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WHITE PAPER

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Sustainable Finance Regulations, Rules, and Guidelines in the European Union and United States—Time to Get Prepared

Due to the increasing awareness of the importance of environmental, social, and governance ("ESG") initiatives, the European Commission came forward at the end of May 2018 with a proposal related to this topic. The proposal is intended to reorient capital flows toward sustainable investments, manage financial risk stemming from climate change, and foster transparency and a long-term outlook for the financial economic activity.

Other similar initiatives are underway around the world, creating a quickly evolving regulatory landscape. Financial market participants should take note.

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OVERVIEW

Environmental, social, and governance ("ESG") concerns have been on the agenda of standard setters and rule-making bodies, including self-governance organizations, for almost three decades.[1] Many ESG initiatives, whether on a global, greater regional, or national level, began by promoting principles-based approaches that not only led to widespread awareness of ESG-related matters but also to substantial investments that fostered various goals linked with ESG.[2] In line with this increasing and accelerating trend, the European Commission came forward at the end of May 2018 with a proposal for a set of regulations addressing specific aspects associated with ESG:

- A regulation to establish a framework to facilitate sustainable investment ("Taxonomy Regulation");
- A regulation on disclosures relating to sustainable investments and sustainability risks, amending Directive (EU) 2016/2341;
- A regulation on low-carbon benchmarks and positive carbon-impact benchmarks, amending Regulation (EU) 2016/1011;
- A regulation with regard to organizational requirements and operating conditions for investment firms and other defined terms, amending Regulation (EU) 2017/565 supplementing Directive 2014/65/EU; and
- A regulation with regard to ESG preferences in the distribution of insurance-based investment products, amending Delegated Regulation (EU) 2017/2359 (together with the proposed regulation referred to immediately above, "ESG Organizational Requirements Regulations").

This package of proposed regulations emanates from the EU action plan on financing sustainable growth[3] launched in March 2018. Its purposes are to:

- Reorient capital flows toward sustainable investments;[4]
- Manage financial risk stemming from climate change; and
- Foster transparency and a long-term outlook for financial economic activity.

The package also ties in with the ongoing efforts to create a true capital markets union by better connecting markets with the real needs of the European economy and by emphasizing the role that capital markets can play in financing the transition toward a more circular economy. In this context, scientific research suggests that companies adhering to ESG principles can consistently achieve returns of 2 to 3 percent higher than those of peers who have not implemented ESG principles.[5]

This set of proposals comes at a time when, despite growing interest in the green bond market to finance ecological and energy transition, the lack of commonly understood and solid standards has left the door open for "green washing" cases. Indeed, some projects labelled as "green" have been financed without clear evidence of environmental benefit, and capital raised for "green" purposes has sometimes been used to finance or refinance the issuer's traditional activities.

These ambiguities highlight the technical environmental and tax law issues that green finance raises. Clients have recently mandated us to assess the legal issues raised by financial institutions' use of certified emission reductions ("CER") and verified emission reductions ("VER") to offset the carbon emissions that an investment fund generates. Indeed, technical questions, such as the methodology applicable to the calculation of the investments' carbon footprint as well as the choice of a trustworthy project generating VER are key concerns. There are basic differences between VER and CER, including in terms of their legal nature, as well as the safety mechanisms underlying the purchase and cancellation of CER and VER and the need to provide legal certainty in such purchases and cancellations. Finally, information provided to the market and in particular to investors must be carefully reviewed, both at the time the structure is put in place and during the life of the finance structure, in coordination with the competent regulator.

Many market participants are therefore calling for a better regulatory structure of this fast-growing but still-evolving market, starting with a clear definition of what can be considered as a "green" asset or project and more stringent control of the auditing and valuation of assets or projects that are labelled as "green." Multiple initiatives around the globe are underway, with regulations, rules, and guidelines being proposed, adopted, and amended by the European Union, EU Member States, the State of California and U.S. federal agencies, the Loan Market Association ("LMA"), and the International Capital Markets Association ("ICMA"). It is time for market participants to incorporate these trends and anticipate their likely changes into their operating principles and deal structures to continue to benefit from growing investor demand for these products.

