SULLIVAN & CROMWELL LLP

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Sustainable Finance Update

EU Taxonomy, Updated Equator Principles, New Actions by Securities Regulators and Other Recent Developments

SUMMARY

Sustainable finance is increasingly mainstream. Global sustainable debt issuance reached $465 billion in 2019, up 78% from 2018.[1] New sustainable finance products continue to debut, along with scores of new issuers and borrowers. Regulators, particularly in Europe, have started enacting measures to ensure greater market transparency and consistency, although voluntary industry-led initiatives largely continue to define market practice.

The COVID-19 pandemic has disrupted financial markets and consequently deferred many sustainable finance transactions. However, the pandemic has also underlined social and sustainability challenges globally and presented new opportunities for financial markets to help solve these challenges.

This update covers several recent (voluntary and mandatory) regulatory developments in the market following our last update from July 2019.[2] The most notable of these is the European Union (EU) Taxonomy Regulation, an ambitious effort to define what qualifies as sustainable and guard against misleading claims of an investment's sustainability, known as "greenwashing." We expect the EU's sustainable finance initiatives to drive minimum global standards across the market. However, recent comments by the chairman of the U.S. Securities and Exchange Commission indicate that U.S. regulators too are looking closely at how issuers disclose information on environmental- and climate-related matters. Now more than ever, companies, financial institutions and investors need to be aware of the growth of the sustainable finance market and the multitude of sustainability-related voluntary and mandatory market standards and practices applicable to debt, equity, investment funds and other financial products.

BACKGROUND

"Sustainable finance" refers to the financial instruments and related regulations and industry standards aimed at promoting desirable environmental and/or social outcomes. Current sustainable financial products include green bonds and loans, social bonds, transition bonds, sustainability bonds and sustainability-linked loans, along with various sustainable/green-labeled equity, indices and investment funds. This update covers several recent (voluntary and mandatory) regulatory developments in the market following our July 2019 update.[3]

I. EU RECENT DEVELOPMENTS

A. EU TAXONOMY: DEFINING SUSTAINABILITY

In April 2020, the Council of the European Union reached a key milestone in its drive to promote sustainable finance with the adoption of the Regulation on the establishment of a framework to facilitate sustainable investment (the "Taxonomy Regulation").[4] The Taxonomy Regulation sets mandatory EU-wide criteria for classifying economic activities as environmentally sustainable and thus aims to standardize the growing universe of sustainable finance products and related disclosures. Proponents of the Taxonomy Regulation note that providing a common way to define sustainability can both reduce greenwashing and promote market growth by giving issuers and investors clear guidance as to what can qualify as sustainable financing.

Under its classification system, an economic activity is considered environmentally sustainable if it (i) contributes substantially to one or more of six specified objectives, which together focus on climate change, the transition to a circular economy, and protection of ecosystems, (ii) does not harm any of the other objectives and (iii) adheres to minimum social safeguards set forth by the OECD, the United Nations and the International Labour Organisation. The EU will establish technical screening criteria to determine whether an activity contributes to one of the six specified objectives. The expert working group dedicated to providing recommendations on the technical screening criteria for climate-related activities produced its final report in March 2020.[5] Notably, while the Taxonomy Regulation itself is silent on whether nuclear energy generation should be considered green—a contentious political issue within the EU—the expert working group has suggested not classifying it as green, as although nuclear energy generation has low greenhouse gas emissions, it may cause other environmental damage.[6]

Member States and the EU must apply this classification criteria if regulating financial market participants or issuers in respect of corporate bonds and certain financial products marketed as "green." In addition, certain firms and financial market participants must apply such criteria when making certain disclosures under the EU's Non-Financial Reporting Directive and when making available certain financial products, particularly structured products.

The Taxonomy Regulation does not itself establish requirements applicable to issuers of corporate bonds labeled "green" or "sustainable." However, issuers seeking to comply with the voluntary EU Green Bond Standard (the "EU GBS") must apply its criteria in determining whether a given investment is eligible as a green use of proceeds. The Taxonomy Regulation may also, in turn, determine whether retail bond investment funds can carry the recently proposed voluntary EU Ecolabel for retail financial products, which would require that 70% of the total portfolio value of such a fund is invested in bonds that comply with the EU GBS.[7]

The Taxonomy Regulation will next be considered by the European Parliament for final adoption and implementation would be phased in starting in December 2021 with provisions addressing climate-related activities.

