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The Ripple Effect of EU Taxonomy for Sustainable Investments in U.S. Financial Sector

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Environmental, Social and Governance ("ESG") Funds have demonstrated competitive financial performance in recent years, and were found by a recent Morningstar survey to be more resilient than their conventional counterparts to the financial impacts of the COVID-19 pandemic. As U.S. investors increasingly take ESG factors, and particularly climate change, into account, they should monitor and, where warranted, incorporate emerging EU guidelines. Adopted by the Council of the EU on April 15, 2020, with specific criteria being developed throughout 2020 and 2021, the "EU Taxonomy" aims to provide a unified classification system for "green" and "sustainable" economic activities under the EU's sustainable finance regulations. Regardless of regulatory applicability, non-EU funds may face pressure by EU-based or other ESG-minded investors to disclose the percentage of investments that are aligned with the EU Taxonomy and ultimately may face pressure to allocate capital towards such investment activities. Accordingly, funds that are already invested in EU Taxonomy-aligned activities may want to consider adopting the framework quickly to benefit from the "first mover advantage." Finally, funds in jurisdictions without clear guidelines may benefit from utilizing EU Taxonomy terminology to provide some clarity to investment professionals and protection against "greenwashing" claims.

ESG Funds are growing exponentially and ESG index funds are outperforming non-ESG peers, even during COVID-19.

In 2019, assets managed by the 75 ESG Funds in Bloomberg's annual survey of the largest ESG funds with five-year track records grew more than 34%, to $101 billion, as investors increasingly bet on securities with sustainable and ethical assurances. The same survey found that nine of the largest ESG mutual funds in the U.S. outperformed the Standard & Poor's 500 Index last year, and seven beat their market benchmarks

over the past five years. In the first quarter of 2020, ESG index funds outperformed their conventional counterparts in the face of the unprecedented COVID-19 pandemic and ensuing stock market decline. In an April 2020 article, Morningstar attributed this resilience to the funds' ESG-driven investment strategies, stating: "The better relative performance of sustainable funds in the first quarter derives mainly from their focus on companies that have stronger ESG profiles/lower ESG risk."

Climate-focused funds are also growing, due to both the potential value of sustainable investments and a growing awareness amongst some investors that climate change poses a fundamental risk to investment performance and long-term financial success.

Climate change now ranks amongst one of the most significant ESG issues for U.S. asset managers, and several commentators have drawn a parallel between the "twin threats" of COVID-19 and climate change. The financial risk of climate change was discussed in a CDP report, in which 215 of the world's biggest companies — representing nearly $17 trillion in market capitalization — report almost $1 trillion at risk from climate impacts, with many likely to hit within the next five years. At the same time, the value proposition is clear — the same report found that the potential value of sustainable business opportunities exceeds seven times the cost of realizing them ($311 billion in costs; $2.1 trillion in opportunities). Likewise, the Global Commission on Adaptation reported in September 2019 that $1.8 trillion of climate investment in five areas between 2020–2030 could yield $7.1 trillion in total net benefits. In the same month, the Lightsmith Group stated in a Forbes article that it had identified 20 sectors of the economy related to climate resilience, representing $130 billion in current market size, that are growing 20%–30% per year.

Funds that specifically focus their investment strategies on climate change are gaining momentum. In February, Allianz Global Investors launched the Allianz Climate Transition fund to invest in companies that have proven or planned greenhouse gas emission reductions. Further examples are mounting in frequency and ambition, such as BlackRock's decision to place sustainability at the center of its investment approach, Microsoft's dedication of a $1 billion climate innovation fund, Delta's $1 billion climate commitment and Jeff Bezos' $10 billion climate commitment, suggesting that climate change will continue to drive the reallocation of capital. In addition, several of the largest U.S.-based private equity firms have formed "impact funds" focused on solving environmental or social challenges (which could include climate change mitigation or adaptation) and at least one such firm has reportedly begun marketing a dedicated climate infrastructure fund.

While the U.S. has yet to develop a comprehensive regulatory regime for sustainable finance, the EU has taken a lead by issuing an Action Plan on Financing Sustainable Growth (Action Plan) and developing the EU Taxonomy, starting with climate change mitigation and adaptation activities.

