

**CAPITAL MARKETS**

Sustainable Finance: Taxonomy Regulation

1. Introduction and background

The “Action Plan: Financing Sustainable Growth” was published by the European Commission on 8 March 2018 and it established a financing strategy to redirect capital flows towards sustainable investment. Against this background, the European Parliament recently adopted Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088 (the “Taxonomy Regulation”).

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The Taxonomy Regulation is the latest part of a package of legislation in relation to the above-mentioned Action Plan. It is intended to support a sustainable and inclusive economic system, not only from an environmental, but also from a social point of view.

This new Regulation joins Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector and Regulation (EU) 2019/2089 on EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks.

Rather than establishing a specific definition of financial products considered environmentally sustainable, the Taxonomy Regulation seeks to provide companies and investors with a common language (taxonomy) to identify economic activities that can be considered sustainable, by implementing six environmental objectives. The establishment of this unified classification system for environmentally sustainable activities will allow investors to redirect their investments towards more sustainable technologies and businesses. It is also seen as an essential step towards the climate-neutral impact of the European Union by 2050 and the achievement of the Paris Agreement targets for 2030.

In addition to the taxonomy imposed by the Taxonomy Regulation, the Regulation also determines that the conditions under which an economic activity can qualify as contributing substantially to one of the six objectives listed below will be developed gradually, through the establishment of technical screening criteria by the Commission. The application of these criteria will be evaluated at least every three years and, if necessary, the Commission will amend the delegated acts relating to those criteria. To this end, the Commission will draw on the advice of the Platform on Sustainable Finance, established under the Taxonomy Regulation and composed of experts representing both the public and private sectors. The Platform should be consulted, among others, when developing, analysing and reviewing the technical screening criteria.

2. Environmental objectives

The Taxonomy Regulation sets the following six environmental objectives as the basis for assessing whether an economic activity can be environmentally sustainable:

- **Climate change mitigation** – contribution to stabilising greenhouse gas concentrations in the atmosphere at a level consistent with the long-term temperature target set in the Paris Agreement, by preventing or reducing greenhouse gas emissions or increasing removals of greenhouse gases, for example, by producing renewable energy;
- **Climate change adaptation** – inclusion of adaptation solutions that substantially reduce the risk of negative effects of the current climate and its expected future evolution on that economic activity or on people, nature or assets, in any case without increasing the risk of negative effects on other people, nature or assets;

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- **Sustainable use and protection of water and marine resources** – contributing to the sustainable use and protection of water and marine resources or preventing the deterioration of these resources, for example, by implementing measures such as the reuse of water or ensuring the reduction of pollutant emissions into waters;
- **Transition to a circular economy** – contributing to the prevention, reuse and recycling of waste by taking certain measures, for example, by increasing the recyclability of products;
- **Pollution prevention and control** – contributing to the protection of the environment against pollution by certain means, for example, by eliminating waste or other forms of pollution, and
- **Protection and restoration of biodiversity and ecosystems** – contributing to the protection, conservation and restoration of biodiversity or the achievement of good ecosystem conditions or protection of ecosystems that are already in good condition through specific measures, for example, the sustainable use and management of land by protecting soil biodiversity.

An economic activity may also qualify as contributing substantially to one or more of the environmental objectives described above by directly enabling other activities to contribute substantially to one or more of those objectives, provided that such economic activity: (a) does not lead to dependence on assets that compromise long-term environmental goals, taking into account the economic lifetime of those assets; and (b) has a substantial positive impact on the environment, based on life cycle considerations.

3. Additional criteria applicable to economic activities

In addition to contributing substantially to one of the six environmental objectives already mentioned, for an activity to qualify as a sustainable activity under the Taxonomy Regulation, it must also meet the following criteria:

- **Not significantly harm** any of the environmental objectives described;
- **Comply with the minimum safeguards** relating to the OECD Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights, in particular, the Declaration on Fundamental Principles and Rights at Work of the International Labour Organisation (ILO), the eight ILO fundamental conventions and the International Charter of Human Rights, which may be supplemented in the future by the Commission;

- Be developed taking into account the **technical screening criteria** to be established by the Commission by 31 December 2020 or by 31 December 2021, depending on whether they concern measures relating to the objectives of climate change mitigation and of adaptation to climate change, or measures relating to the other four objectives.
- **Financial market participants that offer financial products** – as a way of promoting transparency of environmentally sustainable investments, financial market participants (as defined in Regulation (EU) 2019/2088) will now disclose in pre-contractual information and periodic reports a description of how and to what extent the investments underlying the financial product finance economic activities that qualify as environmentally sustainable.

In addition to contributing substantially to one of the six environmental objectives already mentioned, for an activity to qualify as a sustainable activity under the Taxonomy Regulation, it must also meet three additional criteria.

4. Scope of application

The Taxonomy Regulation applies to:

- **Member States and the European Union** – Member States and the European Union should take into account the criteria set out in the Taxonomy Regulation when adopting measures to establish requirements for financial market participants or issuers with regard to financial products or bonds that are made available as being environmentally sustainable.

Financial products include, as defined in Regulation (EU) 2019/2088, (a) portfolio management on the basis of a mandate given by the client on an individual and discretionary basis, whenever these portfolios include one or more financial instruments; (b) alternative investment funds; (c) insurance-based investment products; (d) pension products; (e) pension plans; (f) undertakings for collective investment in securities; and (g) individual pan-European retirement products.

It is important to note that the Taxonomy Regulation also directly impacts financial products that are not intended for sustainable investments or to promote environmental characteristics. This is because the pre-contractual information and the information appearing in the periodic reports must include the following statement: "The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities." Consequently, the need to include this statement ultimately covers all financial market participants (and not only those within the meaning of Regulation (EU) 2019/2088) within the scope of application of the Taxonomy Regulation.

- **Companies subject to the obligation to publish a non-financial statement or a consolidated non-financial statement** – companies that have to comply with Directive 2013/34/EU must include in their non-financial statement or consolidated non-financial statement information on how and to what extent the company's activities are linked to economic activities that are qualified as environmentally sustainable. The Commission will specify the content and presentation of the information to be disclosed by 1 June 2021.

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5. Next steps

The Taxonomy Regulation will enter into force on 12 July 2020, twenty days after its publication.

In addition, the Taxonomy Regulation will continue to be developed. It has been established that the Commission will, by 31 December 2020, establish technical screening criteria to determine the conditions under which an economic activity can qualify as contributing substantially to mitigating climate change or to adapting to climate change, with a view to ensuring its application from 1 January 2022. The technical screening criteria for assessing the remaining environmental objectives will be adopted by 31 December 2021, with a view to ensuring their application from 1 January 2023. ■