFC Standards), the incorporation into the EU SF framework by reference makes them *de facto* legally binding. Yet, neither have EU institutions alone any influence on the multiple international standards incorporated in this way, nor are they published in the official EU bulletin for legislative acts. The constitutional issue emerging was addressed in the context of International Financial Reporting Standards by way of legislative acts adopting officially binding accounting standards.[52]

The same issue is now prevalent in large parts of the EU SF framework. Due to incorporation by reference, these standards have become of utmost importance for financial market participants and non-compliance will be sanctioned by financial supervisory authorities. While the conversion of soft-law principles and standards into hard-law provisions is common practice in banking and financial regulation, this process needs to be conducted carefully to avoid enforcement issues. In fact, soft-law standards, with a non-binding nature, are typically principle-based guidelines focussing on the goal(s) that should be achieved through them and the underlying rationale.[53] They are commonly drafted in broad terms on the assumption that when a legislator wants to convert them into binding and enforceable provisions, it will transform them into precise rules, keeping the rationale and the final objective intact. That has been the case of the bank capital requirements adopted by the Basel Committee on Banking Supervision. Its transposition came with detailed and precise rules in the major economies around the world.[54]

By contrast, the EU SF framework embeds a number of sustainability standards simply by reference, without any legislative effort in terms of adaptation, transposition, and re-writing. Due to their vagueness, they will be difficult to enforce despite their binding character.

2. Nature and content of incorporated international standards

A closer look reveals a great variety in the international standards incorporated by reference, ranging from environmental standards to social and governance ones. An analysis of the underlying rationale requires, first, some categorization, along the established categories of ESG, before we discuss them against the background of the EU SF framework.

2.1. Environment

Unsurprisingly, we observe that the EU SF framework incorporates many standards with environmental objectives (see Table 4).

[52] Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, OJ 2008 L 320/1.

[53] See Marco Bodellini and Rosa Maria Lastra, 'Soft law and Sovereign debt, in United Nations Conference on Trade and Development', (7 November 2018), at 1–29.

[54] See Marco Bodellini, 'The Long 'Journey' of Banks from Basel I to Basel IV: Has the Banking System Become More Sound and Resilient than it Used to be?', 20 (1) ERA Forum 81 (2019), at 97.

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Table 3. References to the International Standards made by EU SF Framework (Overview Per Single Set of Standards)

Reference	ESG dimension covered	Disclosure or operations	Recipients	EU SF framework
OECD Guidelines for MNEs	ESG	D-O	Corporates	Recital 18 SFDR; Recital 35–36, 43 TR Art. 18 TR Art. 22, 26, 39, 51, 59, 67 Commission Delegated Regulation of 6 April 2022 Annexes I, II, III, IV, V Commission Delegated Regulation of 6 April 2022 Annex I, Table 1 (ASI 10–11) Commission Delegated Regulation of 6 April 2022
UN Guiding Principles on Business and Human Rights	S	O	Corporates	Recital 35–36 TR; Art. 18 TR Art. 22, 26, 39, 51, 59, 67 Commission Delegated Regulation of 6 April 2022 Annexes I, II, III, IV, V Commission Delegated Regulation of 6 April 2022
Fundamental Principles and Rights at Work of the ILO	S	O	States	Recital 35–36 TR; Art. 18 TR Art. 22, 26, 39, 51, 59, 67 Commission Delegated Regulation of 6 April 2022
International Bill of Human Rights	S	O	States	Recital 35–36 TR; Art. 18 TR Art. 22, 26, 39, 51, 59, 67 Commission Delegated Regulation of 6 April 2022
European Pillar of Social Rights	S	O	States	Recital 35–36 TR
Charter of Fundamental Rights of the European Union	ESG	O	States	Recital 35–36 TR
UNGC Principles	ESG	O	Corporates	Recital 18 SFDR Annex I, Table 1 (ASI 10–11) Commission Delegated Regulation of 6 April 2022
IFC Performance Standards	ES	D-O	IFC Clients	Annex I draft RTS (February) then removed from the Annex I, Table 1 (ASI 10–11) Commission Delegated Regulation of 6 April 2022
UN PRI	ESG	D-O	PRI signatories	Recital 18 SFDR

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Table 4. Environmental Standards Incorporated in EU SF Framework (with Grey Shading Showing Overlaps across Standards)

Environment			
OECD	VI	Environment	E—General
IFC	3	Resource efficiency and pollution prevention	E—Resource efficiency
IFC	4	Community health, safety, and security	ES—General
IFC	6	Biodiversity conservation and sustainable management of living natural resources	E—Biodiversity
UNGC	7	Businesses should support a precautionary approach to environmental challenges	E—General
UNGC	8	Undertake initiatives to promote greater environmental responsibility	E—General
UNGC	9	Encourage the development and diffusion of environmentally friendly technologies	E—Technology

The incorporated standards stem from large international standard setters. The composition prompts the questions of why some standards have been chosen relative to a certain item. This aspect may require some closer look at some of these standards' content and level of detail.

