Ireland Market Pulse
Regulatory Update

September 2020

EY
Building a better working world

Foreword

Friends,

We are pleased to present our latest insights into the Wealth and Asset Management regulatory landscape. Here, we provide an update and our views on the most topical regulatory developments but would be remiss not to preface this with some thoughts on the impacts of Covid-19 on the Irish funds industry, and how we can collectively navigate through - and beyond - these volatile times.

Covid-19 responses have illustrated the potential for scaled transformation at speed. New conceptions of resilience and agility, combined with the prevailing economic conditions, will influence the boldness of future decisions.

The initial focus of the funds industry was the safety and wellbeing of employees. The rush to working from home was largely successful, although there were bumps in the road:

- Laptops and 4G dongles were in great demand, particularly in offshore centres, as disaster recovery second sites were rendered ineffective;
- Risk management and liquidity frameworks were tested as Fund Management Companies reacted to market volatility and were required to explore strategies such as gating funds.

The focus quickly shifted to putting in place processes and tools that would facilitate a prolonged period of working from home. Firms turned their attention to:

- The heightened cyber threat of staff working over partially unsecured networks;
- The roll out of collaboration tools, e.g. video conferencing and screen sharing;
- The physical needs of staff, be that second screens or ergonomic chairs;
- Reminding staff of Market Abuse/ Conduct rules particularly as it pertains to confidential information that might be accidently overheard across the shared workspace that was in effect the kitchen table;
- Embracing microservices; e.g. using tools like Docusign to eliminate the need for wet signatures or replacing swivel chair interfaces with File Transfer Protocols.

More will needed to be done to industrialise the work from home environment. No doubt the Central Bank is evaluating how firms' risk management, liquidity frameworks and governance more generally held up, perhaps tagged on to their upcoming organisational effectiveness thematic inspections.

Societal, customer and employee behaviours and expectations have shifted; for example:

- New forms of hybrid work models will become the norm, the role of the office as a 'place' will be reconceptualised;
- The digital transformation of the customer experience will be accelerated, artificial intelligence (AI) will be used to improve the experience and to better serve existing and new customers;
- Cost pressures will see managers and servicers continue to embrace robotic process automation. AI will be deployed in the money management front office;
- Customers will demand enhanced ESG products and processes and new asset classes uncorrelated to the public markets and real estate.

Ireland's funds industry has an opportunity to play a significant role in the transformation of the investment management industry globally. Covid-19 has demonstrated that technology enabled hybrid and distributed work models can be very effective. The industry in Ireland can help solve the challenges of cost-effective service delivery and the need for regulatory substance arising from Brexit by re-shoring to Ireland value added activities from other financial centres. Given the talent pool (including individuals currently employed in the tech sector) and our proximity to the EU, the UK and the US, the industry is well placed to play an extended role in areas such as:

- Developing AI to deploy across the money management and asset gathering front offices;
- Product development & distribution;
- Fund & operational risk oversight;
- Liquidity & treasury management.

By embracing this opportunity, we will grow employment, position Ireland at the centre of responsible investing and play a role in solving for the global savings shortfall.

For more insights and our latest thinking to support you in leading through these volatile times, please visit www.eyfs.ie/leadingthroughvolatility.

Lisa Kealy
Wealth and Asset Management
Sector Leader

Paul Traynor
Wealth and Asset Management
Consulting Leader

Dean Phillips
Wealth and Asset Management
Associate Partner, Alternatives

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Local Irish Developments

Senior Executive Accountability Regime

In July 2018, the Central Bank of Ireland ("CBI") announced proposals to introduce a Senior Executive Accountability Regime ("SEAR") in Ireland. This will result in significant changes to the CBI's existing Fitness and Probity Regime, as well as its enforcement process. The proposals are similar in aspect to key elements of the UK's Senior Manager and Certification Regime ("SMCR"). Implications for both individuals and firms will be significant.

Our sense is that it is likely to be another year before the legislation is published (to be followed by CBI Guidance and Standards) but we are beginning to see some firms commencing preparations on a 'no regrets' basis now that the first hurdles of managing organisations through C-19 have been overcome. And of course, preparations vary by size, current capabilities and priorities.

On a related point, in July, the EBA and ESMA issued a joint consultation paper on revisions to the assessment of suitability of key role holders. The EBA published a separate consultation paper on revisions to its Guidelines on Internal Governance, reflecting the adoption of CRD 5 and the Investment Firms Directive. Consultations run to end October, revisions likely to take effect end June 2021.

Key themes are:

- Gender diversity at board and executive level and gender-neutral remuneration policies
- Management of financial crime and terrorist financing is under the spotlight
- Increase the transparency of credit institutions' offshore activities

The consideration of risks within change processes

One of the outcomes of the 2008 global financial crisis was a collapse in the public's trust in financial institutions and their leaders. Globally, conduct regulators have been focused on winning back this trust by raising the standards of individual accountability of those in senior management positions within financial services firms.

To understand the proposed changes under the SEAR, we must first look back at the efforts of the CBI to regulate and enforce greater standards of accountability and overall conduct within the industry over the past ten years.

The Central Bank Reform Act 2010, and the revisions under the CBI Fitness and Probity Standards (2014), introduced a revised and significantly enhanced fitness and probity regime, which applies to all Regulated Financial Services Providers authorised by the CBI. The core function of the Fitness and Probity Regime ("F&P") is to ensure that persons in senior positions are competent and capable, honest, ethical and of integrity and financially sound. The F&P also enhanced the CBI's enforcement powers to investigate, suspend or prohibit individuals from holding current and future Control Function and Pre-Approved Control Function roles. While the F&P represented a significant overhaul of the CBI's powers to ensure Board members and Senior Management meet the necessary levels of fitness and probity for the roles they hold, the regime fell short of holding individuals accountable for their conduct.

Subsequently, the CBI introduced the Fund Management Companies Guidance (Dec 2016), referred to in industry as CP86, which came into effect on 1 July 2018. CP86 sets out the Regulator's expectations in relation to the culture and environment in which (delegate) oversight is undertaken; the role of the independent director with responsibility for the specific task of reviewing the effectiveness of the Fund Management Company's organisational effectiveness; and the role of the six pre-identified Designated Persons. Implementation of the CP86 requirements has already focused Board attention on the newly regulated iNED role, in addition to assessing the effectiveness of how the Board functions through reviewing its composition, capacity, meeting materials, power and delegation and oversight of Board Committees and how conflicts are iidentified and managed, particularly perceived conflicts relating to Promoter relationships. For Senior Management, specifically those holding Designated Persons roles, implementing CP86 has required firms to review the effectiveness of engagement between key first line business, operational and control functions, together with the oversight of the first line by the second line risk and compliance functions. Key to the successful implementation of the CP86 requirements will be evidencing the change of focus of Fund Management Company Boards away from a supportive subsidiary culture to a demanding client culture driven to achieve the best outcomes for investors. Crucial to this is how Fund Management Companies will evidence this through the documentation of decision making and the rationales for same, up through the governance structure.

