

ENVIRONMENTAL. SOCIAL. GOVERNANCE.

## EU Taxonomy Regulation and Investment Funds

### The EU Taxonomy

- is an EU-wide unified classification system of environmentally sustainable activities
- seeks to eliminate inaccurate marketing of financial products as 'green' or 'sustainable', a practice commonly known as greenwashing
- sets performance thresholds for economic activities to determine when an economic activity can be considered sustainable

### The EU Taxonomy Regulation

- sets out the framework and environmental objectives for the taxonomy
- contains tools to help investors, companies and issuers navigate the transition to a low-carbon, resilient and resource-efficient economy
- supplements the EU Disclosures Regulation and creates taxonomy-related disclosure obligations for financial market participants, which include UCITS management companies and AIFMs

### Taxonomy-related disclosures

- are mandatory for certain types of fund, and on a comply-or-explain basis for all others
- are to be made in prospectuses and in financial statements
- are a combination of a narrative explanation and proportion of underlying investments that are taxonomy-aligned expressed as a percentage
- will be in addition to any disclosures required under the EU Disclosures Regulation
- will begin to apply from 1 January 2022 in respect of the climate change mitigation and adaptation environmental objectives and from 1 January 2023 in respect of the other four environmental objectives

### What is the EU Taxonomy?

The EU Taxonomy is a classification system of environmentally sustainable activities. It provides tools to help plan the transition to an economy that is consistent with the EU's environmental objectives. It sets performance thresholds, called technical screening criteria, for economic activities to establish whether they can be considered sustainable and hence taxonomy-aligned.

The economic activities should:



The six environmental objectives are:

-  Climate change mitigation
-  Climate change adaptation
-  Sustainable use and protection of water and marine resources
-  Transition to a circular economy
-  Pollution prevention and control
-  Protection and restoration of biodiversity and ecosystems

Complying with the OECD guidelines on multinational enterprises and the UN Guiding Principles on Business and Human Rights are examples of meeting minimum safeguards under the Taxonomy.

**Impact on Investment Funds**

The impact of the EU Taxonomy Regulation on investment funds can be looked at under two headings:

- specific disclosure requirements
- assessing a portfolio for EU Taxonomy alignment

The disclosure requirements will affect all funds. The nature and extent of disclosure will depend on the fund’s investment objective and asset classes in which the fund proposes to invest. A fund which is not required to make a full EU Taxonomy disclosure will carry a standard disclaimer that:

**The investments underlying this financial product do not take into account the EU criteria for environmentally sustainable economic activities**

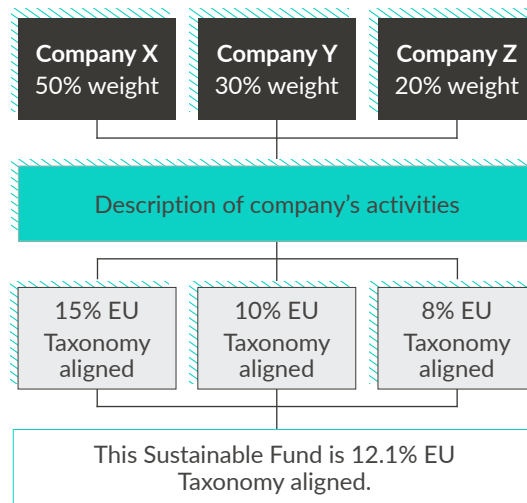
The taxonomy-related disclosures will be in addition to any disclosures required under the EU Disclosures Regulation. Here is a reminder of the EU Disclosures Regulation financial product categories:

Investment fund financial product categories		
Description	Investment fund product type	EU Disclosures Regulation article
ESG Labelled Fund	Investment fund promoting environmental or social characteristics	Article 8(1)
Sustainable Fund	Investment fund with sustainable investment as its objective with or without a reference benchmark index	Article 9(1) /9(2)
Carbon Reduction Fund	Investment fund with reduction in carbon emissions as its objective	Article 9(3)

For funds which are required to make a full EU Taxonomy disclosure, which are essentially ESG Labelled Funds, Sustainable Funds and Carbon Reduction Funds, they will need to

- describe how and to what extent they have used the EU Taxonomy to determine the sustainability of the underlying investments
- state to what environmental objective(s) the investments contribute
- give the proportion of underlying investments that are EU Taxonomy aligned expressed as a percentage of the investment, fund or portfolio.

The final report of the technical expert group on Sustainable Finance (TEG), see background below, gives examples and explanations of how to apply the EU Taxonomy to a portfolio of investments. To give a simplified example, the disclosure for a Sustainable Fund investing in equities from three issuers might look something like this:



Data availability is a challenge in producing the narrative and for percentage alignment of underlying investments. Compliance by issuers with the EU Taxonomy and the amended Non-Financial Reporting Directive should help. Where a fund is subject to disclosure requirements under the EU Disclosures Regulation and the Taxonomy Regulation there may be some practical issues to resolve to align both sets of disclosure requirements.

### Background

According to the March 2018 EU Action Plan on Financing Sustainable Growth, finance is a critical enabler of transformation and improvements in existing industries in Europe and globally. The transition of existing objectives to a more sustainable footing is expected to make the most substantial contribution to the EU’s environmental objectives. The Action Plan called for the creation of a classification system for sustainable activities. The EU Regulation on the [Establishment of a Framework to Facilitate Sustainable Investment](#), known as the EU Taxonomy Regulation, provides a legal basis and framework for the EU Taxonomy. It will be supplemented by delegated acts containing the technical screening criteria.

The European Commission established a technical expert group, TEG, on sustainable finance. The TEG published a final [report](#) in March 2020 setting out its recommendations to the European Commission. The report contains information on the overarching design of the EU Taxonomy, guidance on how users of the EU Taxonomy can develop disclosures and a summary of the

economic activities covered by the technical screening criteria for the objectives of climate change mitigation and adaptation. The report doesn’t reflect the view of the European Commission and so will not automatically translate directly into what may appear in the regulatory technical standards to be developed under the EU Taxonomy Regulation. However given the extensive expert, scientific, industry and public body input into the TEG report, it will certainly influence the outcome. Further development of the EU Taxonomy will be managed by the Platform on Sustainable Finance established by the European Commission.

### Timing

The EU Taxonomy Regulation was published on 22 June 2020 and came into force on 12 July 2020. Many key provisions will not apply until a later date. The first taxonomy-related disclosures for investment funds will apply from 1 January 2022 in respect of the climate change mitigation and adaptation environmental objectives. Disclosures in relation to the other four environmental objectives apply from 1 January 2023. Regulatory technical standards for each disclosure requirement are scheduled to issue six months before each respective disclosure requirement takes effect.

### Next steps

UCITS managers and AIFMs should

- take steps to familiarize themselves with the EU Taxonomy disclosure requirements
- identify how each of the funds under their management will be impacted by the EU Taxonomy disclosure requirements
- be aware of how they align with or are different from disclosure requirements under the EU Disclosures Regulation
- watch out for forthcoming consultations
- stay tuned to industry developments
- add EU Taxonomy disclosure requirements to the ESG planning agenda

You can contact a member of the [Asset Management & Investment Funds team](#) for more information.

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