B. EU DISCLOSURE REGULATION: INCREASING TRANSPARENCY

The EU took another major step towards integrating sustainability considerations into financial services with the adoption of the Regulation on sustainability-related disclosures in the financial services sector (the "Disclosure Regulation") in December 2019.[8] The Disclosure Regulation imposes new ESG-related transparency and disclosure requirements on certain investment advisers and asset and fund managers, including alternative investment fund managers and firms providing portfolio management and investment advice, and may require such entities to conduct additional due diligence on sustainability risks and impacts related to their investments.

As with the Taxonomy Regulation, the Disclosure Regulation aims to avoid greenwashing and increase sustainability-related disclosures so that investors can better understand both the impact of their investments on sustainability and the impact of sustainability-related risks on their investments. The Disclosure Regulation does not apply to "plain vanilla" corporate debt issued by corporate issuers but could indirectly drive prospectus disclosure and "sustainability" terms of such debt as investment funds and managers seek to comply with the Disclosure Regulation. The main provisions of the Disclosure Regulation will apply from March 2021. Draft technical standards specifying how companies will be required to comply with the Disclosure Regulation were released for comment in late April 2020.[9]

The European Commission is separately soliciting feedback on, among other matters, prospectus disclosure requirements applicable to green bond issuances.[10]

C. ESMA AND EBA SUSTAINABLE FINANCE PLANS: EXECUTING ON SUSTAINABILITY

Both the European Securities and Markets Authority (ESMA), the EU securities markets regulator, and the European Banking Authority (EBA), the EU banking sector supervisor, recently released sustainable finance action plans that explain how they will put into practice the EU's agenda on sustainable finance.

ESMA's Strategy on Sustainable Finance (published in February 2020) explains how the regulator will consider sustainability factors across its activities.[11] Among other priorities, ESMA notes that it will work towards building common approaches for how EU Member State securities regulators incorporate sustainability-related factors in their supervisory practices. ESMA is also beginning to develop a comprehensive analytical framework for monitoring sustainability-related market developments and risk, including financial risks stemming from climate change and climate transition costs.

The EBA's Action Plan on Sustainable Finance (published in December 2019) likewise outlines its deliverables related to sustainability.[12] Notably, the EBA encourages regulated financial institutions to proactively address emerging risks prior to being formally required to do so, including by identifying metrics that provide transparency as to how they incorporate climate change-related risks into decision-making processes. Among other deliverables, the EBA expects to seek stakeholder feedback in 2020 and may then issue guidelines on the uniform inclusion of ESG risks in the supervisory review and evaluation process conducted by Member States' competent authorities. The European Central Bank is also assessing banks' approaches to climate risks and developing supervisory expectations on those risks.[13] Bank climate risk stress tests have the potential to drive bank lending policies towards more sustainable assets.

II. DEVELOPMENTS IN BANK POLICIES

A. EQUATOR PRINCIPLES 4

The Equator Principles (the "EPs"), adopted by over 100 commercial banks and developmental lenders, are one of the most widely followed voluntary ESG standards in the financial sector and serve as a risk management framework for project and project-related financings. The fourth version of the EPs ("EP4") was released in November 2019 and is effective from July 1, 2020.

The updates are generally modest. Most notable is a new requirement to conduct a climate change risk assessment, a summary of which must be made public. The assessment should follow the framework developed by the Task Force on Climate-related Financial Disclosure for analyzing the risks related to the transition to a lower-carbon economy (transition risk) and the risks related to the physical impacts of climate change (physical risk). The analysis should address at a high level the current and anticipated risks of a project's operations; whether the client seeking financing has policies and systems to manage those risks; and the project's compatibility with the host country's national climate commitments.

EP4 also aims for greater consistency between standards applied to projects in high-income and low-income countries. Lenders to projects in higher-income OECD nations were previously permitted to rely on host country law alone, in lieu of the IFC Performance Standards on Environmental and Social Sustainability, in determining how to assess and mitigate a project's environmental and social risks. Under EP4, lenders will also need to consider whether the IFC Performance Standards should be used as additional guidance in evaluating project risk in a high-income country (i.e., where the host country laws may not adequately cover one of the IFC Performance Standards). How this is applied in practice will necessarily vary by country and, in many cases, by state/local authority.

The application of the EPs has also been widened to now include project refinancings and acquisition financings where the underlying project financing was within the scope of the EPs.

