

This paper provides the technical advice from EFRAG SR TEG to the EFRAG SRB, following EFRAG SR TEG's public discussion. The paper does not represent the official views of EFRAG or any individual member of the EFRAG SRB. This paper is made available to enable the public to follow the EFRAG's due process. Tentative decisions are reported in EFRAG Update. EFRAG positions as approved by the EFRAG SRB are published as comment letters, discussion or position papers or in any other form considered appropriate in the circumstances.

## SEC 1 Sector classification – SR TEG recommendations

### Objective

- 1 This paper provides a summary of the SR TEG discussions and decisions taken during its meetings of 15 and 18 January 2024 in relation to the updating of the SEC 1 Sector Classification. Next to the changes needed to align with NACE 2-1, the EFRAG Secretariat proposed in these meetings a number of enhancements to the classification thanks to the ongoing research for high impact sectors.

### Summary of discussions and decisions

#### *Alignment SEC 1 with NACE 2-1*

- 2 Members agreed with using NACE 2-1 as the default version for building SEC 1. They also agreed with the resulting reclassification of “NACE 72.10 Research and experimental development on natural sciences and engineering” from “ESRS Pharma and biotechnology” to “ESRS Professional Services”.
- 3 Members noted that reclassifications should be adopted using uniform criteria to be used when determining all ESRS Sectors. Possible criteria could include: i) an analysis of how European companies are organised and whether they are vertically or horizontally integrated; ii) whether different technologies are being applied and to which extent these technologies are subject to the same impacts. The EFRAG secretariat notes that in the work presented today, it has consistently used the criteria agreed when SEC 1 was developed <sup>1</sup>.

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<sup>1</sup> The sector classification is based on the following considerations:

- (a) the business activities determine which sector the undertaking is operating in. Sectors share similar sustainability impacts, risks and opportunities;

The changes discussed today are due to new information obtained from the sector communities about the commonalities of sectors in market practice.

- 4 Members noted that, beyond the high impact sectors for which better visibility is now available, when EFRAG will define the content of the respective sector ESRS, the evidence about commonalities will be higher than what is available today, despite the research conducted so far and the input expected from the workshops in February. This means that it cannot be excluded that further changes are necessary in the future. However, postponing the issuance of SEC 1 as Delegated Act and issuing non-authoritative guidance for the time being, would not be an option. SEC 1 is needed to implement the requirements on SBM –1 in ESRS 2 and cannot be postponed. Changes could be also considered to SEC 1 in future amendments or in a post-implementation review, benefitting from the progresses done in the meanwhile in the ESRS sector programme. It was also noted that changes could be disruptive for preparers after the adoption of ESRS 2, so they should be kept to what is strictly needed.
- 5 While acknowledging the work done to arrive at the current set of sectors, one SR TEG member noted there was a need for a more granular list of sectors. On this point, one SR TEG member noted the necessity to create a separated sector dedicated to NACE Division 78 Temporary employment agency activities, due to its peculiarities.
- 6 In contrast to that, others noted that aggregation at a lower level could also be done by defining sub-sectors within the current list of sectors. This could fix the issue of the NACE Division 78 Temporary employment agency activities. In addition, opportunities to merge some of the actual sectors into a single sector may emerge during the standard setting.
- 7 The EFRAG Secretariat noted that a certain level of pragmatism is also needed without compromising in any way the relevance of the resulting requirements. With some flexibility, the combination of more sub-sectors into a single sector may be needed in order to keep the number of draft ESRS in preparation manageable.

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(b) the impacts, risks and opportunities analysis enables the identification of the sector’s sustainability matters that are material for the sector, and for which the undertaking shall report on in accordance with the sector-specific [draft] ESRS; and

(c) the sustainability matters identified in the sector standard shall be considered in the materiality assessment of the undertaking which shall report the Disclosure Requirements of the material sustainability matters.

## SEC 1 Sector Classification – SR TEG recommendations

- 8 Members tentatively disagreed with the creation of a separate sector on “Biofuels” proposed by the EFRAG Secretariat. Biofuels are now divided over three ESRS sectors: liquid biofuels are integrated with “ESRS Chemicals and polymers”, solid biofuels are integrated with “ESRS Paper and Wood” and gaseous biofuels are – at granular level – part of “ESRS Power production and Energy Utilities”. EFRAG Secretariat plans to re-discuss in a future meeting considering an illustration of the consequences for this decision.

