ALLEN & OVERY

GREAT FUND INSIGHTS

Taxonomy Regulation (ESG)

What fund and asset managers need to know

Up to date as of 14 September 2020

A key plank in the European Commission's work programme to help it move to a carbon neutral, sustainable EU involves the Taxonomy Regulation. This is a framework which allows for the progressive development over time of a taxonomy, meaning a classification system that will essentially define what activities are "green" and what are not. A brief update on what fund and asset managers need to know about this is set out below. (For our separate briefing on the European Green Deal see here[1].)

How did we get here?

8 March 2018 – The Commission published an Action Plan on Financing Sustainable Growth, which stated as follows (among other things). For a copy see here[2]:

"A shift of capital flows towards more sustainable economic activities has to be underpinned by a shared understanding of what 'sustainable' means. A unified EU classification system – or taxonomy – will provide clarity on which activities can be considered 'sustainable'. ***It is at this stage the most important and urgent action of this Action Plan.*** *Clear guidance on activities qualifying as contributing to climate change mitigation and adaptation, environmental and social objectives will help inform investors. It will provide detailed information on the relevant sectors and activities, based on screening criteria, thresholds and metrics. This is an essential step in supporting the flow of capital into sustainable sectors in need of financing. An EU taxonomy will be gradually integrated into EU legislation to provide more legal certainty."*

Two specific actions that were recommended:

- Table a legislative proposal to ensure the progressive development of an EU taxonomy for climate change, and environmentally and socially sustainable activities. The aim is to *"embed the future EU sustainability taxonomy in EU law and provide the basis for using such a classification system in different areas (eg standards, labels, green-supporting factor for prudential requirements, sustainability benchmarks)".*
- Set up a technical expert group.

The EU Technical Expert Group on Sustainable Finance (**TEG**) was subsequently formed and issued its "Taxonomy Technical Report" in June 2019 (for a copy see here[3]). This was a vast endeavour, looking at the development of an EU classification system for environmentally sustainable economy activities as regards 67 activities across 8 sectors. It was accompanied by a call for feedback that closed on 16 September 2019. The TEG has now considered this feedback and published its final report (for a copy see here[4]).

In parallel, the Commission progressed work on a regulation "on the establishment of a framework to facilitate sustainable investment". This has become known as the **Taxonomy Regulation**.

- The Council of the EU reached political agreement on this on 17 December 2019. A copy of the Council's press release published on 18 December 2019 can be found here[5]. A copy of the agreed text was published on 18 December 2019 and can be found here[6].
- The Commission has published a Q&A on the regulation and more recently some FAQs – these can be found here[7] and here[8].
- The text of the regulation was approved by the European Parliament in June 2020. A copy of the press release can be found here[9].
- The Commission's further work will be assisted by a technical expert group, the "platform on sustainable finance", which will be mandated to provide advice for developing and revising the technical screening criteria as well as reviewing its usability. The Commission will also be advised by a "Member State Expert Group".

1 https://www.allenovery.com/en-gb/global/news-and-insights/publications/european-green-deal-roadmap-to-a-climate-neutral-europe
2 https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en
3 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf
4 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf
5 https://www.consilium.europa.eu/en/press/press-releases/2019/12/18/sustainable-finance-eu-reaches-political-agreement-on-a-unified-eu-classification-system/
6 https://www.consilium.europa.eu/media/41897/st14970-ad01-en19.pdf?utm_source=dsms-auto&utm_medium=email&utm_campaign=Sustainable+finance%3a+EU+reaches+political+agreement+on+a+unified+EU+classification+system
7 https://ec.europa.eu/commission/presscorner/detail/en/QANDA_19_6804
8 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200610-sustainable-finance-teg-taxonomy-green-bond-standard-faq_en.pdf
9 https://www.europarl.europa.eu/news/en/press-room/20200615IPR81229/green-finance-parliament-adopts-criteria-for-sustainable-investments

Will the taxonomy regulation apply to fund and asset managers?

