Katten

ESG and Sustainable Finance: The European Perspective

March 16, 2020

KEY POINTS

- Environmental, social and governance (ESG), green finance, sustainable finance, ethical investing are all widely used terms in the financial services industry — though they are used with no common agreement, international understanding or standards.
- The signing of the Paris Agreement[1] on December 12, 2015 and the adoption of the UN 2030 Agenda for Sustainable Development on September 25, 2015 evidenced a sea-change in global attitudes towards climate change and the environment.
- In the past five years, regulators, central banks and trade associations have begun to create the regulatory framework that individuals and firms need to support the re-orientation of private capital flows towards sustainable investments, while continuing to ensure financial stability.
- The European Commission (Commission) developed a framework, "Action Plan on Financing Sustainable Growth,"[2] to create a common language for sustainable finance (i.e., a sustainability taxonomy) which, together with the requirement for financial market participants to disclose the degree of environmental sustainability of their products, means that the European Union (EU) is leading the evolution towards sustainable and long-term investments.
- This Katten advisory explores the impact of this "ESG revolution"[3] and highlights changes required in order to comply with changing market expectations and the Commission's new requirements.
- The following examines key developments in ESG in financial services, and green lending in particular, as well as the EU's new regulations and their impact on financial market participants operating in or into the EU.

Background

The Paris Agreement is an agreement within the United Nations Framework Convention on Climate Change (UNFCCC) that aims "*to strengthen the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty*". This will be done by "*holding the increase in global average temperature to well below 2°C above pre-industrial levels*", as well as "*increasing the ability to adapt to the adverse impacts of climate*

[1] United Nations Treaty Collection, *Paris Agreement*, https://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XXVII-7-d&chapter=27&clang=_en.

[2] European Commission, *Financing Sustainable Growth*, https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200108-financing-sustainable-growth-factsheet_en.pdf.

[3] Robin Wigglesworth, *'The ESG revolution is widening gaps between winners and losers'*, FT Opinion, February 4, 2020, https://www.ft.com/content/12bd616e-442b-11ea-a43a-c4b328d9061c (subscription required).

change", and, crucially, by "*making finance flows consistent with a pathway towards low greenhouse gas emissions*".[4] The Paris Agreement was adopted by consensus on December 12, 2015, and was signed over the course of 2016 by representatives of 196 UN states.[5]

Since the signing of the Paris Agreement, trade associations and industry bodies have been working to develop guidance for firms who want to engage with sustainable investments or other financial instruments. For example, in 2018 and 2019 the Loan Market Association (LMA), in partnership with the Asia Pacific Loan Market Association (APLMA) and the US-focused Loan Syndications and Trading Association (LSTA), published principles for green and sustainable lending, respectively.

Most international hedge funds and other asset managers trade on LMA, LSTA or APLMA documents when trading in debt instruments, and so it follows that in the UK and the European Economic Area (EEA) many Alterative Investment Fund Managers (AIFMs) and firms regulated under the revised Markets in Financial Instruments Directive (MiFID II) also will likely have to comply with these principles, which are explored in more detail below.

In addition, the institutions of the EU have been working to address sustainability, climate change and other environmental concerns through a number of initiatives, as part of a wider, global initiative into ESG issues. This work is done under the umbrella of the Commission's "Action Plan on Financing Sustainable Growth" (Action Plan), published in March 2018.[6]

In December 2019, the Commission and the European Parliament reached agreement on the text of a proposed Regulation on the Establishment of a Framework to Facilitate Sustainable Investment (Taxonomy Regulation)[7], which will establish a pan-European classification system (or 'taxonomy') for firms and investors to identify which economic activities are "environmentally sustainable". This works in parallel with the Regulation on sustainability-related disclosures in the financial services sector (Disclosure Regulation)[8], which will require EU-based asset management firms to disclose the degree of environmental sustainability of funds and pension products that they manage, or to include disclaimers where they do not, as well as requiring most EU-based firms to give environmental disclosures in their regulatory filings.

What is sustainable finance?

The concept of sustainable finance is not well defined in all markets, though there is progress. As is discussed below in more detail, in the EU the Commission has established a framework that puts ESG considerations at the heart of the European financial system. This is to help transform the economy of the EU into a greener, more resilient and circular system. The Commission defines sustainable finance as "*the process of taking due account of environment and social considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities*".[1]

Environmental considerations include climate change mitigation and adaptation, and the prevention and control of air and water pollution, resource depletion and biodiversity loss. Social considerations could include issues of inequality, inclusiveness, labor relations, investment in human capital and communities.[2]

1 European Commission, "*Action Plan: Financing Sustainable Growth*", page 2, https://ec.europa.eu/info/publications/sustainable-finance-resources_en.