### *Redefining relationship SEC 1 with EU Taxonomy*

- 9 The EFRAG Secretariat submitted three alternatives to SR TEG for dealing with the EU Taxonomy:
- (a) Decoupling ESRS Sector standards and EU Taxonomy;
  - (b) Adapt the scope of ESRS Sectors to fit in with EU Taxonomy activities; or
  - (c) Use references to the EU Taxonomy activities that are indicative only.
- 10 The EFRAG Secretariat noted that, while the paper presented three different theoretical options, the preference would be for option 3 - *Use reference to EU Taxonomy that is indicative only*. Most SR TEG members disagreed with the EFRAG Secretariat proposal and preferred option 1: *disconnecting ESRS Sectors and EU Taxonomy activities*, as they think that there is no sufficient relationship between the two. From one side we have regulatory requirements for banks and from the other we have the creation of ESRS Sector standards and the two things should not be mixed. The TEG member that is a banking preparer noted in this context that the detailed data needed for the taxonomy cannot be derived from undertakings' ESRS reports.
- 11 Few SR TEG members agreed with the EFRAG Secretariat proposal of option 3, which is a middle ground. Others noted that it is necessary to avoid giving the false impression of alignment, given that such an alignment is impossible in practice.
- 12 Consensus wise SR TEG members agreed it was impossible to align the frameworks and asked the EFRAG Secretariat to illustrate the reasons for that in the Basis for Conclusions to the SEC 1 Sector classification, using elements of option 3.

### *Proposed detailed modifications to SEC 1*

- 13 SR TEG members did not agree to create a "Metallurgical industry" standard, rather it was suggested to define it as a sub-sector as part of the Metal Processing standard.
- 14 SR TEG members generally agreed to locate the growing of tobacco plants under the Agriculture sector. The other NACE activity "Manufacture of tobacco products" is to be located as part of the "Food and Beverages" sector, as a separate sub-sector, based on

comparable impacts relating to health, regulation, protection of consumers as for example the production of alcohol. It was noted this NACE activity also included electronical products such as vaping tools.

- 15 SR TEG members also agreed to the EFRAG Secretariat reclassifications of NACE activities 33.15 Repair and maintenance of civilian ships and boats, and 35.30 Steam and air conditioning supply. SR TEG members agreed with the name changes of the "Chemicals" and "Constructions and Furnishings" sectors.
- 16 SR TEG members were informed about the EFRAG Secretariat proposal to change the sector definition of the financial sector, given the difference in scope between the sector regulation used currently and the NACE activities relating to this sector. Broadly, a number of inconsistencies arise between the scope of many sectoral regulations and the scope of economic activities part of the NACE codes relating to the financial sector. Examples include “employee participation schemes” and “central securities depositaries” as part of the “ESRS Capital Markets sector” or “post office giro institutions” and “credit unions” as part of the “ESRS Credit Institutions”. The EFRAG Secretariat is – parallel to the work on SEC 1 – developing new proposals to be discussed with the FI panels once created.
- 17 SR TEG members had no objections on the proposed alignments between ESRS sectors and GRI sectors.
- 18 SR TEG members did not agree to split the "Sales and Trade" sector and assign the wholesale activities to the underlying manufacturing sectors, splitting it off from the retail activities. The EFRAG Secretariat notes that each ESRS Sector will include disclosures that will cover both the upstream and downstream activities. In terms of standard setting, the disclosures defined in a given sector will inform the standard of the ESRS sectors that correspond to its downstream and upstream sectors, as appropriate. In this way the companies will have to apply only the ESRS corresponding to the sector where they have own operations. Similarly, they did not agree to remove the leasing activities from the "Sales and Trade" sector. Reasons for these were i) wholesale activities rely on large storage halls with specific impacts, ii) the impacts of sale activities are different compared to manufacturing activities, iii) in oligopolistic production processes the sales activities have an important say in how the manufacturing is being done in the value chain, iv) wholesale and retail sales are intrinsically bound through the e-commerce business model, v) in some Member States specific wholesale distributors exist which distribute their products to professional counterparties, vi) as too many different business models exist, integrating

## *SEC 1 Sector Classification – SR TEG recommendations*

wholesale with manufacturing would not catch the variety the different impacts relating to those business models.

- 19 As for leasing activities, SR TEG members noted that if leasing is defined as financial services, then: i) leasing can be seen as having a similar business model as providing funding and ii) specific indicators can be added in the section of the standard dedicated to the leasing sub-sector. The EFRAG Secretariat notes that financial leasing (NACE 64.91) is part of the “ESRS Credit Institutions”. The SR TEG comments rather relate to operational leasing activities which will remain part of the “ESRS Sales and Trade”.

### *Questions to stakeholders during public consultation*

- 20 Some SR TEG members noted that, while being technical and complex, the questions were in line with what was expected, given the nature of the matters. The questions may be revised after the engagement with sector communities to discuss SEC 1.

### **Next steps**

- 21 The EFRAG Secretariat will organise during February 2024 a number of workshops to consult stakeholders on how the different NACE activities are being combined into different ESRS sectors. The exposure to stakeholders in these workshops will be used as a fatal flaw review of the proposed ESRS Sector standards in SEC 1, which tentatively should be ready for approval in March.

#### **Questions for EFRAG SRB members**

- 22 Do EFRAG SRB members have comments on the above discussions and decisions? Please explain.