The 2020 phase of the CBI's culture enhancements will see the implementation of an Irish Individual Accountability regime, the SEAR, which they have indicated will be similar to the UK's SMCR. While the legislation and guidance have not been published, we know the following:

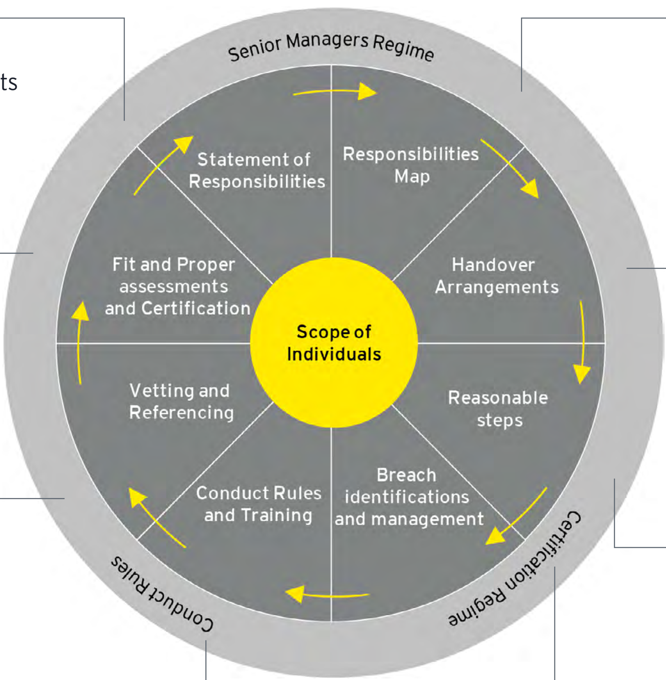
- initially, it may not include investment managers, and will likely extend further than the entity types identified within the CBI's current proposals
- the recent thematic review of UCITS performance fees has indicated that some entities may not have been acting in the best interests of their investors
- once individual accountability is introduced, in-scope entities will be required to document governance arrangements in accordance with the requirements and also to comply with the relevant conduct rules
- the CBI has indicated the regime will include the following conduct enhancements:
  - 5 clear enforceable conduct standards for all employees in all regulated firms. Additional standards for senior executives and overall business standards for firms; the CBI is actively engaged with Department of Finance on the scope of the SEAR

- enhancements to the current F&P regime to strengthen onus on firms to proactively assess individuals taking up of senior positions
- proposed enhancements to overcome some current limitations of the CBI's F&P oversight function, e.g., ability to investigate some people who performed controlled functions in the past
- unified enforcement process and removal of "hurdle of participation" so that the CBI can pursue individuals directly
- SEAR would initially apply to credit institutions, certain insurance and investment firms and third country branches of all of these
- Senior Executive Functions under the regime would include board members, executive functions and heads of critical business areas.

It is worth noting that the SM&CR would not have been extended to the Asset Management sector in the UK had it not been considered a success.

Boards and Senior Management will need to ensure their entities have developed a strategy to implement the regime and have identified the key areas of impact and change focus. The illustration below provides a summary of the potential implications of the SEAR:

All elements of the business operating model are impacted



Senior Manager Functions
- Organisational design
- Responsibilities Map and Statements of Responsibilities
- Risk culture and tone
- Basis for reasonable steps

Business lines (Sales, Distribution, Prod Dev, Trading, Investment Management)
- Impact of certification regime
- Conduct rules
- Reasonable steps framework
- Record keeping

HR (Employee lifecycle)
- Remuneration and reward strategy
- Performance management
- Population tracking
- Training and development
- Onboarding

Technology
- HR systems enhancements
- Enhancements to support reasonable steps
- MIS provision

Governance
- Governance framework
- Reporting lines
- Management information
- Committee protocols
- Breach reporting

Legal and Compliance
- Rule change Interpretation
- Application and authorisation framework
- Implementation and monitoring

Internal Audit
- Implementation assurance
- Monitoring
- Effectiveness testing
- Stakeholder management
- 'Reasonable Steps' Assessment

Other control functions (Risk, Finance, Ops)
- Impacted individuals
- Alignment to new requirements
- Enhance existing control frameworks

In light of the CBI's challenge to industry not to wait for the legislation to be put in place, but to act now to address the key culture concerns the regime seeks to address, the question for Fund Management Companies is what actions should they take.

Suggested steps: Now, Next and Beyond

Now		Next	Beyond
Priority Focus Areas on a 'no regrets' basis			
Review current governance and committee structures	Review organisational design of Senior management team	Review and map current HR processes and activities	Technology enablement
Key Activities			
• Review terms of reference and membership of each governance committee, board and executive management (FCA's applicability of SMCR to itself is a good guide) • Assess how committee discharges its responsibilities • Review quality of information provided for decision making • Assess records of basis for decisions taken	• Revisit 2019 Dear CEO letter - are existing Fitness and Probity standard being met? • Using current job descriptions/role profiles, create statements of responsibility for each PCF • Align to create responsibilities map • Create Responsibility Assignment Matrix (RACI) for internal frameworks and activities so that lines of responsibility are clear • Conduct Senior Executive Interview across full SEF population	• Job profiles/descriptions • Talent, succession management • Delegation of duties/ responsibilities • Performance management • Development and communication of conduct standards • Recruitment, assessment and on boarding • Conduct & Breach management • Learning and induction • Exits/Handovers/ Regulated References • Remuneration polices • Vetting and referencing	• Analyse capability to update in- house records of annual F&P assessment of SEFs and Certified roles using regulatory compliance technology solutions • Define SEF employees and Certified Persons HR record maintenance and storage process • Design and implement technology solutions for identified gaps and evidencing of reasonable steps

CBI Consultation on the Treatment, Correction and Redress of Errors in Investment Funds

Background

In 2015, the Central Bank of Ireland (the CBI) carried out a thematic review of the fund industry's approach to the treatment of NAV pricing errors. It was noted that a longstanding guidance paper issued by Irish Funds (the representative body for the funds industry in Ireland) was widely adopted and applied however this guidance was never sanctioned nor approved by the CBI. On 9 September 2019, the CBI published Consolation Paper 130 (CP130) on a regulatory framework that establishes rules and guidance in relation to the treatment, correction and redress of errors in investment funds.