According to the OECD Guidelines chapter VI, MNEs shall operate in a way that respects the environment, public health, and safety and promotes sustainable development. On these grounds, MNEs are, *inter alia*, expected to set up and maintain an environmental management system, engage in timely communication and dialogue with employees and local communities on potential environmental, health, and safety impacts, and assess and address potential foreseeable environmental, health, and safety impacts deriving from their activities.

Differently, while the OECD Guidelines provide general recommendations on the establishment and operation of an environmental management system, the IFC Standards offer both general and specific guidance concerning resource efficiency and biodiversity. Thus, identification and evaluation of environmental risks and impacts are emphasized in IFC Standard 1, proposing the adoption of mitigation strategies and the establishment of an environmental and social management system, which would enable the implementation of virtually all IFC Standards, and a communication system to prevent or minimize such environmental risks and impacts.

Furthermore, the UNGC principles 7 to 9 are dedicated to environmental considerations. While principles 7 and 8 contain general recommendations on managing environmental risk, principle 9 introduces a novel concept concerning the 'development and diffusion of environmentally friendly technologies'.

Already from this list, it becomes apparent that the delineation between the standards incorporated in the field of environmental sustainability may be improved.

2.2. Social standards

The social standards incorporated by the EU SF framework primarily focus on three main categories: human rights, labour, and communities. These include the UNGC, the OECD Guidelines, the UN Guiding Principles on Business and Human Rights, and the IFC Standards (see Table 5).

Again, we observe significant overlap across these standards, and unsurprisingly so given that nearly all human rights and labour standards in this field have been inspired by the International

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Table 5. Social Standards Incorporated in EU SF Framework (with Grey Shading Showing Overlaps across Standards)

Social			
International Bill of Human Rights			S—Human Rights
ILO Declaration			S—Labour
UN Guiding Principles on Business and Human Rights			S—Human rights
OECD	IV	Human rights	S—Human rights
OECD	V	Employment and industrial relations	S—Labour
OECD	VIII	Consumer interests	S—Consumers
IFC	2	Labour and working conditions	S—Labour
IFC	4	Community health, safety, and security	ES—General
IFC	5	Land acquisition and involuntary resettlement	S—Community
IFC	7	Indigenous peoples	S—Community
IFC	8	Cultural heritage	S—Community
UNGC	1	Businesses should support and respect the protection of internationally proclaimed human rights	S—Human rights
UNGC	2	Make sure that they are not complicit in human rights abuses	S—Human rights
UNGC	3	Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining	S—Labour
UNGC	4	The elimination of all forms of forced and compulsory labour	S—Labour
UNGC	5	The effective abolition of child labour	S—Labour
UNGC	6	The elimination of discrimination in respect of employment and occupation	S—Labour

Bill of Human Rights and the ILO Declaration. This becomes apparent from a closer look at some of these standards.

According to the OECD Guidelines chapter IV, MNEs should operate by respecting internationally recognized human rights and fulfilling local human rights obligations. In particular, they should respect human rights and prevent, mitigate, or address adverse human rights impacts in the context of their own activities or related businesses.

The UN Guiding Principles on Business and Human Rights offer general guidance to states on how to prevent, investigate, punish, and redress human right abuses from any third party, including business enterprises. Under the foundational principles 11 to 15, business enterprises should respect 'internationally recognized' human rights, consisting at least of those included in the International Bill of Human Rights and ILO's Declaration on Fundamental Principles and Rights at Work.

Standards on rights of workers and working conditions were first established by the ILO Declaration on Fundamental Principles and Rights at Work. The ILO's core conventions establish four main categories of labour principles that were later incorporated in the UNGC principles 3 to 6 and the OECD Guidelines chapter V. The latter provides that MNEs should respect the rights of workers to establish and join trade unions, contribute to the abolition of child labour and all forms of forced labour, and follow the principle of equality of opportunity and non-discrimination.

