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Asset Management & Investment Funds Update

June 2023

Key Dates & Deadlines: Q2/3 2023

Date	Source	Summary	Action/Impact
2023 (date dependent on publication date of relevant financial report)		SFDR Level 2 – fund annual report disclosures SFDR Level 2 financial report disclosure rules, effective 1 January 2023, must be addressed in annual reports published after that date irrespective of the relevant financial or reference period.	Fund managers must ensure annual financial statements published after 1 January 2023, for funds subject to SFDR Article 7, 8 or 9, incorporate the relevant disclosures and using the Level 2 templates where applicable.
Q2/3 (exact date TBC)		ESMA Guidelines on Fund Names – publication of final report Guidelines on use of ESG or sustainability-related terms in the name of funds are expected to be finalised and published with an application date of 3 months post publication and a 6-month transition period for existing fund names. See here for further details.	Draft Guidelines set out quantitative thresholds for investment in E/S aligned or sustainable investments for Article 8 and 9 funds which use ESG/sustainability-related terms in the fund name.
31 May		ESMA publishes Report on Greenwashing The first of two reports addressing the Commission's request for input relating to greenwashing risk and potential regulatory framework changes necessary to address the risk. See article on topic in this month's update for further details.	Fund managers should take account of the report in seeking to avoid greenwashing including in fund documents, names and marketing materials (factsheets, sustainability impact reports, engagement reports).

13 June		IAF & SEAR – Consultation response deadline Draft regulations and guidance for SEAR, the Conduct Standards and enhancements to the F&P regime are under consultation. See here for further details.	Consultation response deadline.
30 June		SFDR- first entity-level PAI statements due and second calculation date in current reference period First full PAI statements are due for publication reflecting the entity-level PAIs of investments as identified on at least four calculation dates during the initial reference period of Jan – Dec 2022. See here for further details. CSRD – first set of reporting standards due for adoption The Commission will adopt the draft reporting standards published by EFRAG last November as CSRD delegated acts and these will be applicable from the first effective date of CSRD of 1 January 2024. See here for further details.	SFDR Level 2 requires entity-level PAIs to be disclosed using the template PAI statement at Annex I which must be published by the 30 June deadline on the website of the relevant entity.
4 July		SFDR Level 2 – Consultation response deadline Included for consultation are proposals for an extended list of social PAI indicators and refinement of existing indicators, decarbonisation targets, further specification of the DNSH disclosure rule, simplification of the templates and other technical adjustments. See here for further details.	Consultation response deadline.
28 July		Retail Investment Strategy – Consultation response deadline UCITS, AIFMD and PRIIPs amendments are under consultation which target increased value for money for investors and digitalisation of PRIIPs KIDs. See article on topic in this month's update for further details.	Consultation response deadline.

ESMA Defines and Cites Myriad Examples of Greenwashing

In May 2022, the Commission requested input from the European Supervisory Authorities (**ESAs**) on the issue of greenwashing, including the key features, drivers and risks associated with the practice. The Commission requested two reports from the ESAs: a progress report by May 2023 and a final report by May 2024.

On 31 May 2023, ESMA responded with publication of its progress report which outlines preliminary findings on the issue of greenwashing including from its November 2022 call for evidence of greenwashing from industry (the **Report**).

ESMA Report on Greenwashing

The Report sets out an ESA-agreed definition of greenwashing, the areas which it considers are exposed to greenwashing risks and potential remediation actions. The following summary of the Report focusses on the greenwashing risks highlighted for fund and asset managers and the potential actions which may be taken to mitigate those risks.

ESA definition of greenwashing

> The ESAs understand greenwashing as a practice where sustainability-related statements, declarations, actions, or communications **do not clearly and fairly** reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice **may be misleading** to consumers, investors, or other market participants.