Recognizing the need to take action on the UN Sustainable Development Goals and the Paris Agreement, and the lack of financial regulation in the space, the European Commission released its Action Plan on Financing Sustainable Growth in March 2018. The Action Plan sets out a strategy to encourage the integration of ESG factors into investment decisions and to steer private capital towards a low-carbon future. The strategy aims to integrate ESG considerations into the investment and advisory process in a consistent manner. As part of this plan, the EU developed the Taxonomy Regulation to support the development of the EU Taxonomy.

The EU Taxonomy is designed to help investors, companies, issuers and project promoters transition to a climate-resilient economy by providing a common language and uniform criteria to identify the extent to which economic activities may be considered environmentally sustainable. The EU Taxonomy sets performance thresholds ("technical screening criteria") to help parties identify environmentally friendly activities and access green financing, in order to grow low-carbon sectors and decarbonize high-carbon sectors. The Taxonomy Regulation applies to:

1. Financial market participants offering financial products in the EU, including investment funds, portfolio managers and occupational pension providers;
2. Large companies that are already required to provide a non-financial statement under the Non-Financial Reporting Directive; and
3. The EU and Member States, when setting public measures, standards or labels for green financial products or green (corporate) bonds.

Under the EU Taxonomy, environmentally sustainable activities must:

1. Make a substantive contribution to one of six environmental objectives (listed below) or be enabling or transitional activities (see below);
2. Do "no significant harm" to the other five environmental objectives, where relevant;
3. Meet minimum safeguards, including OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights; and
4. Comply with technical screening criteria.

The six environmental objectives set out in the Taxonomy Regulation are:

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
6. Protection and restoration of biodiversity and ecosystems

An enabling activity is an activity that directly enables other activities to make a substantial contribution to the environmental objectives, provided that such activity does not lead to a lock-in of assets that undermine long-term environmental goals and has a substantial positive environmental impact, on the basis of life-cycle considerations.

A transitional activity is an activity for which there is no technologically and economically feasible low-carbon alternative, that has substantially lower greenhouse gas emissions than the sector or industry average, does not hamper the development and deployment of low-carbon alternatives, and does not lead to a lock-in of assets incompatible with the objective of climate-neutrality, considering the economic lifetime of those assets.

The Taxonomy Regulation provides a general framework for the development of a classification system for environmentally sustainable economic activities. Detailed requirements will be established through technical screening criteria. The European Commission is responsible for adopting these technical screening criteria, and gave the EU Technical Expert Group on sustainable finance ("TEG") the task of developing the criteria.

On March 9, 2020, the TEG released its final recommendations for the design and implementation of the EU Taxonomy. The report provides guidance for users to develop disclosures based on the EU Taxonomy, as well as a summary of the economic activities covered by the EU Taxonomy's technical screening criteria. The report is supplemented by a technical annex containing technical screening criteria for 70 climate change mitigation and 68 climate change adaptation activities, as well as criteria for the "do no significant harm" standard.

Requirements for Financial Market Participants

Private and public sector actors will use the EU Taxonomy in a range of both equity- and debt-based financial products, such as investment and mutual funds, insurance-

based investment products, and private and occupational pensions, and in insurance and investment advice. The EU Taxonomy disclosure requirements vary by financial product and form part of a broader sustainability-related disclosure regime under the Regulation on Sustainability-Related Disclosures in the Financial Services Sector (Disclosure Regulation). The Taxonomy Regulation amends the Disclosure Regulation and increases the amount of information that needs to be disclosed by financial market participants. The Taxonomy Regulation and the Disclosure Regulation together will require financial market participants to provide specific disclosures for financial products that have sustainable investment objectives or promote environmental characteristics. For products that do not have sustainable investment objectives or promote environmental characteristics, a negative disclosure must be made.

Parties offering financial products in the EU will be required to make EU Taxonomy disclosures as part of pre-contractual and periodic reporting requirements that will apply to them under the Disclosure Regulation, including:

- How and to what extent they have used the EU Taxonomy in determining the sustainability of the underlying investments;
- To what environmental objective(s) the investments contribute; and
- The proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage of the investment, fund or portfolio. This disclosure should include details on the respective proportions of “enabling” and “transition” activities, as defined by Taxonomy Regulation.