A condition for sustainable development while performing business activities is the protection of local communities. This entails promoting the health, safety, and security of local

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Table 6. Governance Standards Incorporated in the EU SF Framework

Governance			
OECD	VII	Combating bribery, bribe solicitation, and extortion	G—Corruption
OECD	X	Competition	G—Competition
OECD	XI	Taxation	G—Taxation
UNGC	7	Businesses should work against corruption in all its forms, including extortion and bribery	G—Corruption

communities, protecting indigenous peoples, avoiding eviction and minimizing involuntary resettlement due to land acquisitions, protecting consumer interests, protecting cultural heritage, and supporting the development of local communities through science and technology. Under IFC Standard 4, businesses should operate in respect of local communities in order to avoid or minimize risks and adverse impacts on health, safety, and security. IFC Standard 5 aims to avoid forced eviction and minimize displacement due to land acquisitions and restrictions related to project or business-related activities in a host country. Adverse social and economic impacts from land acquisition or restrictions should also be avoided or minimized with appropriate compensations and resettlement activities. IFC Standard 7 specifically considers the rights of indigenous peoples, emphasizing the importance to ensure 'dignity, aspirations, culture, and natural resource-based livelihoods of indigenous peoples'.

In order to facilitate sustainable development and the enhancement of mutual confidence between MNEs and local communities, enterprises should also operate in respect of consumer interests and foster development through science and technology. According to the OECD Guidelines chapter IX, MNEs should operate in accordance with science and technology policies and contribute to further innovation in the communities in which they operate. MNEs should also allow for the transfer of technologies and know-how and support the development of science and technology while also promoting research projects and cooperation with local universities and public research institutions in each country where they are active.

Comparing the list of environmental and social standards reveals that the EU SF framework cites the social standards in a less detailed manner than the environmental standards. This issue is further discussed in the remainder of this article.

2.3. Governance

On governance issues (see Table 6), the OECD Guidelines provide the most complete set of standards touching upon different aspects such as anti-corruption (OECD VII), taxation (OECD XI), and competition (OECD X).

3. *Preliminary insights*

The analysis so far has led to two insights.

First, there is overlap. Most standards incorporated by reference deal with similar matters. The fact that citations create overlaps while the focus and content of these standards differ will render the application of the EU SF framework a challenge. For instance, some standards refer to the same subject area in different contexts, such as 'science and technology', which are mentioned both in OECD IX and UNGC 9, whereas OECD IX emphasizes the social implications of furthering innovation and UNGC 9 refers to the importance of environmentally friendly technologies.

Second, within the standards incorporated, it becomes apparent that the EU SF framework cites social and governance standards in a broad and rather unprecise fashion, while standards

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Table 7. Interaction between International Standards and EU SF Framework (Analysis Per Article, Annex and Set of Standards)

EU SF framework	International standards
Art. 18 TR	OECD, UN guiding principles, ILO, International Bill of Human Rights
Art. 22(c)(ii) of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles, ILO, International Bill of Human Rights
Art. 26(2)(b) of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles, ILO, International Bill of Human Rights
Art. 39(b) of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles, ILO, International Bill of Human Rights
Art. 51(d)(ii) of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles, ILO, International Bill of Human Rights
Art. 59(e)(ii) of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles, ILO, International Bill of Human Rights
Art. 67(c)(ii) of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles, ILO, International Bill of Human Rights
Annexes I, II, III, IV and V of Commission Delegated Regulation of 6 April 2022	OECD, UN guiding principles
Annex I, Table 1 (ASI 10–11) of Commission Delegated Regulation of 6 April 2022	OECD and UNGC
Annex I Draft RTS (Feb)	IFC6

for environmental matters are cited in a granular manner, sometimes even referring to sentences and sub-sentences of a given standard. The latter observation indicates that the EU legislative bodies have looked closely into environmental standards and decided which of these standards they intended to adopt. On the other hand, a closer look at the interaction of clauses in the EU SF framework and the respective international standards might reveal whether the same is true for social and governance standards as well.

V. INTERACTION OF THE EU FRAMEWORK AND INTERNATIONAL STANDARDS

As to the interaction between international standards and the EU Taxonomy, different reflections can be advanced depending on the content of the standards concerned (see Table 7).