EU REGULATIONS

In this *White Paper*, we focus on what we believe will have the greatest impact on operations of financial market participants from certain aspects of the Taxonomy Regulation and of the ESG Organizational Requirements Regulations.

Taxonomy Regulation

The Taxonomy Regulation is addressed to EU Member States and financial market participants offering financial products as environmentally sustainable investments or as investments with similar characteristics. Financial market participants in this context include all:

- Insurance undertakings that make available certain insurance-based products;
- Alternative investment fund managers;
- Investment firms that provide portfolio management services;
- Institutions for occupational retirement provisions;
- Providers of pension products;
- Managers of qualifying venture-capital funds registered in accordance with Regulation (EU) No. 345/2013;
- Managers of qualifying social-entrepreneurship funds registered in accordance with Regulation (EU) No. 346/2013; and
- Undertakings for the Collective Investment of Transferable Securities ("UCITS") management companies.

From a purely legal view, the Taxonomy Regulation seems to be a welcome step in the right direction, as it gives all stakeholders a more practicable and consistent tool for dealing with certain ESG matters when compared to the various principle-based approaches currently in existence. As laudable as many principle-based approaches were (provided one agrees with the general approach that ESG aspects should be integrated into financial market operations), they lacked homogeneity and made comparisons between companies that had adopted different standards difficult. A clear taxonomy should help, despite certain weaknesses inherent in legal definitions at EU level, to establish a level playing field for all relevant market participants and to compare certain ESG-related activities of these market participants better.

What can then be expected from the Taxonomy Regulation? The Taxonomy Regulation addresses only environmental issues (the "E" of ESG) related to sustainable finance. Social and governance-related requirements will be dealt with at a later stage by means of separate legislative proposals. They are, therefore, by and large exempt from the current proposal except for some safeguards that must be complied with, such as the International Labour Organization's Declaration on Fundamental Principles and Rights at Work.

Moreover, the Taxonomy Regulation sets out only the framework for six environmental objectives laid down in its draft, each of these becoming operational just six months after technical screening criteria have been developed and a corresponding delegated act has come into force.

The following table gives an overview of the six environmental objectives and the times by which the delegated acts should be expected:

OBJECTIVE	EXAMPLES	ENTRY INTO FORCE
Climate change mitigation—the process of holding the increase in the global average temperature to well below 2°C above pre-industrial levels and limiting the temperature increase to 1.5°C above pre-industrial levels	• Generating, storing, and using renewable energy; • Improving energy efficiency; • Producing clean and efficient fuels from renewable or carbon-neutral sources.	July 1, 2020
Climate change adaptation—the process of adjustment to actual and expected climate and its effects	• Preventing or reducing the location- and context-specific negative effects of climate change; • Preventing or reducing the negative effects that climate change may pose to the natural and built environment within which the economic activity takes place.	July 1, 2020
Sustainable use and protection of water and marine resources	• Protecting the aquatic environment from the adverse effects of urban and industrial wastewater discharges by ensuring adequate collection and treatment of urban and industrial wastewaters; • Protecting human health from the adverse effects of any contamination of drinking water by ensuring that it is free from any micro-organisms, parasites, and substances that constitute a potential danger to human health.	December 31, 2022
Transition to a circular economy and waste prevention and recycling	• Improving the efficient use of raw materials in production; • Increasing the durability, reparability, upgradability, or reusability of products; • Prolonging the use of products, including through increasing reuse, remanufacturing, upgrading, repair, and sharing of products by consumers.	December 31, 2021
Pollution prevention and control	• Reducing air, water, and soil pollutant emissions other than greenhouse gases; • Minimizing significant adverse effects of the production and use of chemicals on human health and the environment.	December 31, 2021
Protection of healthy ecosystems	• Nature conservation (habitats, species); • Sustainable land management, including adequate protection of soil biodiversity; • Sustainable agricultural practices, including those that contribute to halting or preventing deforestation and habitat loss.	December 31, 2022

Furthermore, for the purposes of establishing the degree of environmental sustainability, an economic activity will be environmentally sustainable only if the economic activity does not significantly harm any of the environmental objectives listed above. This would be the case if the activity in question significantly harms climate change mitigation because that activity leads to significant greenhouse gas emissions. It would also be the case if the activity significantly harms the circular economy and waste prevention and recycling because that activity leads to significant inefficiencies in the use of materials in one or more stages of the life cycle of products, including in terms of durability, reparability, upgradability, reusability, or recyclability of products.

