



Ep. 50: Taxonomy Regulation for Beginners

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Jose Garriga:

Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga. This is the second episode in a three-part miniseries on ESG, or environmental, social and governance, matters featuring Akin Gump financial regulatory partner Ezra Zahabi.

The first, to which I hope you've already listened, covered the Sustainable Finance Disclosure Regulation, or SFDR. In this episode, we look at the EU's Taxonomy Regulation, its origins, purpose and applicability.

Welcome to the podcast.

Ezra, thank you for returning to the show today. So, as I mentioned, last time we looked at SFDR, so let's discuss the Taxonomy Regulation. To start, what are its origins, and what is its purpose?

Ezra Zahabi:

Thanks, Jose. So, the Taxonomy Regulation, as the SFDR, is part of a package of legislative measures that the European Commission has put out as part of the European Green Deal. So, that's, effectively, the commitment that the European Commission has made to achieving the Paris Treaty objectives and achieving net-zero status or climate carbon neutrality by 2050.

What the Taxonomy Regulation does, is that it establishes a taxonomy for environmentally sustainable activities. And, so, a taxonomy is a system of classification. And, so, basically, what it sets out is a common set of measures and standards for what is considered to be environmentally sustainable, such that when financial products or when companies make reference to sustainable activities, this is what they are meant to be. So, the regulation sets out specific criteria around what is environmentally sustainable. And it sets out also the criteria on what is deemed to be activities that cause, or may cause, significant harm to environmental objectives.

And both of those elements are important in assessing whether or not a particular product, or a particular asset, or a particular set of activities will be considered environmentally sustainable in a way that's consistent with the EU rules.

The Taxonomy Regulation also sets out certain additional disclosure requirements. So, if you recall in the last podcast, we discussed the SFDR, and we established that the SFDR, effectively, categorizes financial products in what are quote-unquote standard products without any particular focus or kind of objective of being sustainable in light-green and dark-green products. The Taxonomy Regulation establishes some additional disclosure requirements for those light-green and dark-green products.

Jose Garriga: Thank you. So, when we discussed SFDR, and I alluded to this earlier in speaking about applicability, you noted that it applied to financial market participants in the EU and to non-EU entities meeting that description. Can we say the same thing about the Taxonomy Regulation, or is it even more broadly applicable?

Ezra Zahabi: So, the same kind of complexity exists. It is more broadly applicable in that the disclosure requirements under the Taxonomy Regulation apply to the financial market participants to whom the SFDR applies, where those financial market participants have these light-green or dark-green products. But in addition to that, it also introduces certain additional disclosure requirements that apply to certain entities in the EU that are currently subject to the Non-Financial Reporting Directive also, the requirement to provide certain nonfinancial information. And those are, generally, large undertakings that have over 500 employees and are considered to be public interest entities, so, often listed entities, but certain other entities may also be designated as public interest entities.

And those entities are then required to make similar types of disclosures, the financial products in terms of their economic activities and whether they are sustainable. On the application to financial market participants in the EU and elsewhere, so we touched on this in the last podcast already, but it's worth just reiterating that, technically, the rules apply to EU undertaking without doubt. And then there's a question as to whether the rules apply on an extraterritorial basis to those entities that meet the description of a "financial market participant" but are established outside the EU, whether they would apply, full stop, if you meet the description of an "investment firm," regardless of where you are in the world. That seems not to be the case, and it's not really the industry position at the moment, or whether these rules would apply, as the SFDR disclosure requirements, in certain circumstances such as where the non-EU entity is marketing financial products to EU clients. And that's, largely, where the industry got to in the leadup to the SFDR implementation. Although, I think that it's fair to say that there's a great deal of uncertainty on that, and the clarification requests that the European supervisory authorities submitted to the European Commission on this point remain outstanding.

Jose Garriga: Thank you. That's a good point to reiterate. So, adding a little specificity to this and bringing it into the concept of ESG itself, I mean, which is essentially the *raison d'être* of this, how do the ESG principles, and particularly those related to environmental objectives, play into the Taxonomy Regulation's application?

