ALLEN & OVERY

GREAT FUND INSIGHTS

New ESG changes to MiFID II, AIFMD and the UCITS Directive

What fund and asset managers need to know

Up to date as of 1 January 2021

As a further step in the roll out of its green agenda, the European Commission is shortly expected to finalise certain ESG-related changes to MiFID II, AIFMD and the UCITS Directive. These will contain various requirements, including a new obligation on portfolio managers to capture information about their client's ESG preferences and comply with these when managing client portfolios. There are also prescribed changes to organisational requirements.

This briefing gives further detail on the new requirements and when they will come into effect.

How did we get here?

In June 2020, the European Commission published the long-expected drafts of its proposed changes to MiFID II, AIFMD and the UCITS Directive to reflect ESG considerations. These operate in tandem with the Disclosure Regulation (sometimes also referred to as the Sustainable Finance Disclosure Regulation or SFDR) (Regulation (EU) 2019/2088) and the Taxonomy Regulation (Regulation (EU) 2020/852). If you want a copy of our separate briefing on these, let us know.

The latest ESG proposals would amend:

– the MiFID Delegated Regulation (2017/565/EU)[1]

– the MiFID Delegated Directive (2017/593/EU)[2]

– the AIFMD Delegated Regulation (231/2013/EU)[3]

– the UCITS Implementing Directive (2010/43/EU)[4].

For a copy of the drafts, please see the links in the footnotes. To see a mark-up of the proposed changes, please click **here**, **here** and **here**. This reflects various recommendations made in a 2018 report published by the High-Level Expert Group on Sustainable Finance.[5]

More broadly, this is a key part of the European Commission's strategy to reorient private capital flows into investments that will help "green" the EU. In turn, this will help realise the Commission's aim to make Europe the world's first climate- neutral continent and achieve net zero carbon emissions by 2050. Announcing agreement on the European Green Deal, Commission President Ursula von der Leyen used a beautiful turn of phrase:

"Today is the start of a journey. But this is Europe's 'man on the moon' moment."[6]

Underlying one of the key changes being proposed to MiFID II is essentially a hope or belief that, if asked whether they care about ESG or (in particular) climate change, a number of clients will say "yes". Their portfolio managers will then have to make investments for their portfolios that match those preferences. In turn, this will encourage a flow of funds into investments that are, at minimum, "ESG friendly".

1 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12068-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Regulation-EU-2017-565-
2 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12067-Strengthening-the-consideration-of-sustainability-risks-and-factors-for-financial-products-Directive-EU-2017-593-
3 https://op.europa.eu/en/publication-detail/-/publication/ec27495c-a98a-11ea-bb7a-01aa75ed71a1/language-en/format-RDF/source-134942417
4 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11959-Integration-of-sustainability-risks-and-factors-for-undertakings-for-collective-investment-in-transferable-securities-
5 https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf
6 https://ec.europa.eu/commission/presscorner/detail/en/speech_19_6749

What are the new requirements?

To navigate the new rules, you need to know four key concepts. These relate to key concepts in the new Disclosure Regulation[7] – if you would like a copy of our briefings on this, let us know.

"Sustainability preferences"

This means a client's choice as to whether either of the following should be integrated into their investment strategy:

(a) a financial instrument that has as its objective "sustainable investments" (defined as explained below); or

(b) a financial instrument that promotes environmental (E) or social (S) characteristics, and that either:

(i) pursues (among others) sustainable investments; or

(ii) as of 30 December 2022, considers the principal adverse impacts on sustainability factors, as referred to in Article 7(1) of the Disclosure Regulation.