Next Steps for the EU Taxonomy

The European Commission will use the TEG Report to develop explicit legal requirements for climate change mitigation and adaptation by the end of 2020. It is expected that financial market participants will be required to complete their first set of disclosures against the EU Taxonomy by December 31, 2021. Companies that are required to provide a nonfinancial statement under the Non-Financial Reporting Directive will be required to start disclosing against the EU Taxonomy in the course of 2022. Finally, technical screening criteria for activities that make a substantial contribution to sustainable water, a circular economy, pollution prevention and control, and protection of ecosystems will be released by the end of 2021. While the European Council adopted the Taxonomy Regulation on April 15, 2020, the Regulation needs to be adopted by the European Parliament before it is published in the Official Journal and enters into force.

Although the EU Taxonomy is not binding on non-EU financial market participants (unless they are active in EU markets), U.S. investors may use the Taxonomy to gauge whether an investment contributes to an "environmental objective," such as climate change mitigation or adaptation. Investments in activities that would not qualify under the EU Taxonomy, but are touted as environmentally friendly, may be subject to more scrutiny by investors or regulators.

Parties that actively work with EU investors may be required to comply with the requirements of the Taxonomy Regulation.[1] Parties that do not actively work with EU investors may choose to make their own disclosures in line with the EU Taxonomy, and the EU Taxonomy may influence international reporting frameworks over time. For example, Japan's Transition Finance Study group proposed the creation of a "transition taxonomy" on April 30, 2020, and Canada and Malaysia are reportedly developing their own classification systems. In the interim, U.S. investors may use the EU Taxonomy to:

- **Avoid "greenwashing" risks.** So long as the U.S. Securities and Exchange Commission and other U.S. federal and state regulators remain silent on creating uniform criteria for defining sustainable economic activities in the U.S., the EU framework provides the most explicit guidance to investment funds and companies seeking clarity as to whether a technology, product or service makes a substantial contribution to an environmental objective. As a consequence, U.S. asset managers may look to the EU Taxonomy language and metrics to avoid misleading investors about the environmental benefits of a product or company — a marketing tactic referred to as "greenwashing."
- **Attract investment from EU and certain other institutional investors.** A voluntary alignment to the EU Taxonomy would likely attract additional capital from certain EU investors, who may be required to conduct their own Taxonomy-alignment reporting, and other institutional investors who are looking for action on climate change and other environmental concerns.
- **Benchmark against peers.** The EU Taxonomy provides financial market participants with a new metric to assess their sustainability performance against that of their peers, namely, the proportion of their underlying investments that are EU Taxonomy-aligned.

At the same time, while the EU Taxonomy serves as a resource for assessing the sustainability-related merits of an investment, U.S. investors need not limit themselves to the four corners of the document. A potential misconception is that the EU Taxonomy contains a comprehensive list of "green" activities, and that parties should therefore avoid economic activities outside the scope of the text. In fact, the European

Commission has yet to assess a number of activities, in part because for some industries (e.g., aviation), no technologically and economically feasible low-carbon alternatives existed at the time of drafting.

Additionally, the EU Taxonomy may become under-inclusive as new technologies and science-based solutions to climate change emerge, although this concern is mitigated by the fact that the Taxonomy Regulation requires the European Commission to review all technical screening criteria regularly. The European Commission's "Platform on Sustainable Finance" will develop new iterations of the EU Taxonomy.

U.S. investors should continue to monitor and refer to the EU Taxonomy as it matures where warranted, and should consider the Action Plan and the EU Taxonomy as contributing to a common language for sustainable finance as tools to support the transition to a sustainable economy. Funds that are subject to the Action Plan or that are considering whether to voluntarily adopt aspects of the Action Plan, such as the language of the EU Taxonomy, should work with skilled counsel to evaluate these considerations and keep apprised of regulatory changes.

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1. For example, the broad drafting of the definitions of "financial market participant" and "AIFM" for the purposes of the Disclosure Regulation and the Taxonomy Regulation means that non-EU AIFMs managing EU AIFs or actively marketing funds through national private placement regimes in the European Economic Area may be required to comply with the Disclosure Regulation as amended by the Taxonomy Regulation.↩

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Suggested Reading

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- 10 June 2020 Article The CFIUS Proposed Filing Rule—What Dealmakers Need to Know

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