Ezra Zahabi: Right. So, what the Taxonomy Regulation effectively does is that it sets out four steps that an activity must meet or an asset or a product must meet in order to be considered environmentally sustainable. And, so, you think about an asset, whether it's a bond or whether it's shares in the company, and you have to look at the underlying company and its economic activities. In certain circumstances, you have, for example, with green bonds, for example, you have to look at whether the specific activity that the bond is seeking to finance itself would meet the taxonomy standard for being sustainable.

So, the criteria is that the activity must contribute substantially to one or more of the environmental objectives that are specified under the Taxonomy Regulation, that it must substantially contribute to a specified environmental objective. And I'll talk in a little while what those environmental objectives actually are. It must not significantly harm any of the environmental objectives. So, if it substantially contributes to one, it must not also then significantly harm another environmental objective. It must be carried out in compliance with the minimum safeguards that are specified under the Taxonomy Regulation. And then, finally, the activity must comply with technical screening criteria that have been established in accordance with the Taxonomy Regulation. So those are the four steps.

Now what the environmental objectives actually are is set out in the Taxonomy Regulation. And these objectives become effective at different times, but in the first instance, in January 2022, the first two environmental objectives become effective. And those are climate change mitigation and climate change adaptation. The others are, they include the transition to economy, pollution prevention, and protection and restoration of biodiversity, and sustainable use and protection of water and marine resources.

And, so step number one is you establish, does the activity in the first instance substantially contribute to either climate change mitigation or climate change adaptation? Then what this must mean, so what is a substantial contribution to climate change mitigation or climate change adaptation is then specified under the Taxonomy Regulation. Similarly, the other sort of substantial contributions to the other environmental objectives is also discussed under the taxonomy.

It is also possible to consider an economic activity as substantially contributing to one of the environmental objectives if it directly enables other activities to make a substantial contribution. So, if it's an enabling activity, that enabling activity then doesn't undermine the sustainability itself, then it's possible some indirect enabling actions as being environmentally sustainable. So, for example, financing certain types of the projects could be an enabling activity, but in itself could be considered to be environmentally sustainable.

Then the second step is this significant harm. And again, what the significant harm means is specified under the Taxonomy Regulation. So, with respect to climate change mitigation, causing significant harm to that objective means any action where the activity leads to significant greenhouse gas emissions. Under the climate change adaptation, much broader concept of potential significant harm, and that's where the activity leads for an increased adverse impact on the current climate and expected future climate, on the activity itself, or on people, nature or assets. So, it's very broad. Fairly straightforward although broad in itself, I think, is this activity leading to significant greenhouse gas emissions. That's why I think that it's fair to say that at this stage, really, the key test is the greenhouse gas or very clear damage-causing activities, so, environmental damage-causing activities.

Then, the minimum safeguards principles are interesting because the ESG principles feature in this minimum safeguards concept. So, you've established the activity does contribute to an environmental objective. You've established that it doesn't cause significant harm to any of the environmental objectives. And then you have to consider whether the activity's carried out in accordance with the minimum safeguards. And the minimum safeguards are, basically, alignment with certain international principles such as the UN Guiding Principles on Business and Human Rights.

And, so, a fairly high-level qualitative assessment. And in contrast to that high-level qualitative assessment is, then, the requirement that the activities must also comply with the technical screening criteria. And the technical screening criteria are these various specific quantitative measures on what the outputs or the effects of the activity are on the environment. And those screening criteria are set out pursuant to the Taxonomy Regulation by the Platform on sustainable finance, which is essentially a body that's commissioned, the European Commission will establish this body called Platform on sustainable finance, and on board of that are basically representatives of European financial supervisory authorities and the European Investment Bank, European Environment Agency, but also representatives of various other stakeholders, including industry bodies, significant market participants, civil society representatives, academics. And it's the job of the Platform on sustainable finance to then advise the Commission on the technical screening criteria and analyze the impact of the criteria, whether it's appropriate and so forth. And it's envisaged that that criteria will be subject to periodic review and improvement and so forth. So, that is what the Taxonomy Regulation in effect does. That's the interaction with the various ESG principles and objectives and what the Taxonomy Regulation then sets out as the framework for what can be considered to be environmentally sustainable.