A. Gap in the EU social and governance framework

Focussing on social and governance frameworks, a close look at the EU SF framework reveals that there are no EU-own standards. All what the current EU social and governance framework entails is a reference to the international standards.

One reason may lie in the level of specificity.

As to social considerations, international standards are often rather detailed and provide recommendations, *inter alia*, on human rights (OECD IV, IFC 1, UNGC 1–2) and labour rights (OECD V, IFC 2, UNGC 3–6). The OECD VIII focusses on consumer rights and the IFC 7 and 8 on indigenous peoples and cultural heritage, respectively. Overlaps have been identified with regard to human and labour rights among the OECD Guidelines, UNGC, and IFC Standards. However, the social dimension of sustainability has been considerably watered down in the EU SF framework as disclosure is not requested on all of the social standards mentioned above. Important parts of the OECD Guidelines that have been disregarded include consumer interests

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Table 8. Comparison of Environmental Standards and Taxonomy Regulation

E—Categories	EU SF framework	International standards
Biodiversity	Art. 15 TR	OECD VI, IFC6, UNGC 7–9
Resource efficiency	Art. 13 TR	OECD VI, IFC3, UNGC 7–9
Pollution prevention	Art. 14 TR	OECD VI, IFC3, UNGC 7–9
Waste management	Art. 13 TR	OECD VI, IFC3, UNGC 7–9
Water management	Art. 12 TR	OECD II, IFC3, UNGC 7–9
Climate change	Art. 10–11 TR	OECD VI, IFC3 and 6, UNGC 7–9

(OECD VIII), science technology (OECD IX), competition (OECD X), and taxation (OECD XII), while other parts are merely voluntary disclosures. This suggests that the EU legislators so far have not taken the social dimension of sustainability seriously.[55]

The view that some of the ESG aspects are more important than others is confirmed by a look at the governance dimension. Again, we find very few details in the EU framework; on governance issues, the OECD standards touch upon different aspects, such as anti-corruption (OECD VII), taxation (OECD XI), and competition (OECD X). The EU SF framework just cites the former.

All in all, the EU SF framework does not cover the social and governance dimension of sustainability and has not reached the same level of detail and sophistication achieved with regard to environmental considerations. The EU provisions in this regard do not go beyond recalling the international standards previously discussed, although a policy-led debate on the development of a social taxonomy has started.[56] This also means that the EU SF framework still lacks certainty on how to integrate social considerations in investment decisions.

B. Mature environmental rules with standards as floor

With regard to environmental considerations, international standards do not always provide specific recommendations around the main environmental issues. They rather contain high-level recommendations on the establishment of environmental risk management systems, assessment of environmental risks, and introduction of contingency plans for preventing, mitigating, and controlling environmental and health damage (OECD VI and IFC 1). The UNGCs recommend businesses to adopt a precautionary approach to environmental challenges, to undertake initiatives to promote greater environmental responsibility, and to encourage the development and diffusion of environmentally friendly technologies. More detailed guidelines are provided by the IFC on biodiversity (IFC 6) and resource efficiency and pollution prevention (IFC 3).

On the contrary, the EU SF framework over the last 3 years has made significant steps forwards in terms of environmental sustainability. By clarifying when an economic activity is environmentally sustainable, the Taxonomy Regulation allows also for the identification of sustainable investments. In so doing, the EU SF framework aims at ensuring that the financial system channels resource towards sustainable activities. The EU environmental taxonomy is therefore much more rigorous than environmental standards, as it also provides a clear differentiation of environmental categories (Table 8) and lists, over hundreds of pages for each economic activity and sector, what counts and what does not count as (environmental) sustainable.

[55] This may change if the European Commission puts forward a proposal for a Social Taxonomy; see Dirk A. Zetzsche, 'Marco Bodellini, Roberta Consiglio, Towards A New European Social Taxonomy: A Counterproposal Based On A Three-Step Approach', University of Luxembourg Working Paper, 2022.

[56] The Platform on Sustainable Finance advising the European Commission is working on the development of a social taxonomy.

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Economic activities that do not meet the strict taxonomy requirements are not considered environmentally sustainable for that purpose. Still, this does not mean that such activities cannot be performed any more, since there is no prohibition in that respect. Rather, the EU SF framework requires enhanced disclosures in this respect. For instance, de-browning (e.g. foregoing coal in energy production) *per se* is not sustainable under the EU Taxonomy as the alternative use of wind energy may harm biodiversity for killing birds. Yet, de-browning, from a transitional perspective, might be desirable.