In addition to the above, the Report notes the following core characteristics of the practice of greenwashing:

- statements may be misleading due to the **omission of relevant information** (e.g., partial, selective, unclear, unintelligible, vague, oversimplistic, ambiguous or untimely information, and unsubstantiated statements) or due the **provision of false or deceptive information** (e.g., mislabelling, misclassification, mis-targeted marketing, and inconsistent information)
- greenwashing is a type of misconduct that can result in a **direct claim and/or misleading actions**
- greenwashing can be **intentional and/or unintentional** e.g., intentionally, negligently or mistakenly, as a result of inadequate due diligence processes, issuing misleading claims
- greenwashing can occur at **entity level** (e.g., relating to an entity's sustainability risk disclosures), at **product level** (e.g., relating to a product's sustainability performance) or at **service level** (e.g., relating to the integration of clients' sustainability preferences by MiFID firms)
- greenwashing can occur across the **full range of investor materials** and at **different stages of the product/service life cycle** e.g., manufacturing, delivery, marketing, sales, monitoring
- greenwashing can occur when **complying with SFDR** and other EU sustainability-related disclosure regimes and **can also occur outside the EU**
- greenwashing can be **triggered by the financial service provider or by third parties** e.g., ESG rating and data providers or third-party verifiers
- greenwashing may or **may not result in damage to investors and/or an unfair competitive advantage**

High-risk areas for greenwashing by fund managers

The Report identifies several high-risk areas for greenwashing along with potential actions (by the ESAs/the Commission) to address these risks, including:

Impact washing

Impact claims are identified in the Report as frequently including misleading statements and lacking essential information about the key aspects of any impact framework being intentionality, additionality and impact measurement.

In relation to impact measures, the Report identifies three key issues of (i) selection of an inadequate measure of impact because it is either irrelevant or ill-suited to measure impact, (ii) adoption of insufficiently robust standards for measuring product-level impact e.g., not taking into account negative UN SDG contributions and only measuring positive alignment, and (iii) misrepresenting impact through exaggeration, ambiguity or cherry-picking e.g., exaggerated graphical representations in fund factsheets illustrating actual contribution of a fund's underlying stream of revenues to a given UN SDG or the omission of sufficient detail about how a certain metric/chart used as evidence of impact is constructed. The example is given of managers which imply an ESG metric is the direct result of a strategy when it may only be the result of the intrinsic characteristics of the fund's investable universe/target asset class e.g., UN SDG alignment which is not a targeted/intentional part of an actual ESG strategy. A further example is that of an 'ecology' best in class fund that selects the highest rated companies based on a proprietary ESG rating methodology without explaining how the ESG rating measures the attainment of an environmental objective, how it is monitored, how the fund adjusts its strategy if a selected company no longer meets the environmental objective.

ESMA considers there to be two types of impact strategies (i) 'buying' impact where fund investments have a positive sustainable impact and (ii) 'creating' impact which can be implemented in several ways with a common approach being to buy 'brown' investments and engage with them to turn them 'green'. To avoid greenwashing in the case of (ii), fund documents would ideally be transparent 'on likely or expected holdings in addition to what is already required by SFDR templates'.

> *Possible ESA/Commission remediation actions: the Report notes that the ESAs could provide concrete examples of best practices, or unreasonable/sub-optimal practice on sustainability indicators and impact measures in particular to assist investors challenge managers' choice of quantification metrics. Alternatively, the definition of sustainable investments under SFDR could be amended, in particular to specify adequate measures for contributing to sustainable objectives.*

Misleading statements about engagement with investee companies

In the Report, ESMA notes that 'historically, asset managers not very advanced on their ESG journey have used engagement as an easy way to claim they were doing something about sustainability'. To mitigate against greenwashing, engagement strategies should include details about the progress of engagement like buy or sell decisions based on engagement-specific outcomes, specific divestment triggers or the vote against Board members or financial statements as a result of an escalation process.

> *Possible ESA/Commission remediation actions: the Report notes that SFDR could be amended to require clearer disclosures about firm-wide and fund-specific engagement, proxy voting and general stewardship activities such as the number of meetings held with engaged companies, milestones and intermediate targets that need to be achieved to keep engaging, and conditions or triggers that would lead to termination of the engagement process. An EU-level stewardship code could be put in place that could leverage existing codes e.g., the UK Stewardship Code.*

Misleading statements about a manager's ESG strategy and/or credentials

ESMA notes, in the Report, that consideration of E/S characteristics 'can sometimes be vague, exaggerated or incomplete (i.e., omission)' and that fund prospectuses have been found to 'lack a commitment and specificity regarding the sustainable characteristics or objectives of SFDR financial products' e.g., The fund aims at contributing to [one/more sustainable objectives / The fund can contribute to the following SDGs: [number of listed SDGs].

