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European Commission Proposals on Sustainable Finance

July 2018

The European Commission has followed up its Sustainable Finance Action Plan, published in March 2018, with three legislative proposals aimed at creating an EU sustainability taxonomy, requiring disclosures relating to environmental, social and governance factors and the creation of low carbon and positive carbon impact benchmarks.

Following the publication of its sustainable finance action plan in March 2018, on 24 May 2018, the European Commission ("**Commission**") published three legislative proposals aimed at harnessing "*the vast power of capital markets in the fight against climate change and promoting sustainability*". The first proposal aims to establish an EU sustainability taxonomy, the second relates to disclosures to be made relating to environmental, social and governance ("**ESG**") factors and the third relates to the creation of low carbon and positive carbon impact benchmarks.

Taxonomy

The proposal to create a sustainability taxonomy was devised to prevent "greenwashing", or the marketing of financial products which do not in fact meet basic environmental standards or sustainability standards in order to garner a competitive advantage over other products. The Commission's proposal aims to develop a taxonomy for climate change and environmentally sustainable activities so that the classification system can be used with respect to labels, standards and benchmarks recognising compliance with environmental standards across the EU.

The proposed regulation sets out criteria for determining if an activity (not a company or asset) is environmentally sustainable, including whether the activity contributes to or does not significantly harm one or more specified environmental objectives. The environmental objectives include climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy, waste prevention and recycling; pollution prevention and control and protection of healthy ecosystems.

The Commission will have the power to adopt delegated acts to determine the technical screening criteria for determining conditions under which a financial product might be considered to be contributing to these objectives. The technical screening criteria must consider for example, conclusive scientific evidence. They should strive not to distort competition in the market.

There will be a phased implementation of the proposals, with the intention that the provisions will come into effect between July 2020 and December 2022.

Disclosures of ESG Risks

The proposal on disclosure of ESG risks will require institutional investors to consider and disclose in a consistent and harmonised manner how ESG factors are adopted in their decision making and advisory processes. The proposed regulation will apply to asset managers (including AIFMs and UCITS management companies), insurance undertakings, pension funds and investment advisors. The disclosures proposal will require:

- website publication of how sustainability risks are incorporated into investment decision making processes or investment or insurance advice;
- the inclusion of various elements of sustainability risks in pre-contractual disclosures, including the impact of sustainability risks on returns of any financial product; and
- where financial products are marketed as sustainable investments, website disclosures of the sustainable investment target and the methodologies used to measure the impact of the investment, together with the provision of periodic reports detailing the sustainability-related impact of the financial product.

Asset managers will also be required to disclose how their remuneration policies are consistent with the integration of sustainability risks. For funds with no sustainability focus, managers will need to consider whether the new disclosure requirements will translate into a limited form of additional disclosure or whether investor expectations will be impacted so that managers will need to consider sustainability more generally in investment process and strategy.

The European Supervisory Authorities ("**ESAs**") will develop draft technical standards to specify the details of the presentation and content of information to be provided to investors.

Benchmarks

The third draft regulation proposed by the Commission will amend the existing Benchmark Regulation by introducing two new types of benchmarks:

- a low carbon benchmark, where the underlying assets have less carbon emissions than a standard investment index; and
- a positive carbon impact benchmark, composed of assets where the carbon emission savings exceed their carbon emissions.

Administrators of benchmarks that pursue ESG objectives will be required to publish key elements of their methodologies and to include in their benchmark statement an explanation of how ESG factors are reflected. The Commission will adopt delegated acts to provide further detail on the minimum standards for each of the new benchmarks and the requirements applicable to benchmark administrators.

Next Steps

The three proposals will now be considered by the European Parliament and Council of the EU. The Commission is in the process of establishing a technical expert group on sustainable finance and part of its mandate will be to develop the technical screening criteria for determining the conditions under which a financial product might be considered to be contributing to the environmental objectives under the taxonomy proposal.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team can be accessed at www.matheson.com.

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