For that purpose, Art. 9 SFDR provides for the option of non-taxonomy-compliant, yet sustainable investments. The EU SF framework is not crystal clear on when this definition is met but mandates disclosures from financial market participants on the methodology used. Here, it is where international standards matter; in relation to those activities, the international environmental standards will continue playing a significant function, by setting minimum requirements for situations that the EU Taxonomy does not cover. In turn, international environmental standards will be particularly important during the transition towards net zero, which will not be achieved overnight. The main international standards thus will function as a lower 'floor' on environmental sustainability.

C. Double materiality as catalyst

The strict approach of the EU environmental framework is reinforced by the decision to embrace the double materiality principle referred to in part IIIA. Double materiality requires each economic actor, not only to focus on the impact of outside factors on their business but also to provide a detailed analysis of how their own behaviour impacts on the external world. Where this analysis is guided by detailed rules, it may prompt true change in that double materiality paired with detailed criteria concerning sustainability risks and negative impacts on the environment can potentially enable the transition to net zero.

A closer look at double materiality is of essence.

1. Securities regulation roots of double materiality

The concept of 'double materiality' builds upon and adds to the one financial materiality (also referred to as materiality of financial information). Financial materiality relates to those facts which are material in that they can influence the investment decisions of an average prudent investor. In the US system, according to the Securities and Exchange Commission, financial materiality concerns 'the significance of an item to users of a registrant's financial statements'.[57] Thus, a matter is considered material 'if there is a substantial likelihood that a reasonable person would consider it important'.[58] On these grounds, the US Supreme Court held that a fact is material if 'there is – a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available'.[59] Despite relevant case law, what is material in practice remains a vague and subjective concept, often rather difficult to apply.

Linking the concept of financial materiality to sustainability-related factors, it can be argued that the latter are material insofar as they would be taken into account by a reasonable investor when making investment decisions. While it is widely accepted that sustainability-related risks potentially affecting firms can be material, views diverge as to the financial materiality of a firm's impact on sustainability factors.[60]

[57] Securities and Exchange Commission, SEC Staff Accounting Bulletin: No. 99—Materiality, 17 CFR Part 211, 12 August 1999, https://www.sec.gov/interps/account/sab99.htm#foot4 (visited 2 November 2022).

[58] Ibid.

[59] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (U.S. Supreme Court 1976).

[60] See Hester M. Peirce, We are Not the Securities and Environment Commission—At Least Not Yet, Statement 21 March 2022.

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2. *Endorsement by EC*

The concept of double materiality has been endorsed by the EC[61] in the context of sustainability reporting.[62] The EC underlines that according to the Non-Financial Reporting Directive, a company is required to disclose information on environmental, social and employee matters, respect for human rights, and bribery and corruption, to the extent that such information is necessary for an understanding of the company's development, performance, position, and impact of its activities.[63]

According to the Commission, these two dimensions (financial materiality and environmental and social materiality) already overlap in some cases and will increasingly do so in future. As markets and public policies evolve in response to climate change, the positive and/or negative impacts of a company on the climate will translate into business opportunities and/or risks that are financially material.[64]

3. *Key components of double materiality*

Double materiality rests on three conditions.[65]

(i) Both the inward dimension and the outward dimension are considered against the broad concept of sustainability.[66]

(ii) As sustainability risks and externalities can be financially material, namely they can either positively or negatively affect the firm in question in terms of performance and value, both actual and potential externalities and risks shall be taken into account.

(iii) The two dimensions (inward and outward) are seen as interrelated in that one can affect the other. Accordingly, the firm's impacts on the environment and society cannot be disregarded on the assumption that they are not financially material.[67] Any unsustainable activity can turn into a financial risk, through legal liabilities or negative effects on reputation and/or a reasonable investor might base her decisions to invest (or not to invest) upon those factors.[68]. This last point, however, remains controversial as in the past poor environmental and social conduct has sometimes led to higher returns.

Proponents of double materiality argue that by focussing first on externalities (and then on sustainability risks), a firm would be able to align its horizon with the one of its stakeholders (largely understood), turning it from a short-term one into a long-term one.[69] Such shift could be particularly relevant not only for the stakeholders but also from the firm's viewpoint

[61] European Commission, Guidelines on Non-financial Reporting: Supplement on Reporting Climate-related Information, June 2019, https://ec.europa.eu/finance/docs/policy/190618-climate-related-information-reporting-guidelines_en.pdf (visited 2 November 2022).