Finally, financial market participants offering financial products as environmentally sustainable investments, or as investments with similar characteristics, must disclose information on how and to what extent the criteria for environmentally sustainable economic activities are used to determine the environmental sustainability of the investment. That information will then enable investors to identify the percentage of holdings pertaining to companies carrying out environmentally sustainable economic activities and the share of the investment that funds environmentally sustainable economic activities as a percentage of all economic activities.

Misleading information provided to the market could also trigger substantial liabilities for the market participants. Based in particular on consumer laws, false allegations on the green characteristics of a financial product may be considered as misleading advertisement. Underlining the green characteristics of a financial product may also elevate the standard of conduct to which a market participant may be held in the case of claims from investors or other third parties.

ESG Organizational Requirements Regulations

One of the consultations that the European Commission conducted in advance of the legislative proposal revealed that only a minority of clients proactively raises ESG issues during an advisory process. Some of the reasons for this are that the available information on ESG products is not transparent, that there is a high risk of "greenwashing" in existing documentation, and that there is a lack of education on the impact of ESG factors on risk and performance. In an attempt to tackle these findings, the ESG Organizational Requirements Regulations suggest that investment firms within the meaning of MiFID II that provide financial advice and portfolio management should carry out a mandatory assessment of their clients' ESG preferences in a questionnaire.

In contrast to the Taxonomy Regulation, the ESG Organizational Requirements Regulations do not refer only to environmental aspects but also include social and governance aspects. Investment firms should take these ESG preferences into account in the selection of financial products offered to these clients. Similarly, insurance intermediaries and insurance undertakings need to integrate their customers' ESG preferences into the suitability assessment.

The ESG Organizational Requirements Regulations also seek to improve information relating to ESG factors of financial products by requiring investment firms that provide investment advice and/or portfolio management services to disclose to their clients certain ex-ante information and to prepare a report for the client that explains how the recommendation to the client meets her/his investment objectives, risk profile, capacity for loss bearing, and ESG preferences (ex-post information disclosure). In order to be in a position to comply with the foregoing, investment firms need to include ESG considerations in their internal policies and procedures. Again, insurance intermediaries and insurance undertakings must meet similar requirements.

If the ESG Organizational Regulations are enacted in the form of the current drafts, they will become applicable within 18 months from the date upon which the ESG Organizational Regulations come into force. Investment firms, insurance intermediaries, and insurance undertakings, therefore, might be required to comply with the ESG Organizational Regulations beginning as early as Q2 2020.

EU MEMBER STATE INITIATIVES—ITALY AND FRANCE

In Italy, the same evolution is taking place. Indeed, Law No 232/2016 provided a provision on ethical and sustainable finance that amended Legislative Decree No 385/1993 (the Italian Banking Act), adding Article 111-bis. In general, this article sets forth the requirements that a bank should meet to be qualified as an "ethical bank" (i.e. banking operators of ethical and sustainable finance) and to avail itself of favorable tax treatment. A Ministerial Decree must implement Article 111-bis. Moreover, for example, Consob Regulation No 20307/2018 for intermediaries contains provisions on ethical or socially responsible finance, providing, in particular, disclosure obligations (Article 136) and reporting obligations (Article 137) for services and/or products qualified as ethical or socially responsible.

France has also adopted regulations requiring asset management companies, as well as insurance companies and pension funds, to report on environmental, social, and governance criteria taken into account in their investment strategy. In particular, Decree No 2015-1850 of December 29, 2015, codified in the French Financial and Monetary Code, provides that such companies may, when relevant, indicate when environmental criteria taken into account include an assessment of risks associated with climate change and/or an assessment of the contribution of the investment strategy to international goals of limiting global warming. The reporting entities are also encouraged to indicate, with respect to the UCITS or funds that they manage, the consistency of the investments with a low-carbon strategy, in particular for actors involved in fossil fuel activities, as well as greenhouse gas emissions, whether past, current, or future, associated with the issuers that are part of the investment portfolio.