2 While the Commission notes that environmental and social issues are often "intertwined" (for example, climate change could exacerbate existing inequality), addressing these social issues is not the current focus of the Commission. In terms of governance, at the moment the Commission is mainly considering the impact of "capital market short-termism" on corporate decision-making.

4 Article 2, Paris Agreement, https://treaties.un.org/doc/Treaties/2016/02/20160215%2006-03%20PM/Ch_XXVII-7-d.pdf.

5 On June 1, 2017 President Donald Trump announced that the United States would cease all participation in the Paris Agreement, claiming that compliance with it would undermine the US economy. The US officially withdrew from the Paris Agreement on November 4, 2019.

6 Communication from the Commission to the European Parliament etc., "Action Plan: Financing Sustainable Growth", https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097.

7 European Commission, *Regulation on the Establishment of a Framework to Facilitate Sustainable Investment*, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018PC0353.

8 *Official Journal of the European Union, Regulation (EU) 2019/2088 of the European Parliament and of the Council on Sustainability-Related Disclosures in the Financial Services Sector*, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN.

The Commission also has proposed a number of amendments to the EU's existing Benchmark Regulation, the Insurance Distribution Directive, MiFID II, the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD).

Despite the UK's withdrawal from the EU, each of the Disclosure Regulation and the Taxonomy Regulation *will* be implemented into UK law, meaning that UK-based AIFMs, UCITS management companies and MiFID investment firms will have to comply. While these legislative changes will not have any direct effect on US firms, it is highly likely that they will have an indirect effect on US managers to the extent that their activities are conducted in Europe (e.g., European marketing). This is explored in more detail below.

Katten has outlined the status of these initiatives and analyzed the impact they will likely have on asset managers, financial trading firms and other investment professionals.

Impact on asset managers and investment firms

At the most superficial level, these new regulations and trade bodies' principles may require asset managers and investment firms operating in Europe to review and update many of their disclosures (to their regulator, and to investors), as well as their policies and procedures. They will have to revise their regulatory submissions, annual reports, and other disclosures to ensure that they comply with the new regulations.

However, the new structure introduced by the Taxonomy Regulation will allow firms making environmentally sound and sustainable investments to distinguish themselves from those that invest in polluting or unsustainable investments, or do not otherwise meet basic environmental standards. This new structure should reduce "greenwashing", where firms offer ESG products which are in fact not environmentally sound.

Therefore, in the long-term these new regulations may cause a profound change in the nature of the global asset management industry and across the financial services industry more broadly. Many studies and anecdotal evidence indicate that younger investors are more concerned with sustainable investing than older generations were and these new investors may focus their investments on those investment firms and funds that disclose a more environmentally sound strategy. Indeed, many firms — and regulators — both in the EU and elsewhere have already begun to respond to this demographic change.

For example, on April 17, 2019, the governors of the Bank of England and the Banque de France issued an open letter on climate-related financial risks[9] warning that companies who do not adapt to a lower-carbon future will "*fail to exist*". They noted that central banks need to integrate the monitoring of climate-related financial risks into day-to-day supervisory work, financial stability monitoring and board risk management, emphasizing "*climate change is a global problem, which requires global solutions, in which the whole financial sector has a crucial role to play*".

As for the industry response to ESG and sustainable investing, on January 14, 2020, BlackRock's founder, Larry Fink, sent a letter[10] to BlackRock's clients and to corporate executives announcing a change in direction "*to place sustainability at the center of our investment approach*". Mr. Fink argued that "*in the near future . . . there will be a significant reallocation of capital*" because of the threat of climate change, in particular. "*Awareness is rapidly changing, and I believe we are on the edge of a fundamental reshaping of finance*", he wrote, with the $7 trillion AUM investment group committing to incorporating ESG fully into its investment framework, including the requirement that companies in which BlackRock invests disclose their sustainability-related metrics. Keeping to this strategy, on February 6, 2020, BlackRock publicly criticized Siemens (as a major external shareholder) for failing to consider properly the "breadth of risks" it faces as a result of its involvement in an Australian coal-mining project.[11]

---

[9] Bank of England, *Open letter on climate-related financial risks*, https://www.bankofengland.co.uk/news/2019/april/open-letter-on-climate-related-financial-risks.

[10] BlackRock, *A Fundamental Reshaping of Finance*, https://www.blackrock.com/uk/individual/larry-fink-ceo-letter.