[62] See Felix Beske, Ellen Haustein and Peter C. Lorson, 'Materiality Analysis in Sustainability and Integrated Reports', 11 (1) Sustainability Accounting, Management and Policy Journal 162 (2020), at 186; Olivier Boiral, 'Inaki Heras-Saizarbitoria and Marie-Christine Brotherton, Assessing and Improving the Quality of Sustainability Reports: The Auditors' Perspective', 155 (3) Journal of Business Ethics 703 (2019), at 721.

[63] Art. 19a (1) of Directive 2013/34/EU of the European Parliament and of the Council OJ 2013 L 182/19 (introduced by Directive 2014/95/EU, the Non-Financial Reporting Directive of the European Parliament and of the Council, OJ 2014 L 330/1).

[64] European Commission, Guidelines on Non-financial Reporting: Supplement on Reporting Climate-related Information, June 2019, https://ec.europa.eu/finance/docs/policy/190618-climate-related-information-reporting-guidelines_en.pdf (visited 2 November 2022).

[65] See Iris Chiu, 'The EU Sustainable Finance Agenda: Developing Governance for Double Materiality in Sustainability Metrics', 23 European Business Organization Law Review 87 (2022), at 123.

[66] On this see Charl De Villiers, Matteo La Torre and Matteo Molinari, 'The Global Reporting Initiative's (GRI) Past, Present and Future: Critical Reflections and a Research Agenda on Sustainability Reporting (Standard-Setting)', Pacific Accounting Review (2022), forthcoming.

[67] See Carol A. Adams et al., 'The Double-Materiality Concept. Application and Issues', Global Reporting Initiative, May 2021.

[68] See Matthias Täger, 'Double materiality': what is it and why does it matter?, London School of Economics and Political Science and Grantham Research Institute on climate change and the environment, Commentary 21 April 2021, https://www.lse.ac.uk/granthaminstitute/news/double-materiality-what-is-it-and-why-does-it-matter/ (visited 2 November 2022).

[69] See Adams et al., above n 67, *passim*.

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as providers of finance might be interested in the firm's ability to create long-term value both for themselves and for the society.[70] The opposite approach would maintain the focus on short-term profits, thereby being potentially detrimental to both the firm's long-term performance and sustainable development.[71]

Be this as it may, some unwanted consequences are associated with double materiality on environmental objectives. First, assessing the adverse impacts of investment decisions on sustainability factors, as requested by the SFDR, might be rather challenging for financial institutions due to lack of data and uniformly accepted models.[72] Second, applying double materiality does not fully erase the risk that environmental materiality will be used only to preserve the firm's financial value as firms might continue to privilege financial performance over social and environmental sustainability, thus reducing the double materiality's broad accountability potential.[73] Third, there are still uncertainties on what is material and accordingly what needs to be reported in relation to the outward dimension of double materiality.[74]

D. Intermediate results

The EU SF framework assigns to international standards two entirely different roles. With regard to the social and governance dimension, international standards are all that matters, as here the EU SF framework lacks any significant rule. By contrast, the high level of granularity on environmental aspects retains for the international standards only the role of minimum requirements for those products which are non-compliant with the EU Taxonomy (i.e. those products seen as not fully 'green').

All in all, by combining granular environmental rules with 'double materiality' as the core methodology, the EU framework is more demanding on environmental objectives than other jurisdictions.[75] The many pages that environmental RTSs fill in the EU rulebooks are the evidence that the environmental aspect of sustainability is what truly matters. Yet, whether ambition coincides with true progress is a question beyond the scope of this article.

VI. CONCLUSION

A number of international standards have been incorporated in the EU SF framework. We found that the different standards not only incorporate partly overlap but also diverge as to the details. This overlap will likely create practical issues, given that financial service providers need to decide which of the overlapping, yet partly diverging, standards they apply. Issues in this regard would range from investors and asset managers having to align to several different standards, which will increase the costs of compliance, to misalignments as to degree of sustainability of the underlying investments, which will cause investors to struggle in selecting really 'sustainable' investments. In turn, this could also create additional burdens on reporting.

