ESG FOR FUND MANAGERS: BRIEFING 1

The EU Framework Regulation / the Taxonomy Regulation

September 2020

This briefing in our ESG series for Irish funds and fund management companies focuses on the European Commission's proposals to establish a classification system or "taxonomy" to identify whether and to what extent an economic activity can be considered to be sustainable.

With the aim of furthering sustainable finance and ESG integration, the European Commission (the "**Commission**") introduced a package of legislative measures in 2018 that includes three key Regulations: the Taxonomy Regulation, the Disclosures Regulation and the Low Carbon and Positive Impacts Benchmarks Regulation.

The aim of the Taxonomy Regulation is to establish an EU-wide classification system or taxonomy for environmentally sustainable economic activities. This classification system is to be used to reduce fragmentation arising from market-based initiatives and national practices and address practices of "greenwashing" so as to allow investors better compare ESG products.

The Taxonomy Regulation was adopted by the Commission on 18 June 2020 and entered into force on 12 July 2020 and builds on the work of the Technical Expert Group on Sustainable Finance (**TEG**) set up by the Commission to assist in developing the taxonomy and furthering other EU Action Plan initiatives. These EU-wide standards will form the basis for economic and regulatory measures and the eventual creation of labels to enable capital markets to identify investment opportunities that contribute to the EU's environmental policy objectives.

The initial focus of the Taxonomy Regulation is on environmental objectives, with social objectives to be considered later.

At a high level, sustainable investment under the Taxonomy Regulation is an investment in an economic activity that contributes to an environmental objective as measured by key resource efficiency indicators provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices.

For a product to be properly characterised as environmentally sustainable it should:

- Contribute substantially to one of the defined environmental objectives;
- Not harm any of the environmental objectives (i.e. the do no significant harm principle);
- Comply with a series of minimum social safeguards; and
- Comply with performance thresholds.

The six environmental objectives are:

- Climate change migration;
- Climate change adaption;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy;
- Pollution prevention and control; and
- Protection and restoration of bio diversity and ecosystems.

Each objective is explained further in the Taxonomy Regulation and linked to any existing EU law on that area. Further

granularity will be given in technical screening criteria, which will be built up over time and are to be updated on a regular basis to reflect the changing nature of the science and technology that underpin them.

The Taxonomy Regulation also mandates the establishment of a "Platform on Sustainable Finance", which will include representatives of various EU bodies (including the European Environment Agency and the European Supervisory Authorities), environmental experts, and accounting and reporting experts with a broad remit to advise the Commission on the technical screening criteria and on the need to update these based on a number of criteria, including developing trends and stakeholder requests.

The technical screening criteria, or "taxonomy", for the first two environmental objectives - climate change mitigation and climate change adaptation - should be established by the end of 2020 in order to ensure its full application by end of 2021. For the four other objectives, the taxonomy should be established by the end of 2021 for application by the end of 2022.

The Taxonomy Regulation recognises that, while some activities may bring a positive output toward the relevant objective, they may be accompanied by a negative impact and so the taxonomy addresses the need to measure the combined outcome and identify the minimum requirements necessary to avoid a significant harm to other objectives.

The Taxonomy Regulation applies the principles while adopting a neutral stance in relation to different energy forms. The key consideration is whether they are low in greenhouse gas emissions and the categorisation includes two sub-categories of "transitional" and "enabling" activities.

Transitional activities relate to activities for which there are no technologically and economically feasible low-carbon alternatives, but that support the transition to a climate-neutral economy in a manner that is consistent with a pathway to limit the temperature increase to 1.5 degrees Celsius above pre-industrial levels, for example by phasing out greenhouse gas emissions. Enabling activities are those that enable other activities to make a substantial contribution to one or more of the objectives. There will be an obligation to disclose for each financial product the proportion invested in enabling and transitional activities.

One of the difficulties for those tasked with the new evaluations and disclosures is getting the relevant information from the underlying investee companies. The Taxonomy Regulation seeks to assist access to that information by placing an obligation on undertakings that are subject to non-financial reporting requirements to include details of how and to what extent their economic activities are associated with environmentally sustainable activities and large companies will have to report on certain climate–related KPIs.

The Taxonomy Regulation is mainly relevant to managers that make available a product that has an express sustainability focus ('ESG Products'), however, all managers need to take account of it and managers that do not offer ESG Products will at least need to make a negative disclosure to confirm that their product is out of scope and does not adhere to the taxonomy criteria.

The Taxonomy Regulation incorporates certain concepts from the Disclosures Regulation and amends certain provisions of that Regulation. It effectively builds on the three tier categorisation of products set out in the Disclosures Regulation:

1. products that have sustainable investment as an objective (Disclosures Regulation Article 9 products);
2. products that promote environmental or social characteristics (Disclosures Regulation Article 8 products); and
3. products that do not fall into either of these first two categories.

For asset managers that promote ESG Products there will be additional disclosure requirements imposed over and above those already set out in the Disclosures Regulation.

Article 9 products must make pre-contractual and periodic disclosures that include information on the environmental objectives to which the product contributes and a description of how and to what extent the underlying investments qualify as environmentally sustainable and the proportion of investments which are environmentally sustainable.

Article 8 products must make pre-contractual and periodic disclosures relating to information on the environmental characteristics that the product promotes, a description of how and to what extent the underlying investments qualify as environmentally sustainable and the proportion of investments that are environmentally sustainable together with a prescribed disclaimer.

All other products must set out a prescribed disclaimer in their pre-contractual and periodic disclosures that the investments do not take account of the criteria set by the Taxonomy Regulation.

The Taxonomy Regulation also amends the Disclosure Regulation by inserting an obligation for the European Supervisory Authorities to develop technical standards specifying the details of the "do no significant harm" principle expressed in the Disclosure Regulation. Draft technical standards are to be provided to the Commission by 30 December 2020.

The requirements of the Taxonomy Regulation will apply on a staggered basis. The requirements in relation to climate change adaption and migration will apply from 1 January 2022 with the other environmental objectives to apply from 1 January 2023.

For more information on the impact of the EU's ESG initiative on asset managers, see our overview briefing here.

If you would like to discuss the foregoing, or require any assistance assessing these or any other sustainable finance related requirements, please contact a member of our team.

ARTHUR COX & ESG

Arthur Cox is very mindful of its own ESG responsibilities. We have actively reduced our carbon footprint through energy efficiency, waste management and sustainable procurement. Our Dublin HQ was awarded the highest energy efficiency standard ISO 50001:2018, which we only retain through a continuing reduction of energy use each year. We address our social and governance responsibilities though active CSR and D&I programmes. We aim to achieve improvements in all these aspects each year.

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