Yes, the regulation will apply to firms which provide portfolio management, as well as alternative investment fund managers (AIFMs) and UCITS management companies.

It will also apply to other firms falling within the definition of "financial markets participants" in the Disclosure Regulation (2019/2088).

What is the taxonomy and what is its goal?

The taxonomy is a classification framework for assessing activities in order to determine whether they are environmentally sustainable – ie to define what's "green" and what's not. In terms of the drivers behind this:

- In order to meet its climate targets and ensure a transition to an environmentally sustainable economic model, the Commission has indicated that the EU faces an investment gap. Attracting private capital to the activities that have the highest impact on climate is key. This has been reinforced by the EU Green Deal.
- The Commission believes there is currently no common understanding of which economic activities can be considered environmentally sustainable for investment purposes, which in the EU's view, is one of the factors contributing to this investment gap. Eg firms *"presently identify sustainable economic activities and sustainable investable assets in-house and on a voluntary basis. This is time consuming and costly, and the result is that different financial institutions use different taxonomies. Consequently, investors often find it too burdensome to check and compare different information for different financial products. This creates uncertainty and discouragement for investors and hampers the transition towards a sustainable economy."*[10]
- The taxonomy is intended to fix this – eg:
  - provide all market participants and consumers with a common understanding and common language as to what is "green";
  - protect private investors by mitigating risks of greenwashing (ie marketing used to promote the perception that a firm's products, aims or policies are "green" when they are in fact not) – and therefore enhance confidence in products and services marketed as "green";
  - perhaps most importantly, provide the basis for further policy action in the area of sustainable finance, including standards, labels, and potential changes to prudential rules. In particular, there are initiatives underway on an EU Green Bond Standard and an EU Ecolabel for retail investment products.
- The Commission considers this to be a fundamental step in its programme for moving towards a carbon neutral, sustainable EU:[11]

"The taxonomy for sustainable investment is probably the most important development for finance since accounting. It will be a game changer in the fight against climate change", said lead negotiator for the Environment Committee, Sirpa Pietikainen (EPP, FI). "I am satisfied that we reached a balanced agreement with Council, but this is only the beginning. Greening the financial sector is a first step to make investments flow in the right direction, so it serves the transition to a carbon neutral economy", she added.

"All financial products which claim to be sustainable will have to prove it following strict and ambitious EU criteria. The compromise also includes a clear mandate for the Commission to start working on defining environmentally harmful activities at a later stage. Phasing out those activities and investments is indeed as important to achieve climate-neutrality as supporting decarbonised activities", said Economic Affairs Committee rapporteur Bas Eickhout (Greens/EFA, NL)."

10 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-teg-frequently-asked-questions_en.pdf
11 https://www.europarl.europa.eu/news/en/press-room/20191217IPR69202/climate-change- new-rules-agreed-to-determine-which-investments-are-green

Tests

The proposed regulation provides that, to be environmentally sustainable, an activity must satisfy four tests:

Test 1 (E)

It must **substantially contribute** to one or more of the specified environmental objectives outlined in the regulation ((1) climate change mitigation, (2) climate change adaptation, (3) sustainable use and protection of water and marine resources, (4) transition to a circular economy, (5) pollution prevention and control, and (6) protection of healthy ecosystems) – OR be a transitional or enabling activity.

Test 2 (DNSH)

It must **do no significant harm** (**DNSH**) to any other listed environmental objectives.

- The baseline for this is compliance with the relevant EU environmental legislation, with additional criteria where appropriate.
- "Do no significant harm" criteria have been set out for certain priority climate change mitigation activities identified in the TEG's report.

Test 3 (S/G)

It must be carried out in **compliance with minimum social safeguards** (ie the eight fundamental International Labour Organisation conventions and the OECD's Guidelines for Multinational Enterprises, which includes governance considerations).

Test 4 (Technical criteria)

It must **comply with the technical screening criteria** (TSC), which, in effect, define what it means to "substantially contribute" and DNSH to an environmental objective.

A shorthand for remembering this is "E + DNSH + S/G + technical criteria".