[11] Siemens has signed €18m contract to provide rail signaling systems for a large coalmine in Queensland — despite Siemens touting its green credentials in its own marketing materials. "*While [Siemens] followed its internal review process for the project, it is nevertheless clear that it requires a more thorough review of the potential risks, including ESG risks, presented by future projects,*" BlackRock said. F*inancial Times, 'BlackRock rebukes Siemens on its environmental record'*, https://www.ft.com/content/92512bcc-48b3-11ea-aee2-9ddbdc86190d (subscription required).

Similarly, in 2019, Legal & General Investment Management (L&GIM) published its second "Climate Impact Pledge"[12], in which it assessed and scored over 80 of the world's largest companies and engaged with them to improve their strategies to address environmental issues. Significantly, L&GIM have shown themselves willing to divest from those companies that fail to demonstrate sufficient action and the firm votes against the re-election of their board chairs across all funds where it holds voting rights.[13] L&GIM is one of the largest asset managers in Europe and its parent, Legal & General, is a major insurance and pension provider. L&GIM is just one of a number of high-profile European investment groups leading the way by targeting board individuals at portfolio companies over apparent ESG failings.

In January 2020, the US Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) announced its examination priorities for SEC-registered investment advisers during 2020.[14] This announcement made direct reference to the fact that "*OCIE has a particular interest in the accuracy and adequacy of disclosures provided by [regulated investment advisers] offering clients new types or emerging investment strategies, such as strategies focused on sustainable and responsible investing, which incorporate environmental, social, and governance (ESG) criteria.*" Indeed, a number of SEC-registered firms have reported receiving significant document requests from OCIE during 2019 relating to such firms' ESG investment activities, including their disclosures, marketing, use of metrics, internal controls and other policies. While OCIE's focus may be on ensuring that SEC-registered firms are not greenwashing, these activities show that ESG is an area of significant and increasing focus in the US, as well as in Europe.

Finally, on March 6, 2020, the UK's Financial Conduct Authority (FCA) published a consultation paper proposing a new climate-related disclosure in the annual financial reports of companies that are "premium listed" on the London Stock Exchange.[15] The proposed disclosure requirement comes from a report issued in June 2017 by the Task Force on Climate-related Financial Disclosures (TCFD), an industry group established by the Financial Stability Board in 2015.[16] In the report, the TCFD recommended four "overarching recommendations" relating to governance, strategy, risk management and metrics and targets, which are supplemented by 11 "recommended disclosures". In the consultation paper, the FCA proposes a "comply or explain" regime whereby premium-listed UK companies would have to disclose, for example, the board's oversight of climate-related risks and opportunities, or explain why they have not included such a disclosure. This proposal, while not directly impacting asset managers operating in Europe and the UK, may have an indirect impact on portfolio composition and risk weightings. It also indicates the direction of travel by the FCA towards a more rigorous regime for climate-related disclosures.

These recent examples illustrate how sustainability and climate change have moved towards the top of corporate agendas in recent years, with many investors demanding that companies improve their performance on a wide variety of matters that fall under the broad scope of ESG.

Green lending

In this climate of 'green' finance, in 2018, the EMEA-focused LMA, in partnership with the APLMA and the US-focused LSTA, published their Green Loan Principles (GLP)[17] for use within the secondary and syndicated loan markets. These were more recently followed in 2019 by the Sustainability Linked Loan Principles (SLLP).[18] Such collaboration between the three trade associations allows for clarity and global harmonisation on the application of the principles to the market. The GLPs, for example, are aligned with the Green Bond Principles produced by the International Capital Market Association (ICMA).

[12] L&GIM, *Climate Impact Pledge: Tackling the climate emergency*, https://www.lgim.com/web_resources/lgim-thought-leadership/Files/Climate-impact-pledge-2019-Tackling-the-climate-emergency.

[13] Which in 2018 represented votes against 3,864 directors globally, citing climate change, diversity or other governance factors.

[14] SEC OCIE, *2020 Examination Priorities*, https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf

[15] FCA, *Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations*, https://www.fca.org.uk/publication/consultation/cp20-3.pdf.

[16] TCFD, *Recommendations of the Task Force on Climate-related Financial Disclosures*, https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf.

[17] LMA, *Green Loan Principles*, https://www.lma.eu.com/application/files/9115/4452/5458/741_lm_green_loan_principles_booklet_v8.pdf

[18] LMA, *Sustainability Linked Loan Principles*, https://www.lma.eu.com/application/files/8015/5307/4231/lma_sustainability_linked_loan_principles.pdf

Given many international hedge funds and other asset managers that rely on LMA, LSTA or APLMA documents when trading in debt instruments, it therefore follows that in the UK and the EEA many AIFMs and MiFID firms also will likely have to comply with these principles.