Primary Change

The guiding principle of the regulatory framework set out in CP130 is that where an error occurs, the fund and/or the investor must be "Appropriately Rectified", whereby the fund and/or investor is restored to the position that it/they would have been in had the relevant issue not arisen.

The framework defines four error types and differentiates on how an error should be Appropriately Rectified depending on the type of error concerned, dealing specifically with:

- Treatment – how errors should be treated when they arise, including when such errors should be considered as material;
- Correction – how errors should be corrected, including what reporting and notification obligations should apply; and
- Redress – how the fund and/or investors should be Appropriately Rectified following an error.

Timeline

The consultation closed on 9 December 2019 with numerous responses submitted. The Central Bank has confirmed that this will be a 2-step process with a second Consultation Paper being released in 2020.

Key Points

Scope

The proposed framework will apply to Fund Management Companies (FMCs) acting for Irish authorised Funds, both UCITS and AIFs as well as to Irish FMCs, which may be acting for non-Irish authorised Funds. Depositaries are also in scope.

Error Types

Four types of errors are defined within the Framework:

1. an error in the calculation of the Net Asset Value (NAV) (a "**NAV Error**");
2. an error relating to the investments of a fund and non-compliance with the applicable investment restrictions (an "**Investment Breach Error**");
3. an error related to the overpayment of a fee (a "**Fee Error**") and
4. errors which do not fall into the above three categories (a "**Control Breach Error**").

Responsible Parties and Their Obligations

In the event of an error, the FMC will be required to ensure that the error is appropriately rectified, taking into account CBI guidance. The Depositary must ensure that the error has been appropriately rectified by the FMC. Appropriately rectified will entail:

- identification and classification of the error (including assessing materiality);
- correction of the error (including compliance with any reporting and notification obligations); and
- redress of the error (including the payment of redress to the fund and/or investors).

Treatment of Errors - Materiality

Once an error has been identified, it must be corrected without delay. The FMC and depositary will have to assess the materiality of the error. Both Quantitative Materiality Thresholds and Qualitative Materiality Factors must be considered:

Quantitative thresholds

The proposed quantitative thresholds are	
Money Market Funds (MMFs)	0.10% of NAV
Other investment funds	0.50% of NAV

Qualitative thresholds

Even if an error is below the quantitative threshold, it must be assessed in the context of qualitative factors. CP130 provides a non-exhaustive list of qualitative factors to be considered, such as assessing the cumulative impact of a recurring error.

Reporting to the CBI/Notification to investors

Dual reporting to the CBI by FMCs and depositaries is set to continue under the proposed framework however only with respect to material errors. Under current legislation, the FMC must notify the CBI of any breach of the Irish UCITS regulations/AIFM regulations or other relevant Irish legislation, regardless of the materiality.

Recognising that many FMCs rely on the depositary to meet their reporting obligations, CP130 proposes to amend obligations imposed on FMCs to consist of one of the following:

- report errors to the depositary, which in turn would fulfil the regulatory reporting obligation as required; or
- report any material errors which have not been reported by the depositary to the CBI.

It is proposed that both the fund management company and depositary should be required to maintain a written record of all errors that occur.

CP130 also proposes that FMCs be required to report any error deemed to be material, irrespective of whether redress is required. Under current industry practice, investors are typically notified only when compensation is being paid.

Redress

Payment of redress is considered as a payment to return the affected fund/investor to the position that it/they would have been in had an error not arisen. CP130 sets out a list of elements on how such redress should operate, including:

- In the case of NAV Errors or Control Breach Errors deemed to be material, the Payment of Redress should be made in all circumstances;
- in the case of Fee Errors, the payment of redress must be made in all circumstances;
- In the case of Investment Breach Errors, the Payment of Redress should be made in all circumstances where the error is as a result of an advertent breach;
- in the case of inadvertent Investment Breach Errors, the payment of redress will generally not be payable unless otherwise determined by the depositary;
- although errors may arise from the actions of delegates, it is still the responsibility of the FMC to ensure that errors are appropriately rectified.

Current industry practice applies de minimis limits below which redress is not provided and CP130 seeks feedback in terms of the limits (€50 for retail investors and €500 for institutional investors) which the CBI considers to appear excessive.

Practical considerations

FMCs should assess their current governance, policies, processes and procedures to make sure they match the CBI's expectations in terms of correction of NAV errors and investment breaches.

Investment Limited Partnerships (Amendment) Bill 2020

Ireland is a key player in the global asset management industry, specifically in asset servicing. Private Equity (PE) is one area where there the general perception from industry participants is that a suitable vehicle does not exist. Even though Ireland has a range of structures to choose from, Limited Partnerships (LPs) remain the preferred structure for the PE industry.

Ireland does have unregulated Limited Partnerships under the Limited Partnership Act of 1907 and regulated Limited Partnerships under the Investment Limited Partnership Act of 1994. The industry has been seeking enhancements to the ILP Act to make the 1994 vehicle more fit for purpose and more in sync with its international counterparts.

As part of the Irish Government's strategy for the further development of the international financial services sector in Ireland, the Irish Minister for Finance has indicated approval of the legal drafting to amend the decades-old legal framework of the Irish ILP.