[70] See Carol A. Adams, Paul B. Druckman and Russel C. Picot, Sustainable Development Goals Disclosure (SDGD) Recommendations, Association of Chartered Certified Accountants, Chartered Accountants Australia New Zealand, Institute of Chartered Accountants Scotland, International Federation of Accountants, International Integrated Reporting Council and World Benchmarking Alliance, London, (2020).

[71] See Adams et al., above n 67, *passim*.

[72] See Dirk A. Zetzsche and Marco Bodellini, A Sustainability Crisis Makes Bad Laws—Towards Sandbox Thinking in EU Sustainable Finance Law and Regulation, Working Paper, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4147295 (visited 2 November 2022).

[73] See Matteo La Torre, 'Svetlana Sabelfeld, Marita Blomkvist and John Dumay, Rebuilding trust: sustainability and non-financial reporting and the European Union regulation', 28 (5) Meditari Accountancy Research, Emerald Group Publishing 715 (2020).

[74] See Mathilde Bossut, Ingmar Jürgens, Thomas Pioch, Frank Schiemann, Theresa Spandel and Raphael Tietmeyer, What information is relevant for sustainability reporting? The concept of materiality and the EU Corporate Sustainability Reporting Directive, Sustainable Finance Research Platform—Policy Brief—7/2021, 11, urging the European Commission to provide a definition of double materiality and to precisely indicate what to report and who should report.

[75] In the U.S., on 21 March 2022, the SEC proposed a rule that would make corporate greenhouse gas (GHG) emissions reporting mandatory, thereby adopting the double-materiality principle.

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We further found that at environmental level, the EU SF framework presents unique features and a higher level of sophistication when compared to international ESG standards. This results from adopting both the taxonomy and the double materiality principle.

This may result in both upsides and downsides. On the upside, the EU SF framework could function as a pacemaker and global standard setter and facilitate impact measurements, thereby leveraging on the 'Brussels Effect'. Accordingly, the EU has the power to unilaterally regulate global markets.[76] In fact, the EU sets rules which often end up having a global reach in several areas (e.g. food, chemicals, competition, and privacy). The EU's rules penetration into other jurisdictions takes place through the process of unilateral regulatory globalization, which occurs when a single state (or jurisdictional domain) manages to externalize its laws outside its territory through market mechanisms without any active imposition of them and possibly in the absence of the willingness of others to adopt such laws.[77]

This process, which leads to the globalization of standards and rules, is clearly different from political globalization of regulatory standards whereby regulatory convergence arises from negotiated standards, but it also differs from unilateral coercion, whereby one jurisdiction imposes its rules on others through threats or sanctions.[78]

Bradford identified three conditions as necessary for a jurisdiction to be able to adopt rules with global application: the jurisdiction concerned has: (i) a large domestic market; (ii) a significant regulatory capacity; and (iii) the ability to enforce strict rules over inelastic targets (e.g. consumer markets) as opposed to elastic targets (e.g. capital).[79] Additionally, for unilateral regulatory globalization to take place, the benefits of adopting a uniform global standard shall exceed the benefits of adhering to multiple, including laxer, regulatory standards. This is typically the case when it is neither legally feasible nor economically viable for firms operating on a cross-border basis to maintain different standards in the different markets where they operate.[80]

The EU meets all the above-mentioned conditions, as it has: (i) the world's largest internal market; (ii) strong regulatory institutions; and (iii) strict rules in several areas. As a consequence, doing business in the EU requires foreign firms to adjust to (typically more demanding) standards. Although the EU regulates only its internal market, cross-border operating firms often have an incentive to standardize their operations globally and adhere to a single standard, that is the strictest one.[81] This is the way in which typically EU rules are converted into global rules, through the '*de facto* Brussels Effect'.[82] Interestingly, once such export-oriented firms have voluntarily aligned to the EU's standards, they have the incentive to pressure their home governments to adopt the same standards with a view to levelling the playing field against their domestic and non-export-oriented competitors—the '*de jure* Brussels Effect'.[83]

We argue that the same unilateral regulatory globalization can take place at the initiative of the EU also in the context of environmentally-related and socially-related standards (and then rules). The EU has currently the most developed legal framework in the area of environmental sustainability and a number of legislative initiatives are on-going in relation to making the financial system actively support the transition to net zero. Once these demanding standards

[76] See Anu Bradford, 'The Brussels Effect', 107 Northwestern University Law Review 1 (2012).