Green Loan Principles (GLPs)

The GLPs can apply to any type of loan instrument made available exclusively to finance green projects, which are defined to include projects such as those relating to renewable energy, biodiversity conversation and climate change adaptation. Such loans must comply with the four GLPs:

1. **Use of proceeds**. The proceeds must be used for green projects that provide clear environmental benefits, which will be assessed and, where feasible, quantified, measured and reported by the borrower;
2. **Process for project evaluation and selection**. The borrower should clearly communicate to its lender the environmental sustainability objectives, the process by which the borrower determines how its projects fit within the green loan definition, and any related eligibility criteria, such as exclusion criteria;
3. **Management of proceeds**. The proceeds should be credited to a dedicated account or otherwise tracked by the borrower; and
4. **Reporting**. The borrower should maintain and readily make available up-to-date information on the use of proceeds. This should renewed annually and include a list of the green projects to which the green loan proceeds have been allocated. This list will include a description of the projects, the amounts allocated to the projects and information on their expected impact.

The LMA recommends that external parties be commissioned by the borrower to review, verify, certify rate or otherwise provide guidance in relation to a loan issued following the GLPs. The LMA also acknowledges that definitions of "green" and "green projects" may vary depending on sector and geography.

Sustainability Linked Loan Principles (SLLPs)

Under the SLLPs, sustainability linked loans are defined as any type of loan instrument or contingent facility which incentivises the borrower's achievement of ambitious, predetermined sustainability performance objectives. Like the GLPs, the SLLPs apply to loans made for a specific purpose but, unlike the GLPs, this purpose can be to facilitate and support any environmentally or socially sustainable economic activity. The core components of the SLLPs are:

1. **Relationship to the borrower's overall Corporate Social Responsibility (CSR) strategy**. The borrower of a sustainability linked loan should clearly communicate to its lenders its sustainability objectives for the loan in the context of its overarching CSR objectives, strategy, policy and processes;
2. **Target setting**. Appropriate sustainability performance targets (STPs) should be negotiated and set between the borrower and the lender for each transaction. Such STPs should be ambitious and meaningful and ideally accompanied by a third-party opinion;
3. **Reporting**. As with the GLPs, transparency is key to the success of these principles; and
4. **Review**. The borrower's performance against the SPTs should be independently verified by a qualified external reviewer, such as an auditor, environmental consultant or independent ratings agency. The identity of the reviewer and the frequency of the review should be negotiated and agreed between the parties on a transaction-by-transaction basis.

The LMA has listed some common categories of SPTs, such as improvements in the energy efficiency rating of building, or increases in the use of verified sustainable raw materials and supplies. The LMA also notes that the impact metrics being developed by the ICMA may be useful for firms to identify relevant SPTs and calculation methodologies.[19]

[19] See, for example, the ICMA's 2019 "*Handbook: Harmonized Framework for Impact Reporting*", https://www.icmagroup.org/assets/documents/regulatory/green-bonds/june-2019/handbook-harmonized-framework-for-impact-reporting-web-100619.pdf.

The Commission's Action Plan

Following the signing of the Paris Agreement, the Commission established the High-Level Expert Group on Sustainable Finance (HLEG) in December 2016, who delivered their final report to the Commission in January 2018.[20]

Following the recommendations of the HLEG, the Commission published its "Action Plan on Financing Sustainable Growth" (Action Plan) in March 2018,[21] which was followed by legislative proposals in May 2018.

The three goals of the Action Plan are to:

1. reorient capital flows toward sustainable investment in order to achieve sustainable and inclusive growth;
2. manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues (or, "mainstreaming sustainability in risk management"); and
3. foster transparency and long-termism in financial and economic activity.

In the Action Plan, the Commission set out 10 actions that they will take in order to achieve the goals, ranging from establishing an EU classification system for sustainable activities (i.e., the Taxonomy Regulation) and creating standards and labels for green financial products, to fostering sustainable corporate governance and attenuating short-termism in capital markets.

Each action carried with it several 'sub-actions' for the Commission to take, such as to develop delegated acts, conduct studies and revise guidelines. The initiatives that are the focus of this Client Digest are the result of these actions and sub-actions.

It is generally anticipated by the Commission that a harmonized EU taxonomy will have the dual benefits of both preventing the fragmentation of different EU Member States' systems, while also avoiding greenwashing.

To which firms does this apply?

The initiatives apply to two types of EU-based firms involved in investment decision-making processes:

- **Financial Market Participants**, including UCITS management companies, AIFMs, managers of European venture capital funds and European social entrepreneurship funds, MiFID II investment firms, and EU providers of pension products and providers of certain insurance-based investment products; and
- **Financial Advisers**, being firms providing investment advice in the EU or to persons in the EU.