B. BANK FOSSIL FUEL LENDING POLICIES

Continuing a trend which gained momentum following the 2015 Paris Agreement,[14] commercial banks and developmental lenders continue to enact and/or tighten restrictions on lending and other business activities in the fossil fuel market.

For example, multiple Japanese financial institutions have pulled back from coal within the past month. Mizuho Financial Group and Sumitomo Mitsui Banking Corporation announced new policies against financing of any new coal-fired power plant, even ultra-super critical plants in developing countries, which have been exempted from other banks' restrictive policies.[15] The Japanese export credit agency JBIC, previously a major lender to coal projects, will also no longer accept applications for loans to new coal projects.[16] A range of banks have also ruled out financing Arctic oil exploration or development, including most recently, Citibank, Goldman Sachs, JPMorgan Chase, Morgan Stanley and Wells Fargo, among others.[17] And in November 2019 the European Investment Bank announced it will cease financing all fossil fuel energy projects by the end of 2021, the most expansive policy announced to-date by a major international lender.[18]

We expect this trend to continue, with banks, export credit agencies, multilaterals and other lenders and investors restricting not only coal-related financings but, increasingly, oil and gas lending. Issuers/borrowers in this sector need to carefully consider the eligibility requirements of prospective lenders/underwriters. The evolution of lending policies, however, also creates new opportunities as financial institutions look to expand their lending to sectors such as renewable energy.

C. UN PRINCIPLES FOR RESPONSIBLE BANKING

The United Nations Environment Programme launched the Principles for Responsible Banking in September 2019, which has now been signed by over 170 banks, including national/regional banks as well as major international banks such as Citi, BNPP, ICBC and SMBC.[19] The Principles commit the signatories to align their business strategies with the United Nations' Sustainable Development Goals (SDGs) and the 2015 Paris Agreement, among other societal goals, and work with clients and other stakeholders in this effort. The most tangible requirement is for banks to publish targets to achieve positive societal impacts and reduce negative impacts and report on their progress. Although the Principles are high-level and voluntary, they add to the "soft law" of sustainable finance that is monitored closely by NGOs and other stakeholders.

III. NON-EU DEVELOPMENTS IN ESG DISCLOSURE AND LISTING REQUIREMENTS

A. STOCK EXCHANGE DEVELOPMENTS

Stock exchanges around the world continue to cater to the sustainable finance market. Issuers should check any ESG-related requirements or optional listing features of the exchange(s) on which they intend to list their sustainable finance instruments.

Notable recent developments include: (1) the London Stock Exchange's Sustainable Bond Market (SBM) (launched in October 2019),[20] (2) Euronext's Green Bond listing (launched in November 2019)[21] and (3) Nasdaq's Sustainable Bond Network (launched in December 2019).[22] The requirements for inclusion in these exchange segments are substantially the same as other exchanges, such as the Luxembourg Green Exchange, and typically include an independent third-party review (e.g., a second opinion), post-issuance reporting on the use of proceeds and alignment with an international standard, such as the International Capital Market Association's (ICMA) Green Bond Principles/Social Bond Principles.[23]

In addition, the Hong Kong Stock Exchange has updated its ESG reporting requirements for listed companies with effect for financial years beginning on or after July 1, 2020. The requirements are a notable example of mandatory ESG reporting for listed companies. The updates aim to ensure meaningful board oversight of ESG issues and enhanced reporting on identified material environmental and social Key Performance Indicators (KPIs), in particular climate-related risks and greenhouse gas emissions and social KPIs. The Exchange provides guidance materials to assist issuers in compliance, which can include compliance with relevant international reporting standards.[24]

B. UK FCA DEVELOPMENTS

In October 2019, the UK Financial Conduct Authority (FCA) released a feedback statement setting out its expectations for its near-term actions on climate change disclosure and green finance.[25] These include:

- proposing new disclosure rules (published for comment in March 2020[26]) for UK premium-listed companies to either align with the Taskforce on Climate-related Financial Disclosures' recommendations or explain why that is not possible;
- challenging firms where the FCA sees potential greenwashing, carrying out further policy analysis on greenwashing and taking action (e.g., guidance) to address concerns as appropriate; and
- monitoring the implementation of the EU Taxonomy Regulation and other EU sustainable finance regulatory activity and their impacts on the UK market.