Other common issues include a lack of specification of the potential trade-off that can be made, vague and non-binding statements about the consideration of PAIs, the sustainability indicators and the criteria to assess sustainable investments. The Report also repeats ESMA's continuing issue with funds' use of Article 8 or 9 as fund labels but also notes that a fund disclosing under Article 6 that integrates ESG factors is 'guilty of misrepresentation via omission'. Misleading claims regarding ESG qualifications include overstating the significance of a label, ESG award, ESG external rating or being a signatory to a voluntary reporting framework.

Misleading fund names

ESMA notes that terms such as 'sustainable' or 'sustainable growth' should no longer be used in the name of funds that are not disclosing under Article 8 or 9 SFDR, even though historically these terms were not used specifically in the context of ESG.

> *Possible ESA/Commission remediation actions: the Report notes that consideration could be given to new EU labelling legislation or changes to the current legislative framework to create distinct investment product labels or categories based on minimum standards. The Report also notes the merit in aligning fund and benchmark names as much as possible e.g., by requiring passive funds and ETFs to seek consistency in the naming convention of funds with that of the benchmark tracked.*

Unsubstantiated claims about ESG governance

The Report cites the examples of managers having ESG integration policies but no tracking systems to evidence compliance with those policies and disclosing unsubstantiated or exaggerated claims about how sustainability risk is taken into account. The risk of greenwashing can be mitigated by good quality governance around ESG implementation and sound governance checks.

Portfolio holdings differ from investors' expectations

While the Report acknowledges that this is in part the result of investors misunderstanding of the EU sustainable finance framework, it also notes that this can be the result of insufficient transparency about likely portfolio holdings and inherent characteristics of the fund as well as unbalanced communication as to the limitations of the fund's ESG strategy.

> *Possible remediation actions: the Report notes that SFDR could be amended to require further transparency of likely portfolio holdings and overall exposures of expected holdings e.g., sector, industry, capitalisation breakdown and ESG profile (exposure to green or transitioning companies, Taxonomy-aligned activities or sectors).*

Competence greenwashing

'Competence greenwashing' describes the misrepresentation of knowledge, skills, competences, or expertise relating to ESG-related activities e.g., reliance on introductory-level ESG certificates to display expertise which could be deemed neither fit nor proper, or presentation of progress on decarbonisation strategies using claims on governance and resources such as the hiring of a sustainability officer (noted as an input that can lead to a result but which is not in and of itself an actual decarbonisation result).

Net-zero or transition claims

Voluntary reporting of net-zero claims is an area of key concern with the Report citing (i) premature commitments without achievable, concrete, measurable implementation plans for the short, medium and long-term horizons; (ii) declarations focussed on emission reductions/intensity-based targets without context as to the added value of the target; (iii) lack of regular progress monitoring using regularly reported comparable data; (iv) lack of transparency of the amount and quality of carbon credits used for offsetting; (v) lack of transparency of the necessity to rely on offsets; and (vi) lack of transparency on resources allocated to achieve commitments or lack of consistency between targets, plans and resources.

Next Steps

The Report acknowledges that the EU sustainable finance framework may itself be a key driver of greenwashing e.g., due to the incoherent sequencing of measures and the high level of flexibility and absence of thresholds in the definition of sustainable investments. However, it also notes that fund and asset managers already have a responsibility to make substantiated claims and to communicate sustainability information in a balanced manner under the framework. The Report recommends fund managers seek to enhance the reliability and comprehensiveness of sustainability data including with further transparency on ESG data methodologies, clarifications on the use and calculation of estimates, external verification and auditing.

A Final Report on greenwashing will be published in May 2024 which will include final recommendations, including on possible changes to the EU regulatory framework.