Jose Garriga:

That's interesting. Thank you. A reminder, listeners, we're here today with Akin Gump financial regulatory partner Ezra Zahabi discussing the EU's Taxonomy Regulation.

So, the extant regulatory framework, what impact does the Taxonomy Regulation have on it, if any?

Ezra Zahabi:

So, for the existing regulatory framework, which is, effectively, the SFDR, currently. And then, I mean, there is some interaction with the AIFMD [*Alternative Investment Fund Managers Directive*], for example, and the MiFID [*Markets in Financial Instruments Directive*] requirements on disclosure to clients and to investors. But the key aspect, probably, is that it creates an additional layer of disclosure for the products that have been assessed by a manager or other person subject to the SFDR as being light green or dark green. And, so, you then have established that you have a product that's light green or dark green, and you have made the disclosures in accordance with the SFDR. From January 2022, you are also required to ensure that your pre-contractual documentation—so, that's your PPM or other document where you make the AIFMD disclosures and other pre-contractual documents that you have to provide to your clients or to your investors, those include the SFDR disclosures, and they also now have to do it from January 22—must include these additional disclosures under the Taxonomy Regulation.

And, so, what are those? Those are a requirement to disclose that the information on the environmental objective or objectives to which the investment that is underlying the financial product contributes. So, if you have identified that you have an Article 9, so, a dark-green product, and you have said this product has environmental objectives, then you have to link them back to the environmental objectives that are set out under the Taxonomy Regulation. So, you would look at, is the objective climate change mitigation? Is it climate change adaptation? Is it both? You are also required to disclose or describe how and to what extent the underlying investments in the product are investments in economic activities that are environmentally sustainable in accordance with the Taxonomy Regulation.

So, you have to explain how your underlying investments are sustainable, to what extent they are sustainable, in what way are they sustainable, and you also have to disclose

essentially like a green asset ratio. You have to disclose a proportion of your investments in environmentally sustainable economic activities. And that includes details of the proportions of any kind of enabling or transitional activities. That has to be expressed as a percentage of all investments within that financial product. So if you've got a fund that's an article 9 dark-green fund, you have to be clear on exactly which environmental objectives that fund is seeking to meet, what are the environmental objectives, and how the investments in the fund, how they qualify as environmentally sustainable, and you have to be clear on what proportion of your assets in the fund are actually environmentally sustainable when classified in accordance with the Taxonomy Regulation.

And then for light-green funds, similar disclosure obligation. The light green funds were products that promote environmental or social characteristics, and here, to the extent that you have an Article 8 fund that promotes environmental characteristics, you have to disclose the same information. You have to be clear on actually what environmental objectives are you promoting, to what extent your products are actually sustainable, if at all. It may be that the investments in an Article 8 fund don't meet all the criteria under the Taxonomy Regulation for them to be considered environmentally sustainable within the meaning of the Taxonomy Regulation. You may still think that they are "environmentally sustainable" in a broader kind of commonsensical sense of the expression, but not necessarily in accordance with the Taxonomy Regulation standards, but you have to be clear about that.

And, again, you have to express this green asset ratio, what percentage of the overall portfolio is in green assets, green being environmentally sustainable under the taxonomy. And you also, of course, you need to be clear that, you have to specifically express that the "do no significant harm" principle only applies to the investments in the fund that follow this EU criteria that's under the Taxonomy Regulation for environmentally sustainable activities.

It's worth noting here that the Taxonomy Regulation will represent additional disclosure to a subset of your Article 8 and Article 9 funds. So, where you have identified your population of Article 8 and Article 9 products, only those that are environmentally sustainable in January 2022, that will be climate change mitigating, climate change adaptation, those will be subject to this additional disclosure under the Taxonomy Regulation. It is contemplated that, in due course, it's expected in like another three years times or so, there will be similar taxonomy developed for what is considered to be social or socially sustainable, but, currently, the taxonomy focuses on environmental criteria only.