In other words, almost all EU-regulated investment firms and asset management firms will be subject to these new regulations, including fund managers, brokers, and proprietary trading firms, among others. Notably, Article 17 of the Disclosure Regulation exempts financial advisers employing fewer than three people from the Disclosure Regulation requirements. However, in Recital 6, the Commission notes that such firms are still required to consider sustainability risks and factor them into the advisory process.

EU Disclosure Regulation

The Disclosure Regulation applies to Financial Market Participants and Financial Advisers (collectively, In-Scope Firms).

It entered into force on December 29, 2019, and the main provisions will apply from March 10, 2022. The Disclosure Regulation mandates that the European Supervisory Agencies (ESAs)[22] develop detailed regulatory technical standards (RTS) for the methodology, presentation and content of the requirements. These must be developed by December 31, 2020 for the environment and climate-related disclosures, and by December 31, 2021 for disclosures relating to employee and social matters.

---

[20] European Commission, *Final report of the High-Level Expert Group on Sustainable Finance*, https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en.

[21] European Commission, *Commission action plan on financing sustainable growth*, https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en.

[22] The ESAs comprise each of the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

There are three areas where these disclosures must be made:

- in firms' pre-contractual disclosures;
- in their periodic reports; and
- on each firm's website.

Pre-contractual (prospectus) disclosures

In-Scope Firms will have to make prescribed pre-contractual disclosures relating to the sustainability of investments. These pre-contractual disclosures will have to be made as part of normal investor disclosures and will include:

- the manner in which sustainability risks are integrated into their investment decisions; and
- the results of the assessment of the likely impacts of sustainability risks on the returns of the financial products they make available.

If a firm believes that sustainability risks are not relevant, the pre-contractual disclosure will have to include a "clear and concise" explanation of why they are not relevant.

In addition, a Financial Market Participant must disclose:

- whether, and, if so, how, a financial product considers principal adverse impacts on sustainability factors; and
- that the Periodic Reports (see below) are available and where an investor can access them.

There are many financial products that are held out in the market as being sustainable. However, anecdotal evidence suggests that investors find it hard to distinguish between products and to verify whether a particular product is truly sustainable — hence the reason that greenwashing has become a particular concern. To this end, the Disclosure Regulation requires that if a Financial Market Participant is promoting a product for its environment or social characteristics, the pre-contractual disclosures must include:

- information on how those environmental or social characteristics are met; and
- if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those environment or social characteristics.

If a financial product has a 'sustainable investment' objective and is linked to a benchmark, the Financial Market Participant must explain how the benchmark is linked to the objective, and how the benchmark differs from a "broad market index". If the product is not linked to a benchmark, the Financial Market Participant must explain how the product meets the objective.

Finally, marketing communications must not contradict any information disclosed under the Disclosure Regulation.

Periodic reports

For products with environmental, social or otherwise sustainable characteristics, Financial Market Participants will have to describe in periodic reports the extent to which these characteristics have been met, including (as applicable) a comparison between the product and its benchmark, or the overall sustainability-related impact of the product, with reference to relevant sustainability indicators. Periodic reporting under the Disclosure Regulation will be required to take place in the normal course of business relevant to the specific type of In-Scope Firm — so, for example, for an EU AIFM the reporting would need to be made in the applicable fund's annual report. This requirement comes into effect on January 1, 2022.

Publication on websites

In-Scope Firms will need to publish on publicly accessible pages on their websites written policies on the integration of sustainability risks in the investment decision-making process (for Financial Market Participants) or the integration of sustainability risks in investment or insurance advice (for Financial Advisers).

In-Scope Firms also must publish and maintain on their websites either:

- a statement on due diligence policies relating to the principal adverse impacts of investment decisions on sustainability factors; or
- clear reasons why they do not consider adverse impacts of investment decisions on sustainability factors (after June 30, 2021, this option will not be available to firms who have more than 500 employees).

Financial Market Participants have four specified areas that they will need to cover in these due diligence policies, such as "information about their policies on the identification and prioritisation [sic] of principal adverse sustainability impacts and indicators". These requirements do not apply to Financial Advisors.

In-Scope Firms also will need to include in their remuneration policies information on how those due diligence policies are consistent with the integration of sustainability risks, and publish this information on their websites. There is no provision for a firm who does not wish to account for sustainability risks in their Remuneration Policy.

The final disclosure that Financial Market Participants will need to publish on their websites relates to the Taxonomy Regulation, discussed below. Broadly, if a financial product is promoted as being sustainable, Financial Market Participants have to publish a description of the sustainable objective and information on the methodologies used to assess, measure and monitor the financial product. Financial Market Participants also will need to publish on their websites the information disclosed in the pre-contractual disclosures and periodic reports discussed above.

In-Scope firms will have to keep the disclosure information on their websites up-to-date, including a clear explanation of any amendments to the published information.