AIFMD Review Series: Loan originating AIFs

As trilogue negotiations of the AIFMD Review text continue, we analyse the proposals for loan originating alternative investment funds.

This is the fourth edition in our AIFMD Review Series, which has previously considered proposals in respect of delegation and substance, UCITS and liquidity management.

Loan-origination proposals

The AIFMD review introduces minimum requirements for AIFMs managing AIFs which originate loans (**loan originating AIFs**). According to the Irish minister for finance, *'the introduction of an EU framework [would] if agreed, … be a significant change [and] enable different sources of funding while balancing associated risks to ensure financial stability and investor protection.'*

The following summarises the proposals from the EU institutions and compares these against the Central Bank's national regime for loan-origination AIFs which may only be sold to qualifying investors (**loan originating QIAIFs**). While the EU proposals are for minimum requirements for loan-originating AIFs, only the Council's proposals specifically recognise the ability of individual Member States to adopt and apply more restrictive rules for loan-originating AIFs.

The Central Bank has yet to formally comment on the impact of the AIFMD review proposals on its national framework for loan originating QIAIFs. However, as can be seen from the below, there are several key areas in which the Central Bank's regime differs from that proposed under the AIFMD review including:

- **the scope of the rules:**
  under the AIFMD review proposals, rules for loan originating AIFs would apply principally to those significantly engaged in lending (60% of NAV) as opposed to AIFs engaged in any level of lending, as is currently the case for QIAIFs under the Central Bank's AIF Rulebook
- **risk spreading:**
  under the AIFMD review proposals, lending to a single borrower would be limited to 20% of NAV where the borrower is a bank or authorised investment fund as opposed to a general prohibition for loan originating QIAIFs lending greater than 25% of NAV to a single borrower under the Central Bank's AIF Rulebook
- **risk retention requirements:**
  under the AIFMD review proposals, originate-to-distribute strategies are prohibited and the loan originating AIF must retain a 5% interest in any originated loans which are subsequently sold on, whereas the Central Bank's AIF Rulebook applies retention of interest rules in respect of loans acquired from credit institutions only
- **leverage:**
  although not included in the original proposal from the Commission, the Council proposes a leverage limit of 150% as opposed to the 200% limit applicable to loan originating QIAIFs under the Central Bank's AIF Rulebook

Topic	EU Proposals	Central Bank rules for loan originating QIAIFs
Definition of loan-originating AIF	***Commission proposal*:** loan origination rules apply generally to AIFMs managing AIFs which grant loans however, the requirement for the AIF to be closed-ended only applies if the notional value of the loans originated exceed 60% of the AIF's NAV.	AIFs are prohibited from granting loans unless authorised as loan originating QIAIFs i.e., any level of lending results in the AIF being a loan-origination AIF.

	Both Parliament and Council support the Commission's proposal however Council proposes removal of the 60% threshold.	
Fund structure	***Commission proposal:*** AIFs with loans exceeding 60% NAV must be closed-ended. Both Parliament and Council support the Commission's proposal, but Council removes the threshold, and both also provide that a loan-origination AIF may be open-ended if its liquidity risk management system is compatible with its investment strategy and redemption policy.	All authorised loan originating QIAIFs must be closed-ended.
Borrowing & leverage	***Commission proposal:*** N/A Only Council proposes limiting the leverage of loan-originating AIFs to 150 % of the AIF's NAV.	Loan originating QIAIFs must not have gross assets of more than 200% of NAV.
Policies & procedures	***Commission proposal:*** effective policies, procedures and processes must be implemented and periodically reviewed for the granting of loans including for the assessment of credit risk and administering and monitoring credit portfolios. Both Parliament and Council support the Commission's proposal but limit its application in respect of shareholder loans.	Loan originating QIAIFs must establish and implement appropriate, documented and regularly updated procedures, policies and processes to: (i) monitor the net economic interest of the vendor over the lifetime of the loan; (ii) value the loan where the loan is not purchased at face value; (iii) prudently monitor the performance of the loan; and (iv) stress test the loan independently of the vendor on a regular basis and at least annually, having regard to the changing risk profile of the exposure.
Risk spreading	***Commission proposal:*** lending to a single borrower, when this borrower is a financial institution, an AIF or a UCITS, is limited to 20% of the AIF's capital. Both Parliament and Council support the Commission's proposal.	Loan originating QIAIFs shall limit exposure to any one issuer or group to 25% of net assets within a specified timeframe.
Origination to natural persons	***Commission proposal:*** N/A The Council proposal allows for Member State limitations on the origination of loans to consumers, which limitation should not affect the marketing in the Union of AIFs engaged in consumer lending.	Loan originating QIAIFS shall not originate loans to natural persons.
Conflicts of Interest	***Commission proposal:*** An AIF may not to lend to its AIFM or its staff, its depositary or its delegate. Both Parliament and Council support the Commission's proposal and also preclude lending to the depositary's delegates and any AIFM group entity.	Loan originating QIAIFS shall not originate loans to the AIFM, management company, general partner, depositary, or to delegates or group companies of these.
Retention of economic	***Commission proposal:*** AIFs are required, on an ongoing basis, to retain an economic interest of 5% of the notional	Prior to acquiring a loan from a credit institution, a loan originating QIAIF must have received from the vendor warranties,