Jose Garriga:

Thank you. And I would refer listeners to the preceding episode to get a lot more interesting detail on Articles 6, 8, and 9, and what differentiates them, because I think that would also be useful in understanding how it's going to play out in the Taxonomy Regulation.

So, wrapping up, what are the key takeaways that you would offer listeners? Just boiling down what you've discussed up to now, what would you offer listeners in that respect?

Ezra Zahabi:

So, I think that, probably, the key things are, the practical takeaway, I think, for managers and other financial entities is, probably, you have to complete your SFDR exercise and, to the extent that you are required to comply, it's probably now time to turn your attention to the Taxonomy Regulation and the disclosures required under that. And from January 22, there's also the Delegated Regulation, which is a secondary legislation

under the SFDR and the Taxonomy Regulation, will become effective. And that has a template disclosure format that will incorporate both the Taxonomy Regulation disclosures as well as the SFDR disclosures. And, so, it's probably worth the exercise to now start going through the portfolios and the investment assets to understand which of your underlying investments would meet the criteria under the Taxonomy Regulation.

Now, another key point to note is just that there is a widely recognized issue with there not being adequate information on the market. And, so, part of the issue is really that the companies that are often the investee companies, the information that they produce is inconsistent. There's no single standard that all companies follow. And, as a consequence, there are many proprietary models for considering or assessing what's sustainable. And it's probably another exercise to look at what the proprietary model is if you have one, and to what extent, how does it compare to the taxonomy and what you can do to make the two more consistent.

Maybe another thing to think about is whether, for those who operate in multiple jurisdictions, whether this is something that will mean that the company, ultimately, will run a single standard for what is sustainable. And that standard is actually dictated or strongly formed by the Taxonomy Regulation even in jurisdictions where it doesn't strictly apply. And the final point in this is, as we mentioned, the Taxonomy Regulation also includes transparency requirements for entities that are in scope of the Non-Financial Reporting Directive, and they will be required to make similar disclosures. So, they'll need to disclose the proportion of their turnover that's derived from economically sustainable activities, as well as the proportion of their capital expenditure and operating expenditure that relates to environmentally sustainable economic activities. And, so, when that information starts to actually filter to the market, these disclosures become a lot more meaningful, and it becomes much more straightforward to start comparing the underlying investee companies and their performance.

And, so, in the intervening period, there's a question as to how you actually get information and how you engage with your investee companies, and whether there's an exercise to be had in developing a policy at the level of the manager in engaging with the portfolio companies across different jurisdictions requiring the same type of information, even if the companies are not subject to the Taxonomy Regulation disclosure. So, I think those are probably the key takeaways in the sense of what I'd be thinking about in embarking on the Taxonomy Regulation compliance exercise.

Jose Garriga:

Thank you. Listeners, you've been listening to Akin Gump financial regulatory partner Ezra Zahabi. Thank you, Ezra, for coming back to the show today to flesh this out. I think this is really critical stuff for listeners in the EU and those doing business in the EU.

And thank you, listeners, as always for your time and attention. Please make sure to subscribe to *OnAir with Akin Gump* at your favorite podcast provider to ensure you do not miss an episode. We're on, among others, iTunes, YouTube and Spotify. And stay tuned for the third and final installment of this ESG regulatory miniseries, as Ezra will be tying in the SFDR and the Taxonomy Regulation for listeners in the next episode.

So, to learn more about Akin Gump and the firm's work in, and thinking on, ESG and financial regulatory matters, look for "ESG" and "regulatory" at the Experience and Insights & News tabs at akingump.com, take a moment to read, or reread, Ezra's bio on the site, and then visit our new *Speaking Sustainability* blog, which features our lawyers' thinking and analysis on all matters ESG-related.

Until next time.

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