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ESG - EU Taxonomy Regulation - 6 Months to go

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With just over six months to go before the EU Taxonomy Regulation (EU/2020/852) (the "**Regulation**") becomes effective, firms which are subject to the EU Sustainable Finance Disclosure Regulation ("**SFDR**") should be considering the extent to which the requirements of the Regulation may also be applicable to them and planning to comply accordingly. With this in mind, the following briefing note provides a recap of the Regulation and highlights the legislative developments firms should be mindful of, as we draw closer to the implementation date.

What is the Taxonomy Regulation?

The Regulation supplements (and should be read alongside) the SFDR, which came into force in March this year (please see our update on preparing for the implementation of the SFDR back in February 2021) and establishes an EU-wide classification system or 'framework' which is intended to provide businesses and investors with a common language to identify to what degree their economic activities can be considered environmentally sustainable. The legislative aim is to provide clarity and transparency on environmental sustainability to investors, financial institutions, companies and issuers, thereby enabling informed decision-making in order to foster investments in environmentally sustainable activities.

As such, the Regulation is mainly concerned with the "E" in environmental, social and governance ("**ESG"**) issues and sets out four conditions that an economic activity must meet in order to qualify as 'environmentally sustainable'. These are that a qualifying activity must:

- contribute substantially to one or more of the six environmental objectives set out in Article 9 of the Regulation
- do no significant harm to any of the other environmental objectives set out in Article 9 of the Regulation(in accordance with Article 17)

- be carried out in compliance with minimum (social) safeguards set out in Article 18 of the Regulation
- comply with technical screening criteria established by the Commission through delegated acts.

What firms are in scope?

Similarly to the SFDR, the Regulation will impact Financial Market Participants ("**FMP**s") (including amongst others, EU alternative investment fund managers ("**AIFM**s")) and will make available a "financial product" which either (a) has environmental sustainability as its objective; or (b) promotes environmental characteristics. That said, the scope is wide in that even FMPs who do not take into account the criteria for environmentally sustainable investments should provide a statement to this end, meaning that all asset managers are, to some extent, in scope.

A "financial product" is defined in accordance with the SFDR as including:

- a portfolio manager in accordance with Article 4(1) of Directive 2014/65/EU (MiFID II);
- an alternative investment fund ("**AIF"**);
- an insurance-based Investment Product;
- a pension product;
- a pension scheme;
- a UCITS fund; or
- a Pan-European Personal Pension Product.

Much like the SFDR, to the extent that a non-EU AIFM has marketed their funds in the EU under the national private placement regime of the AIFMD on or after 10 March 2021, non-EU AIFM and the fund(s) that have been marketed will also be in scope of the Regulation. Non-EU AIFMs that admit EU investors into their funds solely on the basis of reverse solicitation are not subject to the SFDR or the Regulation.

What information is disclosed?

The Regulation supplements the disclosure obligations contained in the SFDR with both regulations intended to be read together. Firms will be required to disclose the degree of environmental sustainability of funds and pension products that are promoted as environmentally friendly, and include disclaimers where they do not (as set out in Articles 8 and 9 of the SFDR). It is expected that fund managers in scope will use the technical screening criteria ("**TSC**") to assess a company's economic activities and determine whether each activity does or does not meet the taxonomy criteria and they will need to aggregate the percentage of taxonomy alignment at both investment and product level.

Detailed TSC for determining when an economic activity can be considered sustainable are to be set out in delegated acts (see further below under "Recent developments") and percentages of taxonomy alignment will assist firms to explain their strategies in a way that is both consistent and easily comparable.

Recent developments

The ESMA and EBA issued guidance on Article 8 of the Regulation earlier this year and provided further detail on the Key Performance Indicators ("**KPIs**") that firms should disclose, the scope and methodology for the calculation of those KPIs and the qualitative information that institutions should provide. The Green Asset Ratio ("**GAR**"), being the main KPI proposed, identifies asset financing activities that are environmentally sustainable to firms according to the Regulation, including activities consistent with the goals of the European Green Deal and the Paris Agreement. Information on the GAR is supplemented by other KPIs containing information on the taxonomy alignment of a firm's services other than lending and investing.

Earlier this month, the European Commission published a draft Delegated Regulations supplementing the Regulation by establishing the TSC for defining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives. The Commission has also published a number of documents supporting the draft Delegated Regulation.

In addition to the draft Delegated Regulation, the Commission has also published the Commission Staff Working Document: Impact Assessment Report. The key objectives of the report are to assess the approaches taken to set the TSC for substantial contribution to climate change mitigation and climate change adaptation and to 'do no significant harm' to all environmental objectives against the requirements of the Taxonomy Regulation.

Key dates

The EU Taxonomy Regulation will take effect as follows:

- **1 January 2022**: for the environmental objectives of climate change mitigation and climate change adaptation
- **1 January 2023**: other environmental objectives (sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; and the protection and restoration of biodiversity and ecosystems)

Given that some of these requirements will commence from the start of next year, firms should be considering the taxonomy requirements to determine how they intend to make the relevant disclosures in their marketing materials, including private placement memorandums, portfolio management agreements, annual reports, and on their websites. Given the level of detail involved, firms should work through the taxonomy requirements and those firms in scope will need to align their approaches with the Regulation.

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