JONES DAY

COMMENTARY

JULY 2019

IN SHORT

The Situation: As part of its drive to develop financing for sustainable growth, the European Union is developing an EU-wide classification system for sustainable activities. This common language will be used by market players to foster informed investment decisions concerning environmentally friendly economic activities. This classification system, or "taxonomy," is the first priority of the European Union's 10 Step Action Plan.

The Development: On June 18, 2019, the technical expert group ("TEG") charged with developing the screening criteria by the European Commission released its first report. The report analyzes 67 economic activities across eight sectors and proposes a five-step verification and scoring process to identify investments that are eligible (or not) for a "green" classification and, if necessary, give relative weighting to the eligible activities.

Looking Ahead: This classification system is intended to enable all market participants to include environmental performance criteria as part of their investment decisions. However, market participants will need to remain patient until the full set of screening criteria has been developed, which is not likely to occur before December 2019.

A first draft regulation on the establishment of a framework to facilitate sustainable investments, the so-called "Taxonomy Regulation," was published back in May 2018 by the European Commission. The taxonomy is expected to constitute a cornerstone of EU legislation on environmental, social, and governance ("ESG") issues and be an important tool for "sustainable" capital markets development. Under the draft regulation, screening criteria will be used to identify those economic activities which qualify as sustainable. Such screening criteria would then form the basis for further delegated acts by the European Union aimed at refining the six environmental objectives set out in the Taxonomy Regulation.

On June 18, 2019, the TEG released its first taxonomy report, which proposes an EU-wide definition of the taxonomy and a sector-by-sector sustainability analysis.

The sectors analyzed in the report are:

- Agriculture
- Forestry
- Manufacturing
- Electricity, gas, steam, and air conditioning supply
- Water, sewerage, waste, and remediation
- Transportation
- Information and communication technologies
- Construction and real estate

These sectors are further divided into activities, with detailed analysis proposed for each one.

The activities analyzed are not exhaustive and additional activities are expected to be added in the future. For example, the electricity, gas, steam, and air conditioning supply sector is broken down into 23 different activities, while the construction and real estate sector currently only includes four activities. While the focus of the report is on the environmental goal of "climate change mitigation," the TEG has also been careful to note the interplay with the European Union's other environmental goals.

> The taxonomy is expected to constitute a cornerstone of EU legislation on ESG issues and be an important tool for "sustainable" capital markets development.

As a reminder, in order to be "sustainable," an economic activity must not only materially contribute to one of the six environmental goals, but must at the same time not significantly harm any of the other five goals. The latter is also referred to as the Do-No-Significant-Harm ("DNSH") test, which will be mandatory for certain financial market participants under the proposed Taxonomy Regulation, and which is expected to be widely used by others as well.

The taxonomy sets a five-step approach to help users identify the sustainability of a financial product:

1. Identify the activities conducted by the company or issuer OR those covered by the financial product that could be eligible.

2. For each potentially eligible activity, verify whether the company or the issuer meets the relevant screening criteria.

3. Verify that the DNHS criteria are being met by the company or the issuer (most likely through a due diligence process and reliance on disclosure).

4. Conduct due diligence to avoid any violation of the social minimum safeguards stipulated in the taxonomy.

5. Calculate alignment of investments with the taxonomy and prepare disclosures at the investment product level.

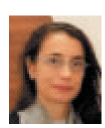
The TEG report on taxonomy continues to bring hope to market participants, as it provides flexible, understandable screening tools and focuses on activities rather than entities, thus encouraging progressive steps towards sustainability in certain high carbon emitting sectors and supporting the transition from brown to green.

Those who were hoping to find final guidance will, unfortunately, need to remain patient. In particular, fund and asset managers to which the proposed ESG disclosure regulation will apply, and market participants subject to corporate social responsibility, or CSR, reporting obligations are not likely to receive further guidance until early next year at the earliest and, even then, the guidance will not be final.

Indeed, the TEG's mandate has been extended until the end of 2019. It will continue to refine its guidance and expand its analysis to other economic activities. It therefore seems likely that the legislative process with regard to the Taxonomy Regulation and the related delegated acts—the first two of which were originally anticipated to enter into force on July 1, 2020—will be delayed. In the meantime, those subject to ESG-related disclosure obligations will need to tackle the task of identifying sustainable activities without any final guidance from the authorities.

THREE KEY TAKEAWAYS

1. The European Union continues to execute on its Sustainable Finance Action Plan, with the recent publication of recommendations for the classification system known as the sustainable finance taxonomy.



Patrizia Gioiosa
Milan

Linda Hesse
Paris

This system enables markets participants to identify and evaluate "economic activities that can make a real contribution to climate change mitigation or adaptation."

2. The proposed classification system already covers eight sectors and 67 economic activities, and sets forth a process to evaluate whether a particular activity provides a substantial contribution to one of six environmental objectives and that it does no significant harm to any of them.

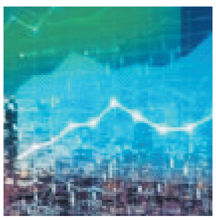
3. While the taxonomy seems cumbersome, given market demand for some common standards, it is already creating significant change in Europe.

Mathias Raabe
Düsseldorf

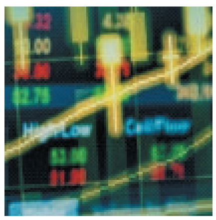
Natalia Sauszyn
Paris

All Contacts >>>

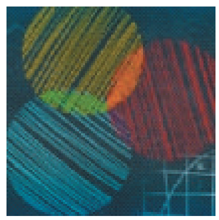
YOU MIGHT BE INTERESTED IN: **Go To All Recommendations >>**



Bank of England Publishes Discussion Paper on Risk Management Systems for Collateral Referencing LIBOR



ARRC Publishes Final LIBOR Transition Recommendations for Floating Rate Notes and Syndicated Business Loans



SEC Explores Ways to Simplify, Harmonize, and Improve the Framework For Exempt Offerings

---

SUBSCRIBE SUBSCRIBE TO RSS