"Sustainability factors"

Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.[8]

A "sustainability risk"

An environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of an investment.[9]

A "sustainable investment"

An investment in an economic activity that:

– contributes to an **environmental objective**, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy; **OR**

– contributes to a **social** objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities,

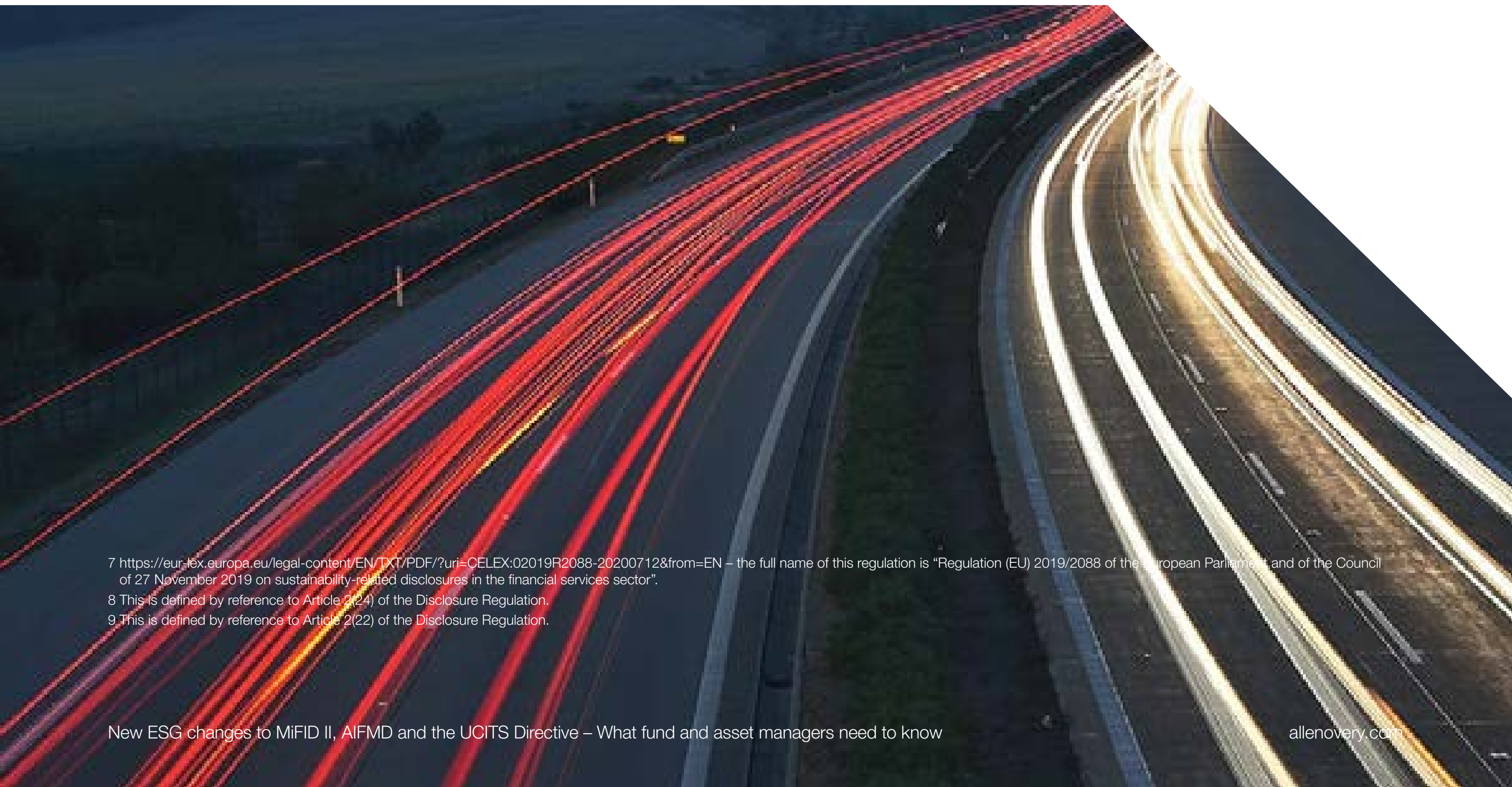
provided that:

– such investments do not significantly harm any of those objectives; **PLUS**

– the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

In short, a "sustainable investment" must therefore advance either a specific "E" OR "S" objective, PLUS it must "do no significant harm" as regards any such objective and involve "G".

A shorthand way to remember this is "E or S + DNSH + G".



7 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02019R2088-20200712&from=EN – the full name of this regulation is "Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector".