interest & originate to distribute limitation	value of the loans they have granted and sold on the secondary market. The requirement does not apply to loans purchased on the secondary market. Both Parliament and Council support the Commission's proposal however Parliament requires retention of the economic interest until maturity whereas the Council requires this for the period of two years from the signing date or until maturity whichever is shorter. Both Parliament and Council carve out loans sold to comply with investment rules, to comply with sanctions or to redeem investors as part of winding up of the AIF. Both Parliament and Council propose a prohibition on AIFMs managing AIFs whose investment strategy is to originate loans with the sole purpose of transferring those loans to third parties ("originate-to-distribute").	including that the vendor will retain, on an on-going basis, a material net economic interest of at least 5% of the nominal value of the loan as measured at origination. Loan QIAIFs shall limit operations to the business of issuing loans; participating in loans; investment in debt/credit instruments; participations in lending; and to operations relating thereto, including investing in equity securities of entities or groups to which the loan originating QIAIF lends or instruments which are held for treasury, cash management or hedging purposes
Transition	***Commission proposal:*** N/A Both Parliament and Council propose a 5-year transition period for AIFMs managing existing loan originating AIFs and a derogation for existing AIFs that do not raise additional capital after this date.	
Look-through	***Commission proposal:*** N/A The Council proposal includes look-through provisions to assets held by wholly owned AIF subsidiaries e.g., in the case of the liquidity rule, leverage rule, and the policies and procedures requirements (as detailed above).	AIF Rulebook applies specific provisions to the QIAIFs investing through subsidiaries.

New ESMA Q&A on marketing under AIFMD

On 26 May 2023, ESMA published a new Q&A on the AIFMD confirming that non-EU AIFMs are not permitted to carry out pre-marketing activities under the AIFMD. The Q&A notes that national private placement regimes (**NPPRs**) may permit pre-marketing by non-EU AIFMD, however, NPPRs can not extend a passport for non-EU AIFMs to carry out pre-marketing on a cross-border basis in the EU. Furthermore, any such NPPRs should not in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs.

Commission Retail Investment Proposals and related ESMA opinion

ESMA Opinion on undue costs

On 17 May 2023, ESMA issued its Opinion on undue costs of UCITS and AIFs setting out suggested legislative clarifications to the UCITS Directive and AIFMD which would:

- establish a list of eligible costs for UCITS and AIFs by reference to the PRIIPs list of costs for investment funds (Annex VI, Part 1);
- ensure appropriate quantum for costs such that transactions take place at prices or at conditions equal to or better than market standards – this would be achieved by legislating for the adoption of a formalised pricing process on terms similar to those set out in the ESMA Supervisory Briefing on the supervision of costs in UCITS and AIFs;
- require the compliance function of the fund manager to ensure stringent internal controls and adequate reporting to competent authorities and investors of detected deficiencies and the actions taken or envisaged to address them;
- provide for reimbursement or indemnification by fund managers of investors without undue delay where undue costs have been charged, including cases where costs have been wrongly calculated to the detriment of investors; and
- require a manager which has intentionally or negligently committed an infringement, to be sanctioned with a fine of a minimum given percentage which should be proportionate to the unduly charged fees.