C. U.S. SEC CHAIRMAN STATEMENT ON ENVIRONMENTAL- AND CLIMATE-RELATED DISCLOSURE

As addressed in a previous memorandum,[27] the Chairman of the U.S. Securities and Exchange Commission (SEC), Jay Clayton, made a public statement in January 2020 outlining a principles-based approach to environmental- and climate change-related disclosure that is less prescriptive than the EU's and centered on existing, generally applicable requirements to disclose information material to issuers' and investors' capital allocation decisions.[28] In discussing the SEC's approach to regulating such disclosures, he noted in particular that:

- the landscape around environmental- and climate-related issues is, and will continue to be, complex, uncertain, multinational/jurisdictional and dynamic;
- capital allocation decisions based on climate-related factors are substantially forward-looking and likely involve assumptions regarding complex and uncertain matters;
- the SEC's disclosure-based regulatory regime is largely built around historic and currently verifiable information, with limited forward-looking disclosure requirements;
- regulators, including the SEC, should not substitute their operational and capital allocation judgments for those of issuers and investors; and
- the U.S. regulatory regime stands apart from an investor protection perspective and public and private liability and enforcement perspective, such that even analogous disclosure mandates should not be expected to create uniform effects across jurisdictions.

Chairman Clayton also affirmed that the SEC will continue to monitor environmental- and climate-related disclosure topics and encouraged market participants to continue to engage with the SEC on these issues. (*See also* our recent memorandum on the Institutional Shareholder Services Inc.'s (ISS) new U.S. Climate Proxy Voting Guidelines, which include the potential for ISS to issue recommendations to vote against public company directors who fail to adequately address climate-related risks, among other ESG failures.[29])

IV. IMPLICATIONS

As the sustainable finance market evolves, financial market participants should be increasingly attentive to the emerging multitude of voluntary and mandatory standards across the globe. Ongoing trends we are monitoring, in addition to those noted above, include:

A. EU GREEN DEAL

The sustainable finance market outlook has been boosted by the EU's recently launched European Green Deal and the related European Green Deal Investment Plan, by which the EU aims to mobilize at least €1 trillion of sustainable investments over the next decade.[30] Achieving this target requires significant financial innovation, and the European Commission is currently soliciting input on how to increase public and private investment in sustainable projects.[31]

B. TRANSITION FINANCING

Transition financing refers to financing used to support the transition to a low carbon economy, including in situations where a debt instrument's use of proceeds would help the issuer reduce its carbon intensity but would not be sufficiently environmentally sustainable to qualify the debt as "green."

An ICMA-led working group has been established to study climate transition finance, while the EU's Technical Expert Group proposed, in its final report on the Taxonomy Regulation, formalizing within the taxonomy a concept of "brown" activities such that investors could more clearly understand when issuers have made incremental improvements in their activities.

The Taxonomy Regulation contains provisions pursuant to which, under certain limited circumstances, economic activities for which there is no technologically and economically feasible low carbon alternative could be classified as contributing substantially to climate change mitigation, and thus potentially defined as sustainable. However, no formal framework for a transition financing debt instrument currently exists, leaving companies so far to design and market their own transition debt instruments, which have not always been well-received by investors.

C. IMPACT OF COVID-19 PANDEMIC

While the COVID-19 pandemic has deferred many sustainable finance transactions, in particular by debut issuers, it has heightened focus on social and sustainability challenges globally and presented new opportunities for financial markets to assist in solving these challenges. The ICMA highlights that social bonds can mitigate social issues related to the outbreak of the COVID-19 pandemic, including by supporting the provision of healthcare services and projects addressing unemployment resulting from the pandemic.[32] A number of issuers have noted this and similar goals in recent social/sustainable bond issuances. In addition, the EU and many major companies and investors active in the market have affirmed or increased their commitments to increasing sustainable investing in light of the pandemic.

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ENDNOTES

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At the national level, in a December 2019 announcement, the Bank of England proposed to conduct stress tests on UK banking and insurance sectors' resilience to climate change risks. The results of such stress tests would be published in 2021. The Bank does not intend to disclose the results of individual firms but anticipates disclosing system-level results.

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[24] HKEx's guidance materials on ESG are available at: https://www.hkex.com.hk/Listing/Rules-and-Guidance/Other-Resources/Listed-Issuers/Environmental-Social-and-Governance/Exchanges-guidance-materials-on-ESG?sc_lang=en.

Note also that the European Commission released in February 2020 a public consultation to collect feedback on possible updates to its Non-Financial Reporting Directive, which requires certain large companies to disclose information about environmental and social matters and related policies. Further information on the consultation on non-financial reporting by large companies is accessible at: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation.

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