EU Taxonomy Regulation

The Taxonomy Regulation applies to Financial Market Participants who offer financial products, as well as companies to whom the EU Non-Financial Reporting Directive applies (generally large, EU-listed public companies). The taxonomy also will be used by the EU itself and by EU Member States if they want to say that something (such as a public measure or standard) is environmentally sustainable.

The Taxonomy Regulation was published on December 17, 2019, and will come into force 20 days after its publication in the *Official Journal of the European Union*. It is not yet known when it is expected to be published. However, it will only apply once all of the delegated acts, implementing measures and RTS (which have not yet been drafted or published) have come into force.

It is currently expected that the first two climate-related environmental objectives will apply from December 31, 2021, and the four remaining objectives will apply from December 31, 2022.

The Commission will publish a report every three years on the application of the Taxonomy Regulation, in which they can make proposals on, for example, revising the criteria or extending the scope of the Taxonomy Regulation. The Commission has explained in its accompanying Explanatory Memorandum[23] that they intend to use this review clause to expand the scope of the Taxonomy Regulation into the social and employment issues.[24]

Taxonomy Regulation overview

The purpose of the Taxonomy Regulation is to enable firms and investors to identify environmentally sustainable economic activities. In order for an activity to be an "environmentally sustainable economic activity", the activity must make a "substantial contribution" to at least one of the six "environmental objectives". These environmental objectives are:

---

[23] EU Monitor, *Explanatory Memorandum to COM(2018)353 - Establishment of a framework to facilitate sustainable investment*, https://www.eumonitor.eu/9353000/1/j4nvhdfdk3hydzq_j9vvik7m1c3gyxp/vkomf69356x9.

[24] Including: the right not to be subjected to forced labor, the freedom of association, workers' right to organize, the right to collective bargaining, equal remuneration for men and women workers for work of equal value, non-discrimination in opportunity and treatment with respect to employment and occupation, as well as the right not to be subjected to child labor.

1. **Climate change mitigation**. An activity will meet this objective if it contributes to greenhouse gas stabilization aims (consistent with the goals of the Paris Agreement) — such as through the generation of renewable energy, improving energy efficiency, switching to the use of renewable materials and/ or increasing carbon capture. The Taxonomy Regulation also makes allowances for those activities for which there is not currently any technologically or economically feasible low carbon alternative — but which nevertheless supports a transition to a climate-neutral economy, for example, by phasing out greenhouse gas emissions;
2. **Climate change adaptation**. An activity will meet this objective if it includes solutions that substantially reduce the anticipated adverse impact on the climate of either 1) other people, nature or assets; or 2) the economic activity itself, in each case without increasing the risk of an adverse impact on other people, nature and assets;
3. **Sustainable use and protection of water and marine resources**. An activity will meet this objective if it substantially contributes to achieving the good status of water bodies or marine resources, or to preventing their deterioration if they already have good status — such as protecting the environment from adverse effects of urban and industrial waste water discharges or contaminants;
4. **Transition to a circular economy**. An activity may meet this objective if it is an economic activity that contributes substantially to waste prevention, re-use and recycling — such as by funding the development of more efficient recycling centers or products, improving the efficient use of natural resources, prolonging the lifetime of products, or minimizing incineration and avoiding the use of waste in landfill sites;
5. **Pollution prevention and control**. An activity would meet this objective if it contributes substantially to pollution prevention and control — such as by preventing or reducing pollutant emissions into air, water or land (other than greenhouse gasses); and
6. **Protection and restoration of biodiversity and ecosystems**. An activity would meet this objective if it contributes substantially to protecting, conserving or restoring biodiversity and to achieving the good condition of ecosystems, or to protecting those that are already in good condition — such as through conservation efforts, or the restoration of ecosystems or habitats, or the remediation of contaminated 'brown-field' sites and their return to greenfield environment.

The further requirements for an activity to be considered to be environmentally sustainable are that it must not "significantly harm" any of the other environmental objectives, that it must meet the "minimum safeguards" (such as complying with the International Bill of Human Rights), and that it must comply with any other criteria specified by the Commission in as-yet undrafted RTSs, which are due to be adopted between now and the end of 2022.

As part of developing the delegated acts, the Commission is to establish a Platform on Sustainable Finance (Platform). This Platform will include representatives from the European Environment Agency, the ESAs, the European Investment Bank and the European Investment Fund, as well as experts representing relevant private stakeholders, and "experts appointed in a personal capacity, with proven knowledge and experience" in relevant areas. The Platform will advise and assist the Commission, and also will analyse the impact of the technical screening criteria and monitor capital flows towards sustainable investment.