The regulation allows the Commission to establish the technical screening criteria through a series of delegated acts, the first of which are expected to cover the first two environmental objectives: climate change mitigation and climate change adaptation.

What will the taxonomy regulation require?

Fund and asset managers

They will be required to disclose information essentially on how and to what extent the investments made for funds or clients align with the taxonomy. This is a "top up" to the new ESG disclosure requirements being imposed under the Disclosure Regulation.[12]

- Financial products/services that do not have a relevant investment objective (eg sustainability, carbon emission reduction or the promotion of environmental characteristics) must make a specific negative disclosure in pre-contractual materials and periodic reports: *"The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments."*

Member States and the EU

- They will have to apply the taxonomy when they indicate that public measures, standards or labels concerning financial products or corporate bonds offered by financial market participants or issuers are environmentally sustainable.

A company within the scope of the Non-Financial Reporting Directive (NFRD)

- It will have to disclose information on how and to what extent its activities are associated with environmentally sustainable economic activities.

Others

- The taxonomy can be used voluntarily by others. Eg a company that wishes to raise finance for sustainable activities could publish the percentage of its turnover or investments considered "green" under the taxonomy.

When will the taxonomy regulation apply?

This will happen in a staged way over time.
What is known so far:

- The Taxonomy Regulation became effective 20 days after its publication in the Official Journal – ie on 12 July 2020. For a copy of the final version of the regulation, see here[13].
- As the Commission has made clear:[14]

"The regulation can be seen as a framework, which allows for the progressive development of [the list of environmentally sustainable activities], ie of the EU environmental taxonomy. The Commission proposes to determine the technical screening criteria, and thereby the list of economic activities, through a series of delegated acts."

- The delegated act on the first two climate-related objectives (**climate change mitigation and climate change adaptation**) is expected to be adopted by 31 December 2020 – in that case, it will apply as of 31 December 2021.
- The delegated act on the **remaining four environmental objectives** should be adopted by 31 December 2021 – in that case, it will apply as of **31 December 2022**.

This will give firms at least a year to familiarise themselves with the criteria contained in the delegated acts before they begin to apply.

12 https://www.allenovery.com/en-gb/global/news-and-insights/publications/new-esg-disclosure-regulation
13 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R0852&from=EN
14 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/ sustainable-finance-teg-frequently-asked-questions_en.pdf

Brexit

The UK government has not made clear whether the Taxonomy Regulation will apply in the UK following the end of the implementation period of the Withdrawal Agreement. In May 2020, City minister John Glen said the government cannot comment at this stage on the extent to which the UK will align with the EU after the implementation period because the delegated legislation containing technical standards has not yet been published by the European Commission, meaning the UK does not "have clarity on the final outcome of the file". Mr Glen said the government will continue to monitor the legislative process as it considers the UK's approach to green finance standards. In other words, the Treasury is reserving its judgment. At the end of June (in response to Mr Glen's statement), the Chair of the House of Commons EU Committee asked:

– for clarification as to why such alignment is under consideration and, in particular, whether the issue of the UK operating something akin to the taxonomy has been raised, or is likely to be raised, in the context of discussions with the EU on equivalence for financial services; and

– to be informed when any draft legislation (under section 8 of the European Union (Withdrawal) Act 2018 or otherwise) is published to amend the Taxonomy Regulation as it applies in domestic law after the end of the implementation period. The committee has stated that, if the government intends to retain a version of the taxonomy in the longer term, it believes that Parliament should take a particular interest in any government proposals relating to the process for establishing the UK's own detailed screening criteria for the environmental objectives set out in the taxonomy.

The implementation period is currently scheduled to end on 31 December 2020.

Recommendations

In terms of what firms should be doing now:

– Get up to speed on the new disclosure regulation and establish an internal team to consider the impact on your business.

– Ensure you are "plugged in" to industry work on ESG

– Look out for the consultations expected to be published in due course on the technical standards

If you have any questions on the new requirements mentioned above or ESG generally, please get in touch with your usual A&O contact.