RULEMAKING IN THE UNITED STATES

Unsurprisingly, the trends are the same in the United States. The United States is among the three nations, including France and China, that issued more than half the green bonds issued in 2017, with Fannie Mae being the largest U.S. player, issuing $24.9 billion in green mortgage-backed securities. The State of California has been leading the country to make the market for U.S. green bonds as attractive as those issued in Europe, Asia, and the rest of the world and to transition the market from fast growth to become thriving and sustainable. In January 2017, the California state treasurer launched an initiative to identify the major barriers to the development of green finance, including the lack of standardization of the green bond label, pricing issues, and market function. In August 2018, in partnership with the Milken Institute and Environmental Finance, it published a series of recommendations to address these challenges, including a responsible issuer program, and other market solutions to enhance municipal programs to finance sustainable investment.

Rising demand by U.S. investors for ESG disclosure has increasingly led issuers to voluntarily incorporate corporate social responsibility data (including reports on climate change mitigation) in their financial data.

However, given the potential liability under U.S. federal securities laws, which impose severe penalties for material misstatements and omissions in companies' public disclosures, some U.S. companies attempt to remain silent on ESG issues despite investor demands, and many have sought guidance from the Securities and Exchange Commission ("SEC") on the materiality of certain ESG disclosures and shareholder proposals. On November 1, 2017, the SEC issued additional guidance, addressing several topics related to the exclusion of shareholder proposals from public company proxy statements.[6] Following the SEC release, two companies successfully sought no-action letters from the SEC to confirm that the SEC will not take enforcement action if they exclude shareholder proposals requesting reports on the companies' efforts to reduce greenhouse gas emissions. Amazon also obtained a similar no-action letter allowing it to exclude a shareholder proposal requesting a report on the company's efforts to manage food waste.

In light of the growing demand for ESG-focused investments, many have called on the SEC to adopt rules aimed at standardizing ESG disclosure for reporting companies in the United States. On October 1, 2018, two law professors submitted a public petition for rulemaking to the SEC by requesting that the SEC develop a comprehensive framework requiring issuers to disclose ESG information relating to a company's operations.[7] The petition was signed by investors and associated organizations representing more than $5 trillion in assets under management. The petitioners pointed to growing evidence that ESG factors increase operational performance of companies and improve investment outcomes and therefore constitute financially material information that influence a reasonable investor's decision-making process. The petition sought prompt rulemaking from the SEC for mandatory rules on ESG disclosure. The SEC so far has not acted on the numerous petitions already filed on the subject, and while companies are facing increased pressure to provide ESG data, it is still unclear whether this petition will change the tides.

INDUSTRY GUIDELINES

The LMA and ICMA have both produced voluntary guidelines on green financing relating to loans and bonds. Green loans and bonds are defined as any type of loan or bond instrument where the proceeds will be exclusively applied to finance or refinance, in whole or in part, new or existing eligible green projects, and which are aligned with the four core components, namely: (i) use of proceeds; (ii) process for project evaluation and selection; (iii) management of proceeds; and (iv) reporting.

Eligible green projects include renewable energy, energy efficiency, pollution prevention and control, environmentally sustainable management of living natural resources and land use, terrestrial and aquatic biodiversity conservation, clean transportation, sustainable water and wastewater management, climate change adaptation, eco-efficient and/or circular economy adapted products, production technologies and processes, and green buildings. The definitions of green and green projects may vary depending on sector and geography, however.

