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ALERT MEMORANDUM

A Framework Taxonomy for Sustainable Finance

November 16, 2020

On July 12, 2020, Regulation (EU) 2020/852 on the establishment of a **framework to facilitate sustainable investment** amending Regulation (EU) 2019/2088 (the "**Taxonomy Regulation**") entered into force.[1]

The Taxonomy Regulation introduces an EU-wide taxonomy (or combined glossary and classification system) of environmentally sustainable activities, as well as new disclosure requirements for certain financial services firms and large public interest entities. In short, the Taxonomy Regulation is intended to provide certain **businesses** and **investors** with a common language to identify the extent to which an investment may be considered environmentally sustainable – and more broadly yet, which economic activities can be considered **environmentally sustainable** (or "**green**").

The initiative falls under Action 1 of the European Commission's 2018 Action Plan on Financing Sustainable Growth,[2] calling for the establishment of an EU classification system for sustainable activities.

This alert memorandum provides an overview of the Taxonomy Regulation (including as to status, scope and conceptual and technical framework), explores the upcoming regulatory implications of this initiative for European companies (and, in particular, financial sector firms), and provides a comparative analysis of similar regulatory developments in other jurisdictions.

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[1] A copy of the regulation is available here.
[2] A copy of the regulation is available here.

I. In a nutshell

The Taxonomy Regulation establishes criteria for determining whether an economic activity can be considered "**environmentally sustainable**". Its ultimate purpose is to be able to measure the degree of environmental sustainability of a financial investment, product, or financial instrument, based on the environmental sustainability (the "E" in "ESG" (Environmental, Social and Governance)) of the underlying activity.

Investments that fund one or several economic activities that qualify as environmentally sustainable under the Taxonomy Regulation will fall within the definition of an "**environmentally sustainable investment**". By taking into account negative impacts as well as positive effects on the environment, it is hoped that this standardised measurement tool will reduce so-called "greenwashing", whereby companies and investors overstate their commitment to environmental sustainability. Equally, the Taxonomy Regulation is expected to encourage market participants to upgrade their existing practices to match those identified in the technical screening criteria as environmentally sustainable.

It is expected that the Taxonomy Regulation will eventually serve as a framework for the other recent and upcoming regulatory reforms in the field of sustainable finance – including the EU's Sustainable Finance Disclosures Regulation (SFDR). In order to provide an objective point of comparison by financial market participants to end investors on the proportion of investments that fund environmentally sustainable economic activities, the Taxonomy Regulation supplements certain SFDR rules on transparency in pre-contractual disclosures and in periodic reports.

II. Status and timing

12 July 2020	The Taxonomy Regulation entered into force, although the related technical screening criteria are not expected to be issued by the Commission until the end of this year.
1 January 2022	The Taxonomy Regulation will begin to apply with regard to its climate change mitigation and climate change adaptation objectives (as described below). In addition, the first company reports and investor disclosures using the EU taxonomy will be due at the start of 2022.
1 January 2023	The Taxonomy Regulation will become fully enforceable with respect to its four environmental objectives (as described below).

III. Scope

The Taxonomy Regulation will affect issuers, investment advisors, banks and insurance firms as follows (although it is worth noting that the scope may be expanded to other types of companies in due course):

— <u>European Member States</u> will be required to use the sustainable finance taxonomy in setting requirements for financial market participants or issuers in respect of financial products or corporate bonds that are qualified as being environmentally sustainable;

— <u>Financial market participants and financial advisers</u> within the scope of the SFDR will be required to use the taxonomy in complying with pre-contractual disclosure and in periodic reporting requirements (in particular, this will apply in relation to so-called "**light green**" investments (*i.e.*, products that promote environmental or social characteristics) and "**dark green**" investments (*i.e.*, products that have sustainability as their outright investment objective) – whereas for all other financial products, disclosures shall state that "*The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities*"); and

— Large listed issuers and large banks and insurance firms will be required to use the taxonomy in their non-financial reporting under the EU's Non-Financial Reporting Directive 2014/95/EU (NFRD).

IV. Key provisions

Under the Taxonomy Regulation, an economic activity will be deemed to be "environmentally sustainable" if:

(a) it contributes substantially, or enables other activities to contribute substantially, to one or more of the Taxonomy Regulation's **six environmental objectives**, that is:

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. the protection and restoration of **biodiversity and ecosystems**; AND

(b) it does not significantly harm (DNSH) any of these environmental objectives; AND

(c) it is carried out in compliance with certain minimum safeguards (*e.g.*, the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles on Business and Human Rights and the ILO's Fundamental Principles and Rights at Work), many of which address other non-environmental sustainability objectives; AND

(d) it complies with the Taxonomy Regulation's own technical screening criteria (which are currently being developed by the Commission).

The Taxonomy Regulation sets forth definitions and criteria that are essentially relevant in relation to the "E" angle of the "ESG" sustainability paradigm, although the requirement to comply with the OECD Guidelines and ILO Fundamental Principles also introduces an element of "S" to the taxonomy equation. Further guidance on activities that contribute to the other sustainability objectives ("S" and "G") is expected to be developed by the Commission at a later stage.

In connection with the preparation of detailed technical screening criteria implementing each of the Taxonomy Regulation's environmental objectives, the EU's Sustainable Finance Technical Expert Group (TEG) issued a report in March 2020[3] setting out detailed proposals for the first tranche of delegated legislation covering the Taxonomy Regulation's first two objectives, which must be published by 31 December 2020. To help inform the delegated acts, the Commission also requested advice from the European Supervisory Authorities in September 2020. The criteria will be accompanied by an impact assessment and will be subject to stakeholder feedback, originally planned for the autumn of 2020.