8 This is defined by reference to Article 2(24) of the Disclosure Regulation.

9 This is defined by reference to Article 2(22) of the Disclosure Regulation.

Summary of the key points

If you are an AIFM or UCITS manager	
ESG due diligence[10]	When conducting diligence in the selection and ongoing monitoring of investments, you must take into account sustainability risks. Also, if you have decided to take into account the principal adverse impacts of your investment decisions on sustainability factors under the Disclosure Regulation, you must take this into account: – when conducting due diligence in the selection and monitoring of investments for your funds; – when ensuring you have an adequate knowledge and understanding of the assets in which your funds are invested; – when establishing and applying policies and procedures on due diligence and effective arrangements for ensuring investment decisions are carried out in compliance with the objectives, investment strategy and risk limits of your funds; and – (for UCITS managers only) when complying with the requirement referred to below. If you are a UCITS manager, you must also take sustainability risks into account when complying with Article 23(4) of the UCITS Implementing Directive. In general terms, this requires managers to: (1) formulate forecasts and perform analysis concerning any individual investment's contribution to the fund's portfolio composition, liquidity and risk and reward profile before carrying out the investment; and (2) exercise due skill, care and diligence when entering into, managing or terminating arrangements with third parties in relation to risk management, including taking steps to verify their ability and capacity and the ongoing assessment of their performance.
Resources[11]	In terms of your obligation to employ sufficient personnel with the skills, knowledge and expertise necessary for discharging the responsibilities allocated to them, you must ensure you retain the necessary resources and expertise for "*the effective integration of sustainability risks*".
Conflicts[12]	When identifying and addressing potential conflicts that may damage the interests of your funds, you must include conflicts that may arise as a result of the integration of sustainability risks in your processes, systems and internal controls.
Risk management[13]	Your risk management policy must include procedures to enable you to assess and manage the exposure of your funds to sustainability risks.
Organisational systems and controls[14]	You must take into account sustainability risks: – in your decision-making procedures and organisational structure; – when ensuring your staff are aware of the procedures to be followed for the proper discharge of their responsibilities; – when establishing and maintaining internal controls and compliance measures; – when establishing and maintaining internal reporting and management information (MI) processes; and – in your record-keeping policies and procedures.

10 See amendments proposed to Article 18 (Due diligence) of the AIFMD Delegated Regulation and Article 23 (Due Diligence) of the UCITS Implementing Directive.
11 See amendments proposed to Article 22 (Resources) of the AIFMD Delegated Regulation and Article 5 (Resources) of the UCITS Implementing Directive.
12 See amendments proposed to Article 30 (CONFLICTS) of the AIFMD Delegated Regulation and Article 17 (CONFLICTS) of the UCITS Implementing Directive.
13 See amendments proposed to Article 40 (Risk management policy) of the AIFMD Delegated Regulation and Article 5a (Investment companies) and Article 38 (Risk management policy) of the UCITS Implementing Directive.
14 See amendments proposed to Article 57 (General requirements) of the AIFMD Delegated Regulation and Article 4 (General requirements) of the UCITS Implementing Directive.

Senior management responsibilities[15]	Your senior management are responsible for the integration of sustainability risks in the following: (a) the implementation of the investment policies for your funds; (b) overseeing the approval of the investment strategies of your funds; (c) your valuation policies and procedures; (d) your compliance function; (e) what is done to ensure and verify on a periodic basis that the investment policy, investment strategies and risk limits of your funds are properly and effectively implemented and complied with; (f) the approval and review on a periodic basis of the adequacy of your internal procedures for undertaking investment decisions for your funds, to ensure such decisions are in line with their respective investment strategies; (g) your risk management policies and procedures, including the risk limits for each of your funds; and (h) (for AIFMs) your remuneration policy.
For MiFID portfolio managers or advisers	
Suitability[16]	You must obtain information from a client about their sustainability preferences so that, when providing advice or portfolio management, you have a reasonable basis for concluding that investments recommended or made comply with those preferences. A client's investment objectives are expressly stated to include their "sustainability preferences, if any".
ESG due diligence	You must have adequate policies and procedures in place to ensure you understand the nature and features of the investment services and financial instruments you select for your clients, "including any sustainability factors".[17]
Pre-contractual disclosures – advisers only	When you provide a description of the factors taken into consideration in the selection process you use to recommend financial instruments (eg risks, costs and complexity of the financial instruments), you must include sustainability factors.[18]
Organisational and systems/controls requirements	You must take into account sustainability risks when complying with the organisational requirements in MiFID II – eg when establishing, implementing and maintaining internal controls, employing personnel with the necessary skills, knowledge and expertise; when establishing, implementing and maintaining effective internal reporting and communication; when keeping records, etc.[19] Going forward, when establishing, implementing and maintaining adequate risk management policies and setting the level of risk tolerated by the firm, you must take into account sustainability risks.[20] When identifying the types of conflict that arise in the course of providing investment and ancillary services and whose existence may damage the interests of a client, the client's interests will specifically include "his or her sustainability preferences".[21]
Product governance – manufacturers[22]	In essence, you must include sustainability preferences and sustainability factors into your target market analysis. In particular: – When you identify the potential target market for a product and specify the type(s) of client for whose needs, characteristics and objectives the product is compatible, you must include sustainability preferences.