Interaction with Disclosure Regulation

As discussed above, the definitions in the Taxonomy Regulation are essentially to facilitate the effective functioning of the Disclosure Regulation. While the RTSs and delegated acts that will bring the two together have not yet been published, the Taxonomy Regulation provides that the information to be disclosed will have to enable investors to identify how much of their investment is into companies carrying out environmentally sustainable activities and, per company, how much of their activity is environmentally sustainable as a percentage of all economic activities.

What investments are "environmentally sustainable"?

While the "technical screening criteria" are yet to be developed, the Taxonomy Regulation offers a comprehensive overview of activities that can be considered to be "environmentally sustainable". For example, the list of nine activities which would be considered to contribute substantially to climate change mitigation includes "increase the use of environmentally safe carbon capture and utilization (CCU) and carbon capture and storage (CCS) technologies".

In addition to the six activities which "in and of themselves contribute substantially to one of the six environmental objectives", an activity also could be deemed to be environmentally sustainable if it is a transition activity or an enabling activity:

- **Transition activities**. If there is an economic activity with no technologically and economically feasible low carbon alternative, it shall be considered to "contribute substantially to climate change mitigation" if it supports the transition to a climate-neutral economy and is consistent with the goal of limiting the temperature increase to 1.5 degrees above pre-industrial levels.
- **Enabling activities**. These are activities that directly enable another activity to make a substantial contribute to the environmental objectives, while not undermining long-term environmental goals in the process. One example could be the manufacture of wind turbines.

Activities that use so-called 'solid fossil fuels' (including both coal and lignite) are explicitly not considered to be environmentally sustainable. Although oil is not referenced in the Taxonomy Regulation, oil is a fossil fuel and is unlikely to be considered to be sustainable.

However, the Taxonomy Regulation does not consider either nuclear energy or natural gas and these energy sources are to be subject to a technical assessment by the EU working groups in the development of the delegated legislation.[25] It is anticipated that nuclear energy will ultimately be classified as a transition activity, although this has not yet been determined.

It is generally anticipated that the initial recommendations of the EU working groups will be published in the first quarter of 2020.

Other EU legislation

The Benchmark Regulation

The new Regulation as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (ESG Benchmark Regulation)[26] has amended the current Benchmark Regulation (BMR) to create two new categories of benchmark:

- low-carbon benchmarks; and
- positive carbon impact benchmarks.

In addition, administrators of benchmarks that have ESG objectives will have to provide an explanation of how the key elements of the methodology reflect the ESG factors.

The amended Benchmark Regulation entered into force on December 10, 2019.

Insurance Distribution Directive (IDD)

The Commission has proposed amendments to the IDD to ensure that customers' ESG preferences are taken into account in the advisory process. In particular, the amendments will oblige EU insurance intermediaries and insurance undertakings to:

- assess a customer's ESG preferences as part of the suitability assessment; and
- expand the suitability statement (used to explain how a recommendation meets a customer's requirements) to include ESG preferences.

This amendment was published by the Commission on January 4, 2019.[27] It has yet to be published in the *Official Journal of the European Union*, but it will enter into force 20 days after that publication, and shall apply 18 months after it enters into force.

---

[25] European Commission, *Questions and Answers: political agreement on an EU-wide classification system for sustainable investments (Taxonomy)*, https://ec.europa.eu/commission/presscorner/detail/en/qanda_19_6804.

[26] *Official Journal of the European Union, REGULATION (EU) 2019/2089 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks*, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2089&from=EN.

[27] European Commission, *COMMISSION DELEGATED REGULATION (EU) …/... amending Delegated Regulation (EU) 2017/2359*, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=PI_COM%3AAres%282018%292681527.

Markets in Financial Instruments Directive (MiFID II)

The Commission has proposed amendments to MiFID II. As with the IDD, the proposed amendments would require EU investment firms to factor ESG considerations and a customer's ESG preferences into their advice and suitability assessments.

This amendment also was published by the Commission on January 4, 2019.[28] It has yet to be published in the *Official Journal of the European Union*, but it will enter into force 20 days after that publication, and shall apply 12 months after it enters into force.

Industry participants have already raised concerns with this proposal. While it sounds simple, the diversity of "ESG preferences" customers could express means that asset managers could face significant difficulty integrating it into their strategies. It may be challenging to reconcile ESG considerations with other customer preferences, such as their risk profile, especially as the ESG profile of a particular investment could change over time.

Similar changes are anticipated for the UCITS Directive and AIFMD (as set out in the Action Plan), but at the time of writing these proposals have not yet been published by the Commission.