Commission Retail Investment Strategy

Following on from the ESMA Opinion on undue costs of UCITS and AIFs, the Commission published a retail investment package for industry consultation on 24 May 2023. The package, which is under consultation until 28 July 2023, includes undue cost/value for money amendments to the UCITS Directive and AIFMD along with amendments to MiFID and the IDD in relation to financial literacy, client categorisation, disclosure and marketing, suitability and appropriateness, inducements, and product governance.

As well as the amending Directive (summarised below), the proposals include targeted amendments to the PRIIPs Regulation to require a new 'Product at a glance' section in the KID, remove the 'complex product' warning requirement, replace the existing sustainability rules with a new 'How environmentally sustainable is this product?' section, and require use of an electronic format (unless paper requested). It is worth noting that the disclosures for Article 8 and 9 funds in the new sustainability section only provide for disclosure of the minimum investment in Taxonomy-aligned investments and the expected GHG intensity of the PRIIP.

UCITS/AIFMD amendments

Proposed amendments include:

1. a requirement to establish a sound pricing process which should provide for the identification, analysis and review of direct and indirect costs charged to the fund. The pricing process should ensure that:

    - costs are justified and proportionate to the fund type so that investors get value for money; and
    - costs are comparable to market standards, including by comparing costs with similar funds;

    ESMA is tasked with developing and publishing cost benchmarks, based on cost and performance supervisory reporting, against which costs can be assessed for value for money. Any funds offering poor value for money/deviating from these ESMA benchmarks may not be marketed to retail investors unless further assessment establishes value for money (which assessment should be documented and made available, on request, to NCAs);

2. the adoption of delegated measures with minimum requirements for the pricing process and for carrying out the value for money assessment and, where necessary corrective measures if costs are not justified/proportionate to the fund type;

3. clarification that costs should be considered due if they comply with fund offering documents, are necessary to the fund's functioning and are borne by investors in a fair way; and

4. a requirement for fund managers to compensate investors where undue costs have been charged.

Next Steps

The UCITS, AIFMD and PRIIPs amendments are under consultation until 28 July 2023. Once finalised, the UCITS and AIFMD proposals provide for a 12-month transposition period and an application date six months post-transposition by Member States.

IOSCO Final Report: Good Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds

On 12 May 2023, IOSCO issued its final report setting out good practices for the implementation of IOSCO's 2013 ETF Principles by regulators, responsible entities and/or trading venues.

The good practices are almost identical to those issued by IOSCO for industry consultation in April 2022. See our previous briefing on the consultation for analysis of IOSCO's proposed good practices for regulators, ETF managers and sponsors and trading venues.

Central Bank authorisation changes

On 5 May 2023, the Central Bank notified changes to its review process for applicants seeking authorisation as a fund management company, fund administrator or depositary.

The Central Bank was the subject of an ESMA Brexit Authorisations Peer Review during 2021/22 and these changes are intended to address some of the recommendations from that report. Below is a summary of the changes.

For all new applications for authorisation and for applications to extend their authorisation, the following policies will be required as part of the formal application:

- conflicts of interest, to include the conflicts register;
- governance policy;
- risk management; and
- delegation/due diligence.

In addition, applicants will also be required to submit:

- an organisation chart detailing group reporting lines;
- details of the internal audit arrangements, specifically where this activity is delegated to a third party (including group);
- details of the technical resources employed by the firm;
- a trade flow diagram relating to the portfolio management process (relevant for fund management companies only); and
- details of whether the firm intends to establish Article 8 and/or 9 funds and how they meet the requirements of SFDR (relevant for fund management companies only).

These changes became effective immediately for any new applications and any current applications at KFD stage. In relation to applications at formal application stage these can be discussed directly with the case manager.

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