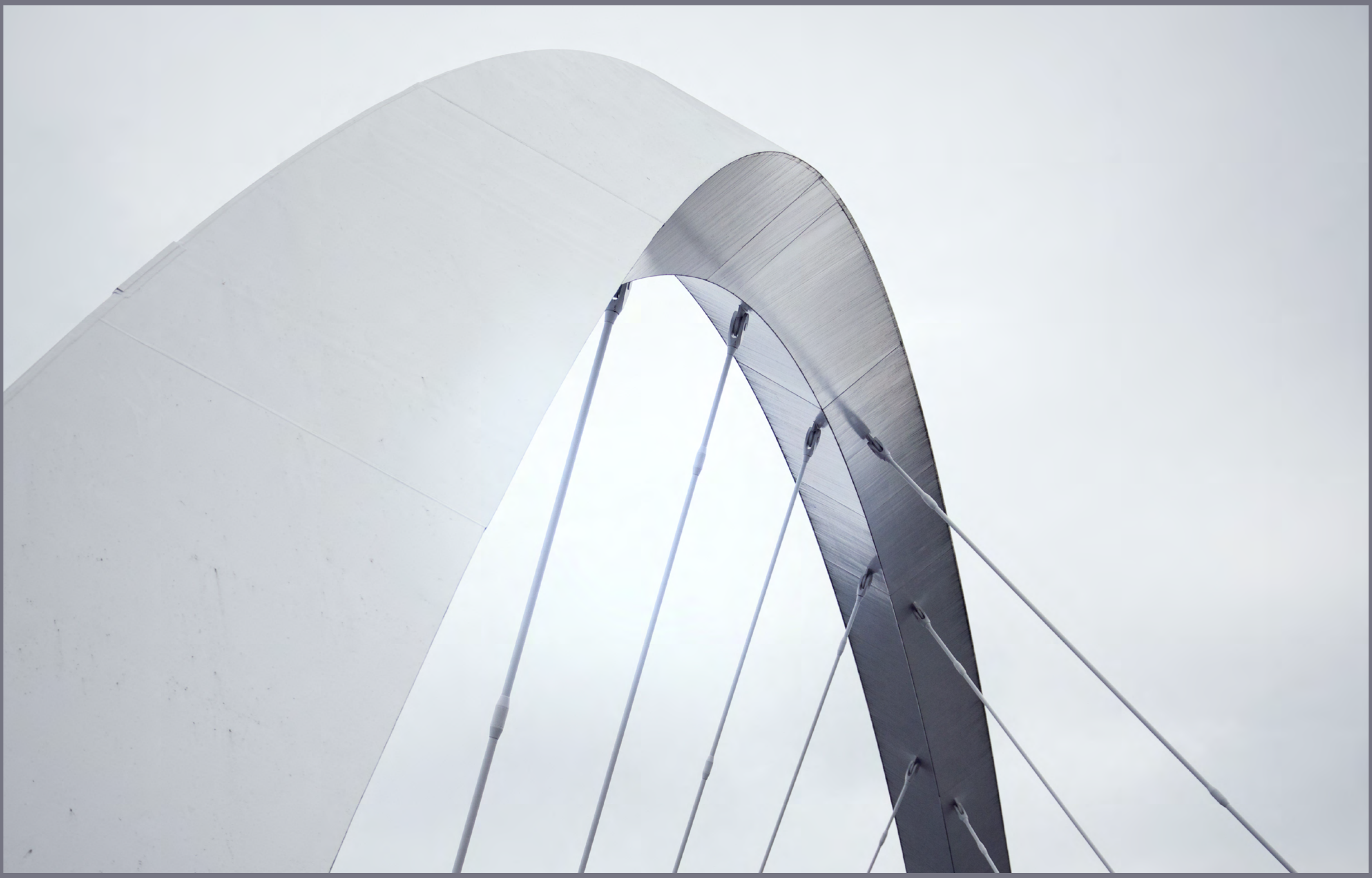
On 20 June 2019, the Irish Government published the Investment Limited Partnership (Amendment) Bill 2019 (the "Bill"), which proposed to reform and modernise Irish legislation regulating investment limited partnerships.

Key changes expected by the new Bill will include:

- allowing an ILP to be structured either as standalone fund or "umbrella";
- aligning the ILP legal framework with EU and domestic funds legislation e.g. AIFMD;
- allowing limited partners to participate in the governance of the ILP (e.g. serving on the board of the ILP etc.) without the loss of the limited liability status of the limited partner;
- clarification of limited partners obligations to include their obligations in respect of capital contribution;
- permitting alteration of partnership agreement by a majority of the limited partners rather than unanimous consent

The Bill had progressed to an advanced stage in the Irish legislative process, but the change in Irish Government combined with the impact of the coronavirus pandemic delayed its progression. The Government has now refreshed the Bill and approved its draft text and publication. We expect the refreshed Bill to now make accelerated progress in line with Ireland's longstanding prioritisation of the 'Ireland for Finance Strategy' and continued commitment to the Financial Services Industry as a whole.

Ireland will see a significant benefit from the introduction of the new ILP in terms of the variety of products that can be housed within the vehicle. There is also a wealth of experience and expertise within Ireland which will benefit the PE industry in general. The PE managers are focussed on expanding internationally, looking for new pools of talent, reducing costs, harnessing the reach of technology/data and increasing their corporate responsibility footprint through ESG initiatives. Ireland's young, dynamic, talented, and experienced workforce is ideal for PE managers to leverage solutions to their areas of focus. Ireland's asset management industry is mature and has a track record in providing an exceptional experience to every facet of the industry. Ireland is also well established as a hub for technology and innovation with every major technology company having a presence in Ireland. Therefore, there is a tremendous potential for Ireland to be a force for disrupting the norm within the PE. This will undoubtedly benefit the PE industry that remained static in the way it has operated historically. The new Irish ILP will help this come to fruition.



Central Bank Communications

Interest Rate Benchmark Reform Letter

In February 2020, the Central Bank issued a letter to fund management companies reminding them to take appropriate action for funds that will be affected by the ongoing developments in the global interest rate benchmark reforms which include the transition that occurred from the euro overnight index average (EONIA) to the new euro short-term rate (€STR), the developments regarding the euro interbank offered rate (EURIBOR) and the London interbank offered rate (LIBOR) and other changes introduced for any relevant benchmark rates, in any currency, for contracts or holdings that an investment fund may have.

The purpose of the letter is to remind those responsible for the management of investment funds of their obligations to adequately prepare for the implementation of these global benchmark reforms and any associated risks. The letter stated that it is important that investment funds take appropriate action now to ensure a smooth transition to alternative or reformed benchmark rates ahead of the deadline of the end of 2021 specified in the revised EU Benchmark Regulation.

It also states that the "Board of each Fund Management Company is responsible for ensuring that appropriate preparations for the impact of the benchmark reforms are in place for each fund it manages." Based on the analysis of the impact of the changes undertaken by the relevant fund management company, the letter advises that "the Board should develop plans to address any potential risks, documentation or prospectus changes or engagement with investors where appropriate."