Involvement of ESAs and change to capital requirements

In the Action Plan, the Commission requested follow-up work from the ESAs:

- the ESMA technical advisory paper, which was published on May 3, 2019;[29]
- the EIOPA technical advisory paper, also published on May 3, 2019;[30] and
- the EBA Action Plan on Sustainable Finance, which was published December 6, 2019.[31]

As part of their Action Plan, the Commission made changes to the regulations from which the ESAs get their powers, and each ESA has a unique work plan to gather, assessments to conduct, risks to monitor and methodologies to develop — in order to support the Commission's objectives. The three ESAs are additionally tasked with gathering evidence on the short-term pressures on corporations from capital markets, which could affect the preparation for long-term risks such as climate change.

Of particular note is the work required of the EBA, who are responsible for assessing the potential inclusion of ESG risks as a Pillar 1 capital requirement. As such, the EBA is required to (among other things) develop a monitoring system to assess material ESG risks, develop a technical standard for the disclosure of ESG risks and develop common methodologies for assessing the effect of economic scenarios on an institutions financial position.

Timing

The key milestones for In-Scope Firms and other market participants are:

April 2020: Anticipated publication of the Taxonomy Regulation in the EU Official Journal.

December 30, 2020: Deadline for submission of the Disclosure Regulation RTS to the Commission.

March 10, 2021: The substantive provisions in the Disclosure Regulation start to apply (pre-contractual disclosures).

June 1, 2021: Deadline for submission of the Taxonomy Regulation RTS to the Commission.

December 31, 2021: Deadline under the Taxonomy Regulation for financial market participants to specify the percentage of a product's investments that are invested in environmentally sustainable activities.

January 1, 2022: The periodic reporting requirements in the Disclosure Regulation start to apply.

September 10, 2022: The ESAs are due to report to European Commission on best practices and voluntary reporting standards.

September 30, 2022: Deadline under the Taxonomy Regulation for financial market participants to specify the percentage of a product's investments that are invested in investments or activities meeting the climate change mitigation and adaptation objectives.

December 30, 2022: The Commission is due to evaluate the application of the Disclosure Regulation.

---

[28] European Commission, *COMMISSION DELEGATED REGULATION (EU) …/... of XXX amending Delegated Regulation (EU) 2017/565 as regards the integration of Environmental, Social and Governance (ESG) considerations and preferences into the investment advice and portfolio management*, https://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-act-2018_en.pdf.

[29] ESMA, *ESMA submits technical advice on Sustainable Finance to the European Commission*, https://www.esma.europa.eu/press-news/esma-news/esma-submits-technical-advice-sustainable-finance-european-commission.

[30] EIOPA, *EIOPA submits advice on Sustainable Finance to the European Commission*, https://www.eiopa.europa.eu/content/eiopa-submits-advice-sustainable-finance-european-commission_en.

[31] EBA, *EBA ACTION PLAN ON SUSTAINABLE FINANCE*, https://eba.europa.eu/sites/default/documents/files/document_library/EBA%20Action%20plan%20on%20sustainable%20finance.pdf.

If firms are required to assess ESG risks as part of their Pillar 1 capital requirements, this could potentially result in significant changes to their regulatory capital requirements.

Impact on US firms

These legislative changes will not have any direct effect on US firms. However, it is highly likely that they will have an indirect effect on US managers. Based on the Disclosure Regulation alone, which references compliance by AIFMs, without specifying if the term means authorised AIFMs (i.e., those in the UK or the EEA) or all AIFMs (i.e., firms managing alternative investment funds), it is possible that US AIFMs may well be in scope — though once the technical standards have been released it will become clearer. The pre-investment disclosure for AIFMs requires ESG-related disclosures within the mandatory disclosures required under AIFMD — this is but one area that US and other non-EEA AIFMs have to comply with if they are marketing their funds in the EU. Consequently, we believe that the legislative changes may impact on US firms in the following circumstances:

- when managing or sub-advising a UK-based or an EEA-based fund; and
- when accessing the UK or the EEA/ marketing funds in the UK or the EEA.

How will this legislation develop?

The Commission has "left the door open" for this legislation to develop and cover a wider area than just the environment. For example, the Taxonomy Regulation includes a review mechanism whereby every three years the Commission will publish a report on whether it would be appropriate to extend the scope of the taxonomy to cover other sustainability objectives. The most widely expected expansion would be into 'social objectives'. Similarly, the amendments to the BMR were drafted to allow benchmark administrators to develop new benchmarks, subject to demand.

CONTACT

For more information on ESG and sustainable finance regulations, contact your Katten lawyer or the following Financial Markets and Funds lawyer:

Neil Robson
+44 (0) 20 7776 7666
neil.robson@katten.co.uk

With thanks to I. Matthewson for her assistance in the preparation of this Katten Advisory.