The Climate Bonds Initiative ("CBI") database lists all debt products aligned with the ICMA Green Bonds Principles or the LMA Green Loan Principles (as applicable) and their Climate Bonds Taxonomy. In 2018, the CBI recorded US$13.38 billion of Certified Climate Bonds issued in accordance with the Climate Bonds Initiative. However, while the CBI database commonly refers to debt instruments as "bonds," it includes under this label any debt format, such as sukuk, Schuldschein, loans, and securitizations. To be certified under the scheme, issuers obtain an external review to confirm their alignment with the ICMA Green Bond Principles or LMA Green Loan Principles. The issuers must also complete a further step whereby at least 95 percent of proceeds are dedicated to green projects, and as such, the CBI scheme goes further than the ICMA Green Bond Principles and the LMA Green Loan Principles.

The LMA Green Loan Principles are built on and designed to coexist with the ICMA Green Bond Principles. However, there are a couple of minor variations among the Principles. A green loan may take the form of one or more tranches of a loan facility. In such cases, the green tranche must be clearly designated, with proceeds of the green tranches credited to a separate account or tracked by the borrower in an appropriate manner. The ICMA Principles are silent on whether a bond could have multiple tranches, of which some could qualify as green. Further, for loans, when appropriate, an external review should be carried out, for example through consultant review, verification, certification, or rating (no details are given as to when an external review would be appropriate). For bonds, in connection with the issuance of a green bond or a program, issuers should appoint an external review provider to confirm the alignment of their bond or program with the four core components detailed above.

IMPORTANT TAKEAWAYS

1. The Taxonomy Regulation addresses environmental issues and sets the framework for six environmental objectives, such as protection of healthy ecosystems and transition to a circular economy and waste prevention and recycling. According to this regulation, an economic activity will be environmentally sustainable only if the economic activity does not significantly harm any of those environmental objectives.
2. Financial market participants falling within the scope of the Taxonomy Regulation must disclose information on how and to what extent the criteria for environmentally sustainable economic activities are used to determine the environmental sustainability of the investment.
3. Certain investment firms, as well as insurance intermediaries and insurance undertakings, would have to carry out a mandatory assessment of their clients' ESG preferences in a questionnaire under the current understanding of the ESG Organizational Requirements Regulations. Those preferences will then be taken into account during the selection process of the financial products that are offered to these clients.

4. Certain investment firms as well as insurance intermediaries and insurance undertakings will have to disclose to their clients certain ex-ante information and to prepare a report that explains how their recommendations fit with the preferences of a particular client. In addition, ESG considerations will need to be included in the internal policies and procedures established by the investment firms or insurance intermediaries/undertakings.
5. Market participants must also heighten their awareness of similar significant regulatory changes underway both at the EU Member State level and in the United States. New regulations and rulemaking are to be expected and will drive changes in market demand for the most attractive investment opportunities.
6. Issuers and other market participants will need to ensure that their product offerings and related disclosures are sufficiently robust from an environmental law point of view to limit risks of liability for misleading or incomplete disclosures as well as to ensure sustainability during the life of the product. They also must remain aware of the voluntary guidelines that are shaping market trends and product offerings, with the LMA and ICMA guidelines leading the way. Keeping these guidelines in mind will be key as other industry and investor groups enter the debate and seek to influence this increasingly significant market segment.

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ENDNOTES

1 For example, CERES (Coalition for Environmentally Responsible Economies), founded in 1989; "Equator Principles" of the International Finance Corporation, launched in 2003; and PRI (Principles for Responsible Investments), created in 2006 as an initiative of the United Nations.

2 According to the GSIA (Global Sustainable Investment Alliance, *2016 Global Sustainable Investments Review*), $22.9 trillion was allocated to sustainable, responsive, and impact investing by the end of 2016; the Loan Market Association reports the issuance of more than €100 billion of green bonds from January to November 2017.

3 Action Plan on Financing Sustainable Growth, launched by the European Commission on March 8, 2018.

4 Based on findings of a high-level expert group involved in preparing the Action Plan referred to in note 3 above, investments of €180 billion annually are needed on an EU-wide level in order to meet the EU 2030 climate targets.

5 Alex Edmans, "Does the stock market fully value intangibles? Employee satisfaction and equity prices," *Journal of Financial Economics*, Vol. 101, 2011.

6 SEC Staff Legal Bulletin No. 14I.

7 Request for rulemaking on environmental, social and governance (ESG) disclosure.