Central Bank - Covid-19 Regulated Firms FAQ

On 24 August 2020 the Central Bank of Ireland ("Central Bank") updated its Covid-19 – Regulated Firms FAQ. The FAQ covers a variety of topics including how they are regulating the financial services industry in the current environment, reporting requirements, dividends and remuneration, the monitoring of securities including investment funds and anti-money laundering.

EU Taxonomy Regulation

Background

On 22 June 2020, the long-awaited Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (the "EU Taxonomy Regulation"), and amending Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the "SFDR") was published in the Official Journal of the European Union.

The EU Taxonomy Regulation is the unified classification system for sustainable activities at the core of the EU action plan on financing sustainable growth, published by the European Commission in March 2018.

Primary Change

The EU Taxonomy Regulation should enable investment fund managers ("IFMs") to gather reliable, consistent and comparable sustainability related indicators from in-scope investee companies and incorporate this data into their investment decision and risk management process and fulfil their disclosure duties under SFDR or applicable sectorial legislation.

The EU Taxonomy Regulation also provides further details on the content of sustainability-related disclosures required in pre-contractual and periodic reports of environmentally sustainable investment funds and investment funds promoting environmental characteristics.

Key Dates

22 June 2020	Publication in the Official Journal of the EU
31 December 2020	Adoption of delegated acts for the technical screening criteria with respect to climate-related objectives
31 December 2021	1. Adoption of delegated acts for the technical screening criteria with respect to all other environment-related objectives 2. Commission to publish a report describing the provisions that would be required to extend the scope of the Taxonomy to cover: • Economic activities that do not have a significant impact on environmental sustainability • Economic activities that significantly harm environmental sustainability • Specific disclosure requirements related to enabling and transitional activities • Other sustainability objectives, such as social objectives
1 January 2022	Application of the requirements for climate-related objectives
1 January 2023	Application of the requirements for all other environment-related objectives

Key Points

The EU Taxonomy Regulation aims to define EU-recognised criteria for identifying sustainable activities. This defines the minimum criteria that economic activities should comply with in order to be considered environmentally sustainable.

- An environmentally sustainable economic activity contributes substantially to one or more of the following environmental objectives:
  - 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
- It does not significantly harm ("DNSH") any of the other environmental objectives
- It is carried out in compliance with minimum safeguards set out in the Regulation (including the OECD Guidelines for Multinational Enterprises, the International Labour Organisation, etc.)
- It complies with the technical screening criteria developed by the Technical Expert Group in the form of delegated acts, applicable from 1 January 2022 for climate-related objectives and from 1 January 2023 for the other environmental objectives
- An activity, referred to as 'enabling activity', can be considered to be contributing substantially to one or more environmental objectives laid down by the Taxonomy if it directly enables other activities to contribute to these objectives, provided that such economic activity:
  - does not lead to a lock-in of assets that undermine long-term environmental goals, considering the economic lifetime of those assets
  - has a substantial positive environmental impact, on the basis of life-cycle considerations

An activity, referred to as 'transitional activity', can be considered to be contributing substantially to the environmental objective of climate change mitigation under the following conditions:

- There is no technologically and economically feasible low-carbon alternative
- It supports the transition to a climate-neutral economy consistent with a pathway to limit the temperature increase to 1.5°C above pre-industrial levels
- That activity:
  - Has greenhouse gas emission levels that correspond to the best performance in the sector or industry
  - Does not hamper the development and deployment of low-carbon alternatives, and
  - Does not lead to a lock-in of carbon-intensive assets, considering the economic lifetime of those assets

The EU Taxonomy Regulation also lays down disclosure obligations that supplement the SFDR and the Non Financial Reporting Directive[1] ("NFRD") with regards to activities that contribute to an environmental objective:

- Undertakings that are required to report on non-financial information under the NFRD must include in their non-financial statement:
  - The proportion of their turnover derived from products or services associated with environmentally sustainable economic activities
  - The proportion of their capital and operating expenditures related to assets or processes associated with environmentally sustainable activities
- Financial products that invest in environmentally sustainable economic activities must disclose the proportion of investments in environmentally sustainable activities selected for the financial product, including the proportion of enabling and transitional activities, as a percentage of all investments selected for the financial product. This information shall be disclosed in the pre-contractual disclosures and in the periodic report.

The EU Taxonomy Regulation will be further developed over time to cover economic activities that are socially sustainable.

Practical Considerations

The Disclosures of investee companies should enable investment funds to report the proportion of their fund invested in Taxonomy-aligned activities for each investee company. For climate change mitigation, turnover can be recognised where an economic activity meets the Taxonomy technical screening criteria for substantial contribution to climate change mitigation and relevant DNSH criteria. For climate change adaptation, turnover can be recognised only for activities enabling adaptation but not for adapted activities.

Companies that disclose their capex investments in economic activities as part of a plan to be Taxonomy-aligned should provide invaluable information for constructing green portfolios, and for analysing companies' transition plans and/or environmental sustainability performance and strategies.

As part of their risk-based due diligence, IFMs should pay attention to what extent investee companies, and other issuers disclosures cover Taxonomy required information on whether they:

- Comply with minimum safeguards
- Embed responsible business conduct into their policies and management systems
- Identify, assess, prevent or mitigate actual or potential adverse impacts
- Gain and use leverage to prevent and mitigate the impacts
- Track performance
- Communicate and report publicly
- Enable remediation when appropriate

Significant challenges are expected for investments in EU companies and bond issuers that do not fall under the scope of the NFRD, and non-EU companies. In such situations, the EU Technical Expert Group recommends a five-step approach:

- Identify the activities conducted by the company or issuer or those covered by the financial product (e.g., projects, use of proceeds) that could be aligned, and for which environmental objective(s)
- For each potentially aligned activity, verify whether the company or issuer meets the relevant screening criteria – e.g., electricity generation <100 g CO_2e/kWh
- Verify that the DNSH criteria are being met by the issuer. IFMs would most likely use a due diligence-type process for reviewing the performance of underlying investees and would rely on the legal disclosures of eligibility from those investees
- Conduct due diligence to avoid any violation of the social minimum safeguards
- Calculate alignment of investments with the Taxonomy and prepare disclosures at the investment product level

For more information, please visit:

EU Taxonomy Regulation

EU TEG Final Report on Taxonomy

[1] Directive 2014/95/EU which is currently being reviewed by the European Commission to potentially expand its scope and improve granularity and standardization of disclosures

Draft delegated acts on the integration of sustainability factors and risks in the UCITS Directive, AIFMD and MiFID II

Background

The European Commission has published on 8 June 2020 a set of draft delegated acts, including, *inter alia*:

- A draft delegated directive amending the Commission Directive 2010/43 implementing certain provisions of the UCITS Directive
- A draft delegated regulation amending the Commission Regulation 231/2013 implementing certain provisions of AIFMD
- Two delegated acts amending two delegated acts implementing MiFID II requirements on product governance, organisational requirements and operating conditions of investment firms

These delegated acts are part of a broader action plan on sustainable finance and look to streamline sectoral legislation with the emerging framework and reinforce the regulations:

- On sustainability-related disclosures in the financial services sector ("SFDR")
- On low-carbon benchmarks ("LCBR")
- On the EU taxonomy for sustainable activities ("Taxonomy")

Primary Change

The sustainable finance action plan will bring significant changes in the investment fund value chain.