15 See amendments proposed to Article 60 (Control by the governing body, senior management and supervisory function) of the AIFMD Delegated Regulation and Article 9 (Control by senior management and supervisory function) of the UCITS Implementing Directive.
16 See amendments proposed to Article 54 (suitability assessments and reports) of the MiFID Delegated Regulation.
17 See amendments proposed to Article 54(9) of the MiFID II Delegated Regulation.
18 See amendments proposed to Article 52 (information about investment advice) of the MiFID II Delegated Regulation.
19 See amendments proposed to Article 21(1) (general organisational requirements) of the MiFID II Delegated Regulation.
20 See amendments proposed to Article 23 (risk management) of the MiFID II Delegated Regulation.
21 See amendments proposed to Article 33 (conflicts) of the MiFID II Delegated Regulation.

Product governance – manufacturers

– When you determine whether a product meets the identified needs, characteristics and objectives of the target market, you must consider whether the product's sustainability factors are consistent with the target market.

– When you periodically review the products you manufacture, you must consider if they remain consistent with the needs, characteristics and objectives, "including any sustainability preferences", of the target market.

Product governance – distributors[23]

Similarly, you must include sustainability preferences and sustainability factors into your target market analysis. In particular:

– You must have in place adequate product governance arrangements to ensure the products and services you intend to offer or recommend are compatible with the needs, characteristics and objectives, "including any sustainability preferences", of an identified target market.

– When you periodically review the products you offer or recommend and the services you provide, you must assess whether the products or services remain consistent with the needs, characteristics and objectives, "including any sustainability preference", of the identified target market.

22 See amendments proposed to Article 9 (product governance - manufacturers) of the MiFID II Delegated Directive.
23 See amendments proposed to Article 10 (product governance - distributors) of the MiFID II Delegated Directive.

Timing

When finalised, the new laws will enter into force on the twentieth day following their publication in the Official Journal of the European Union. Their requirements are expected to apply from 12 months after publication in the Official Journal.

As relevant to this timeline, however, it is yet to be clarified whether the new requirements will apply in relation to existing as well as new clients/funds and their portfolios – in other words, whether there will be any grandfathering or transitional relief.

Brexit

It is not clear whether the changes proposed to MiFID II, AIFMD and the UCITS Directive will apply in the UK post Brexit.

The UK government has expressed a desire to prioritise climate change initiatives, and, in particular, wishes to encourage private investment in activities that would "green" the UK. On the other hand, it may be reluctant to be seen to track EU regulatory initiatives too closely post-Brexit.

This point is therefore one to watch.

Recommendations

In terms of what firms should be doing now:

- Get up to speed on the proposed new regulations;
- Consider establishing a cross-functional internal team to consider what changes will be required within your business;
- Undertake a preliminary gap analysis; and
- In light of the outcome of the gap analysis, identify actions required to put in place the necessary internal systems, procedures, policies and expertise in order to comply with the requirements.

If you have any questions on the new requirements mentioned above or ESG generally, please get in touch with your usual A&O contact.

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