[77] Id.

[78] See Gary Clide Hufbauer et al., 'Economic Sanctions Reconsidered', June 2009, at 11, discussing foreign-policy use of economic sanctions generally.

[79] See Bradford, above n 76, at 1.

[80] See Marco Bodellini, 'The European Union Regulation on Marketing of Alternative Investment Funds: Another Step Towards Integration of the European Union Financial Market', 37 Business Law Review 216 (2016), where the case of the release of the EU passport to non-EU fund managers under the AIFMD is discussed as an example of extraterritorial effects of EU laws.

[81] See Lloyd Gruber, *Ruling the World: Power Politics and the Rise of Supranational Institutions* (Princeton: Princeton University Press, 2000) *passim*, arguing that unilateral regulatory globalization is produced through 'go-it-alone power' by a dominant regulator.

[82] See Bradford, above 76, at 1.

[83] Ibid, at 1.

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will be fully embedded in the legal framework and in light of the large size of the EU internal market, non-EU operators will face the need to comply with them to operate with EU counterparties. In other words, the Brussels Effect is expected to play its role even in the context of environmental sustainability legislation and regulation, thereby making once again the EU a pacemaker.

Yet on the downside, we see additional costs for firms[84] and political resistance[85] against the overly detailed EU approach which could weaken the international recognition of the EU SF framework. At the same time, we found that the EU SF framework lacks details on the social and governance dimensions. Here, the reference to international standards compensates the lack of a social and governance taxonomy. While this allows for alignment of EU and international social and governance-oriented investors, a greater degree of sophistication at the EU level could enhance the potential for impact measurement—a particularly important aspect for social investments. With a view to tackling this issue we have designed and proposed a three-step approach to use as a conceptual basis for a social taxonomy to be adopted at EU level.[86] Challenging the 'winner takes all' character of the environmental taxonomy whereby only economic activities meeting both furthering and facilitating characteristics and the do-no-significant-harm principle can be classified as sustainable, we advocate in favour of an alternative scorecard approach assigning lower scores for transitional and mitigating activities and higher scores for activities meeting stricter taxonomy system criteria. While we admit that this might lessen accuracy for some aspects, the advantage of a scorecard approach lies in its adaptability and indicative effect, putting an emphasis on economic activity's transition towards sustainability.

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[84] PRI, Testing the Taxonomy, Insights from the PRI Taxonomy Practitioners Group, www.unpri.org/download?ac=11662 (visited 2 November 2022).

[85] IEEP, Politics Over Science: Nuclear and Fossil Gas in the Taxonomy, February 2022, https://ieep.eu/news/politics-over-science-nuclear-and-fossil-gas-in-the-taxonomy (visited 2 November 2022).

[86] Dirk A. Zetzsche, Marco Bodellini and Roberta Consiglio, 'Towards A New European Social Taxonomy: A Counterproposal Based On A Three-Step Approach', University of Luxembourg, Working Paper, 2022.

Appendix: International Sustainability Standards

OECD Guidelines for MNEs		
I	Concepts and principles	ESG
II	General policies	ESG
III	Disclosure	ESG
IV	Human rights	S
V	Employment and industrial relations	S
VI	Environment	E
VII	Combating bribery, bribe solicitation and extortion	G
VIII	Consumer interests	S
IX	Science and technology	ESG
X	Competition	G
XI	Taxation	G
IFC Performance Standards on Environmental and Social Sustainability		
1	Assessment and management of environmental and social risks and impacts	ES
2	Labour and working conditions	S
3	Resource efficiency and pollution prevention	E
4	Community health, safety, and security	ES
5	Land acquisition and involuntary resettlement	S
6	Biodiversity conservation and sustainable management of living natural resources	E
7	Indigenous peoples	S
8	Cultural heritage	S
UNGC Principles		
1	Businesses should support and respect the protection of internationally proclaimed human rights	S
2	Make sure that they are not complicit in human rights abuses	S
3	Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining	S
4	The elimination of all forms of forced and compulsory labour	S
5	The effective abolition of child labour	S
6	The elimination of discrimination in respect of employment and occupation	S
7	Businesses should support a precautionary approach to environmental challenges	E
8	Undertake initiatives to promote greater environmental responsibility	E
9	Encourage the development and diffusion of environmentally friendly technologies	E
10	Businesses should work against corruption in all its forms, including extortion and bribery	G

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