V. Relationship with other EU legislation

SFDR

Institutional negotiations on several aspects of the Taxonomy Regulation were still underway at the date of final approval of the SFDR. As a consequence, the SFDR does not always take into account, nor make explicit reference to, the environmental sustainability framework enacted through the Taxonomy Regulation and its relevant definitions. From a general standpoint, this concerns the SFDR's concept of "sustainable

[3] The report is available here.

investment" – which (as far as environmental aspects are concerned) coincides only in part with the Taxonomy Regulation's own category of (environmentally) "sustainable activities".

Greater convergence between the two texts is expected to be achieved, in particular, through the regulatory technical standards (RTSs) that will be issued by the Commission under each regulation. Accordingly, the European Supervisory Authorities' consultation on the SFDR's draft RTSs addressed for instance the criteria that will be universally relevant to the application of the DNSH principle under EU law.

NFRD

Article 8 of the Taxonomy Regulation requires (financial and non-financial) public interest entities covered by the NFRD to disclose, as part of their annual reports, information on how and to what extent their activities – and, especially for non-financial undertakings, what portion of their turnover, capex and operating expenses – are "associated with" environmentally sustainable economic activities. The Commission has undertaken to adopt, by June 2021, a delegated act specifying the content, presentation and methodology that should apply to the additional disclosures that companies subject to the NFRD will have to make in application of this rule.

VI. Parallel developments outside the EU

United Kingdom

The Taxonomy Regulation will partly come into force during the Brexit transition period.

This means that the infrastructure of the Taxonomy Regulation (*i.e.*, its definitions and framework measures establishing the six high-level environmental objectives and the criteria for "environmentally sustainable economic activities") will be "on-shored" into UK law as of 31 December 2020. However, the technical screening criteria setting out substantive disclosure obligations will only become applicable after such date and thus will not automatically form part of the body of retained EU law.

On 9 November 2020, the UK Chancellor of the Exchequer clarified that the UK will have its own "green taxonomy", as the UK seeks to position itself at the forefront of green finance. The UK taxonomy will be based on the scientific metrics in the EU taxonomy, but subject to review by a to-be-established 'UK Green Technical Advisory Group', who will assess the metrics' suitability for the UK market. Additionally, the UK intends to join the International Platform on Sustainable Finance to support the development of common international standards on taxonomies.

United States

Green bond issuances are on the rise in the United States, with key offerings by a number of U.S. financial institutions and technology companies. Lending and bond offering practices are evolving and generally have aligned around the ICMA Green Bond Principles, but there is no set framework or statutory definition in the U.S. for such financings. While legal authority to regulate sustainable investing and finance exists in the U.S. through several government departments and agencies, there has not yet been systemic consideration of sustainable finance. A September 2020 report by the Commodities and Futures Trading Association on managing climate risk in the U.S. financial system outlined the existing authority and made recommendations to financial regulators, which may be considered in the future.

The umbrella framework of the U.S. federal securities laws disclosure regime, which creates liability for offerings with material misstatements or omissions in disclosure and imposes a due diligence obligation on financial institutions underwriting bond offerings, applies and pushes issuers to have clear disclosure of sustainable goals and metrics used to measure progress. Given the general principles-based approach of U.S. securities laws, it is unlikely that, even if new prescriptive requirements around disclosure are adopted and there is convergence around mandated reporting frameworks, there will be any short-term development toward a systemic definition and regulation of sustainable activities, like the Taxonomy Regulation.

MENA

There has been growing awareness of the importance of sustainable finance across MENA, with much of the focus being on the issuance of green bonds and green sukuk to finance sustainable investments (*e.g.*, Egypt recently issued the region's first sovereign green bond); and the region's stock exchanges are among the growing number globally that encourage or require ESG reporting by issuers (*e.g.*, the Bahrain Bourse published its voluntary ESG reporting guidelines in June 2020). We will analyse these ESG reporting developments in later publications, but in the field of sustainable finance taxonomy, it is regulators in the UAE who are currently spearheading regional regulatory reforms.

In January 2020, the leading regulatory authorities in the UAE (including the Central Bank of the UAE, the Abu Dhabi Global Market's FSRA and the Dubai International Financial Centre's DFSA) jointly published the first set of "Guiding Principles on Sustainable Finance", aimed at increasing implementation and integration of sustainable practices among the UAE's financial entities.

The second of the three voluntary principles emphasises the importance of adopting minimum eligibility requirements for what constitute "sustainable" financial products, and signals the authorities' intention to adopt an appropriate taxonomy in the UAE in due course. Until such adoption, the UAE authorities intend to rely on internationally recognised taxonomies for guidance and explicitly refer to (among others) the European Commission's 2018 Action Plan and "associated regulatory proposals" (*i.e.*, the Taxonomy Regulation).

China

ESG investment and green finance have become a focus of China in recent years, and efforts have been made by regulators to produce a standardised framework as to what constitutes "green". In February 2019, the National Development and Reform Commission and certain other regulatory authorities of China jointly promulgated the "Guiding Catalog of Green Industries", which is a list of "green" industries and shall be used by local governments as a basis to make detailed policies regarding investment, pricing, financing and tax of such industries and their sub-industries. China has also introduced a series of measures facilitating ESG investment, including to require A-Share listed companies to make ESG information disclosures, and to require banks to report and categorise green loans.

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