The UCITS Directive and AIFMD draft delegated acts clarify notably the duties of investment fund managers ("IFMs") to take into account the social and environmental factors and risks in their governance, organisation, conflicts of interest policies, investment due diligence as well as their risk policies and procedures.

Investment firms will be required to integrate investors' sustainability preferences, i.e. the appetite of their clients for dark green and light green products, as defined in SFDR, in product governance, financial advice, portfolio management and distribution activities. Ex-post information disclosure, relying on funds and management companies disclosures, will be required to explain how a recommendation to the client to purchase an investment fund meets his investment objectives, risk profile, capacity for loss bearing and sustainability preferences.

Key Points

The UCITS Directive and AIFMD delegated acts provide very similar requirements.

<table>
<tr><th>UCITS (delegated directive)</th><th>AIFMD (delegated regulation)</th></tr>
<tr><td colspan="2">Alignment of definition of sustainability risks with SFDR</td></tr>
<tr><td colspan="2">Requirement to consider sustainability risks in management companies or AIFMS:
• establishment, implementation and maintenance of clear and document decision-making procedures and organisational structure specifying reporting lines
• allocation of responsibilities with proper discharge
• internal control mechanisms to ensure compliance with decisions and procedures
• internal reporting and communication and effective information flows with any third party involved
• maintenance of adequate and orderly records of business and internal organisation</td></tr>
<tr><td colspan="2">Requirement to maintain resources and expertise for the effective integration of sustainability risks</td></tr>
<tr><td>Requirement to integrate sustainability risks in the management of UCITS in a proportionate manner</td><td></td></tr>
</table>

UCITS (delegated directive)	AIFMD (delegated regulation)
Requirement to ensure that senior management of the management company is responsible to take sustainability risks into account in: • the implementation of the investment policy in the prospectus, the fund rules, the instrument of incorporation or the offering documents • the approval process for investment strategies • the compliance function • the investment policy/strategy/risk limits implementation/compliance for each managed UCITS • the approval/periodic review of the adequacy of internal procedures for undertaking investment decisions for each managed UCITS • the approval/periodic review of the risk management policy, arrangements, processes and techniques, including the risk limit system	Requirement to ensure that senior management of the AIFM is responsible to take sustainability risks into account in: • the implementation of the investment policy in the prospectus, the fund rules, the instrument of incorporation or the offering documents • the approval process for investment strategies • the valuation policies • the compliance function • the investment policy/strategy/risk limits implementation/compliance for each managed AIF • the approval/periodic review of the adequacy of internal procedures for undertaking investment decisions for each managed AIF • the approval/periodic review of the risk management policy, arrangements, processes and techniques, including the risk limit system • the remuneration policy
Requirement to identify conflicts of interest arising from the integration of sustainability risks in processes, systems and controls	
Consideration of sustainability risks and, where applicable, principal adverse impacts of investment decisions on sustainability factors when applying investment due diligence requirements	
Requirement to consider sustainability risks in the risk management policy	

Practical Considerations

IFMs should conduct their analysis jointly with the project carried out to reach compliance with the SFDR and the Taxonomy.

The practical reach of the rules in terms of organisation, governance, policies, and operational procedures will need to be proportionate to strategic choices and size (in terms of consideration of principal adverse impacts of investment decisions) as well as the extent to which the investment funds managed by the IFM pursue sustainability-related objectives or promote environmental or social characteristics.

However, some minimum standards stemming from upcoming UCITS Directive, AIFMD and SFDR rules will also be applicable to fund managers who do not consider principal adverse impacts and do not manage light green or dark green products. In particular, all IFMs need to review and update their governance structures, resources and allocation of responsibilities, their investment decision-making and due diligence policies as well as their risk policies and control framework to adapt them in a proportionate manner to the scope of their activities.

Consideration should also be given notably to the legislation applicable to benchmark administrators, investee companies and distributors or advisors in order to set up appropriate communication and data flows.

For more information, please visit:

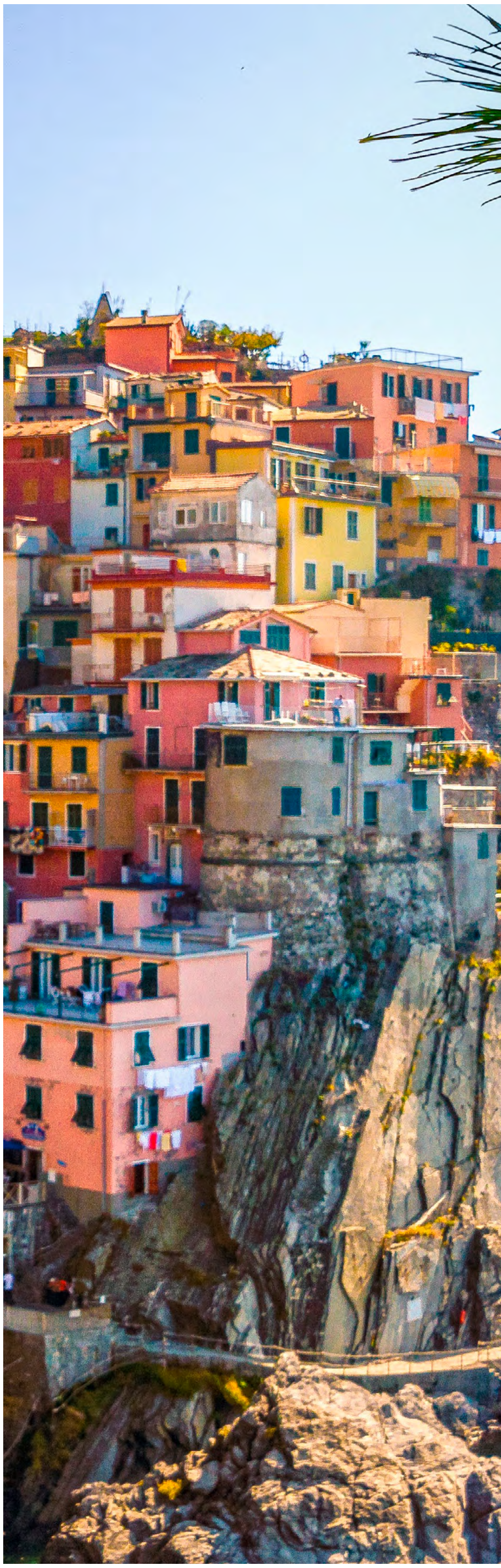
Draft UCITS delegated directive as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities

Draft AIFMD delegated regulation as regards sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers

Draft MiFID delegated directive as regards the integration of sustainability factors and preferences into the product governance obligations

Draft MiFID delegated regulation as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms

European Supervisory Agency Joint Consultation on ESG disclosures



Background

Regulation 2019/2088 on sustainability-related financial disclosures ("SFDR") was adopted on 27 November 2019 with the objective to improve transparency in relation to Environmental, Social and Governance (ESG) factors, risks and impacts. It is applicable notably to fund managers ("entities") and investment funds ("products"). On 23 April 2020, the European Supervisory Agencies ("ESAs") launched a consultation with respect to draft regulatory technical standards ("draft RTS") discussing:

- The disclosure of principal adverse impacts ("PAIs") of investment decisions, required for all entities:
  - Who are employing 500 persons or are the parent company of a group employing 500 persons on a consolidated basis from 18 months after the date of entry into force of SFDR
  - Other entities which do not publish a clear explanation why they do not consider PAIs
- Precontractual, website and periodic disclosures required at product level for both:
  - Products with environmental or social characteristics among other characteristics ("light green products")
  - Products with a sustainable investment objective ("dark green products")

Investment fund sponsors and managers need to make strategic business and policy decisions well ahead of any applicable disclosures which will have to comply with SFDR and the final RTS.

Primary change

The draft RTS provide granular requirements for the content, the methodology and the presentation of disclosures and a template for principal adverse impacts and metrics to be used by entities. While the objective is to improve standardisation and comparability of the information provided to investors, the proposed template is likely to bring significant changes to fund managers.

The ESAs also intend to develop templates for precontractual and periodic report disclosures, but they are not included in the draft RTS.

Timeline

The consultation closed on 1 September 2020 and the ESAs must submit all RTS to the Commission by 30 December 2020, except those in relation to sustainability indicators in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters which must be submitted by 30 December 2021. Most disclosure requirements will apply from 10 March 2021.

However, funds' periodic report disclosures will start applying in respect of financial years commencing 1 January 2022. Disclosure of principal adverse impacts in funds' offering documents and periodic reports will become applicable as from 30 December 2022.

Key Points

Principal Adverse Impacts

Context, scope and implications:

The overall objective of the RTS is to ensure that the entities disclose relevant information regarding their adherence to the "do not significantly harm" principle where their financial products invest in sustainable investments. The objective is to inform end-investors about how the product does not significantly harm the environmental objectives it is not contributing to. The ESAs are of the view that this should be facilitated for those entities which consider the PAIs of their investment decisions since they will already have incurred the costs of assessing their investment decisions against the indicators provided in annex 1 of the RTS.

According to the upcoming Taxonomy Regulation art. 19(1)e, the technical screening criteria developed by the Technical Expert Group to assess under which conditions an economic activity contributes to a sustainable environmental objective should, where feasible, use these sustainability indicators to assess PAIs from these RTS.

Information on PAIs is required to be disclosed first on the entities websites as from 10 March 2021. Any entities that employ less than 500 persons or that are parent undertakings of a group employing less than 500 persons on a consolidated basis during the financial year may opt not to consider PAIs. If they decide to not consider PAIs, they will still need to make a clear statement about this decision, explain the reasons and whether and when they intend to comply. Consideration of PAIs is compulsory for large entities which must disclose on their website the statement in the format prescribed by European Securities and Market Authority Commission (ESMA).

Disclosures of PAI will also be required in offering documents and periodic statements as from 30 December 2022. Where information in periodic reports includes quantifications of principal adverse impacts on sustainability factors, that information may also rely on the provisions of these RTS[1].

Elements of disclosure

Annex 1 provides a PAI statement template structured in three parts including adverse sustainability indicators and associated metrics. One table provides 16 mandatory environmental indicators and 16 mandatory social indicators. Two tables provide 11 additional environmental indicators and 7 additional social indicators. Entities must disclose metrics for all mandatory indicators, at least one additional environmental indicator and one additional social indicator as well as any other PAI deemed to be relevant.

[1] Art. 7(1) SFDR

The content is proposed to be structured as follows:

<table>
<tr><th>Section</th><th>Disclosure item</th><th>Specifications</th></tr>
<tr><td rowspan="4">Summary</td><td>(i) name of the entity</td><td rowspan="4">Maximum 2 pages for the summary</td></tr>
<tr><td>(ii) statement that PAIs are considered</td></tr>
<tr><td>(iii) reference period of the statement</td></tr>
<tr><td>(vi) summary of the PAI statement</td></tr>
<tr><td rowspan="4">Description of principal adverse sustainability impacts</td><td>(i) mandatory PAIs</td><td rowspan="4">Mandatory metrics expressed in market value for (i), (ii) and (iii)
Historical comparison with the shortest of:
a. The previous 10 years
b. From the date the IFM considered first a PAI
c. From 10/03/2021</td></tr>
<tr><td>(ii) at least one additional PAI on a climate or other environment-related sustainability factor</td></tr>
<tr><td>(iii) at least one additional PAI on a social, employee, human rights, anti-corruption or anti-bribery sustainability factor</td></tr>
<tr><td>(iv) any other adverse impact that qualifies as principal</td></tr>
<tr><td rowspan="5">Description of policies to identify and prioritise adverse sustainability impacts</td><td>(i) date of approval of the policies by the governing body</td><td rowspan="5">Where information related to indicators is not readily available, entities should disclose:
a. Best efforts used to obtain information from investee companies
b. If this is not possible, best efforts used to assess PAIs, including a description of any reasonable assumptions used, additional research carried out, cooperation with third party data providers or use of external experts</td></tr>
<tr><td>(ii) allocation of responsibilities for the implementation within organisational strategies and procedures</td></tr>
<tr><td>(iii) description of the methodologies used to assess PAIs, their probability of occurrence and severity, including their irremediable character</td></tr>
<tr><td>(iv) an explanation of any associated margin of error within those methodologies</td></tr>
<tr><td>(v) description of the data sources methodologies used to assess PAI, their probability of occurrence and severity, including their irremediable character</td></tr>
<tr><td rowspan="2">Description of actions to address principal adverse sustainability impacts</td><td>(i) description of actions taken during the reference period and planned for the next period to avoid or reduce PAIs</td><td rowspan="2"></td></tr>
<tr><td>(ii) explanation of the reduction in PAIs achieved by the actions taken</td></tr>
<tr><td>Engagement policies</td><td>brief summaries of engagement policies required pursuant to SRDII, any other relevant engagement policies and an explanation of the reduction in PAIs achieved of the actions taken during the reference period</td><td></td></tr>
<tr><td>References to international standards</td><td>description of the adherence to responsible business conduct codes and international standards for due diligence and reporting and their degree of alignment with objectives of the Paris agreement, including at least forward-looking climate scenarios.</td><td>Adverse indictors used in PAI assessment should be specified</td></tr>
<tr><td rowspan="2">No consideration of PAIs statement</td><td>(i) clear reasons</td><td rowspan="2"></td></tr>
<tr><td>(ii) whether it intends to comply and if so when</td></tr>
</table>

Disclosures applicable to light green and dark green products

General framework and interaction with the upcoming Taxonomy Regulation

The draft RTS provide a comprehensive list of information and sections to be included for precontractual documentation, website information and periodic report for both dark green and light green products. Most disclosure items are common to each support or closely related: logically, pre-contractual information focuses on the description of product features, the definition of investment strategy indicators and the means used to attain the investment objective. Website information provides more information on the data used, the methodological aspects and policies. Periodic reports focus on metrics and sustainability performance measures.

At present, it must be noted that the definition of sustainable investments in SFDR includes both environmental and social objectives while the draft taxonomy is only limited to environmental objectives. Article 25 of the draft taxonomy constitutes an occasion for the ESAs, through the RTS they are empowered to develop, to strengthen the link between sustainable investments as defined under SFDR and investments financing taxonomy-compliant activities but there is no full correspondence between both yet, hence the proposed requirement to disclose proportion of investments in taxonomy-compliant activities.

Elements of disclosure

Light green color requirements apply only to light green products and dark green color requirements apply only to dark green products. Other requirements are substantially the same for both types of product.

Category	Information to disclose		Pre-contractual	Website	Periodic report
Environmental or social characteristics (E/S characteristics) or sustainable investment objective	summary of the information contained in website disclosure of a maximum length of two sides of A4-sized paper when printed			x	
	a description of the E/S characteristics or the sustainable investment objective of the product		x	x	x
	graphical representation of investments	total of sustainable investments with a breakdown between E/S objectives	x	x	x
		total of investments contributing to the attainment of the E/S characteristics promoted by the investment product with a breakdown between E/S characteristics	x	x	x
		remainder of investments	x	x	x
	narrative representation of investments	planned (or actual) proportions with a breakdown of direct holdings/other exposures	x	x	x
		purpose of the planned (or actual) remainder, including any minimum safeguards and whether these investments are used for hedging, relate to MMIs[2] or are investments for which there is insufficient data	x	x	x
		the planned (or actual) proportion of investments in different sectors and sub-sectors, including the fossil fuel sector	x	x	x
		25 top investments constituting on average the greatest proportion of investments of the financial product during the reference period, including the sector and location of those investments or, investments constituting on average 50% if they are less than 25			x
	reference to PAI statement		x		
No significant harm to the sustainable investment	statement that the product does not have as its objective sustainable investment		x	x	
	explanation of how a sustainable investment does not significantly harm the other sustainable investment objectives	how indicators for adverse impacts are taken into account	x	x	x
		no significant harm to the sustainable investment objectives and disclaimer	x	x	x

[2] Money Market Instrument

Category	Information to disclose		Pre-contractual	Website	Periodic report
Investment strategy	description of the strategy, its binding elements and how it is implemented in the investment process on a continuous basis		x	x	
	the rate, where there is a commitment to reduce the investment universe prior to the application of the strategy by a minimum rate		x	x	
	Investment strategy		x		
	description of the policy to assess good governance practices of the investee companies...			x	
		...in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance		x	
Sustainability indicators	list of sustainability indicators used to measure attainment of each E/S characteristics or the sustainable investment objective		x	x	
	monitoring of E/S characteristics or the sustainable investment objective (sustainability indicators) throughout the lifecycle of the financial product and the related internal or external control mechanisms			x	
	Sustainability indicators				x
	historical comparison (shortest of previous 10 years, from the date sustainability indicators were considered or 1/01/2022) between the reference period and previous reference periods (if indicator excluded from previous report or pre-contractual document, explanation and justification of the use of that indicator should be provided)	annual average performance net of fees, including identification of charges and fees included or excluded from the calculation figures			x
		where quantitative disclosures are made, figures with a relative measure such as the impact per euro invested			x
		whether each indicator is subject to assurance provided by an auditor or a review by a third party			x
		the proportion of underlying assets which are not sustainable or enabling investments			x
Due diligence	description of due diligence carried out on the underlying assets, including internal and external controls on that due diligence			x	
	description of the index designated as a reference benchmark, including the input data, the methodologies used to select that data, the rebalancing methodologies, the underlying components, how the index is calculated and the effect of leverage within the index. In case part or all of that information is published on the website of the administrator of the reference benchmark, a hyperlink may be provided to that information.			x	
Engagement policy	if engagement is part of the environmental or social investment strategy, a description of the engagement policies implemented including any management procedures applicable to sustainability-related controversies in investee companies			x	
	actions taken within the reference period to attain the E/S characteristics promoted by the financial product or the sustainable investment objective , including shareholder engagement as defined in Article 3g of Directive 2007/36/EC and any other relevant shareholder engagement.				x
Data sources and processing	data sources used to attain each of the E/S characteristics or sustainable investment objective			x	
	measures taken to ensure data quality			x	
	data sources and processing			x	
	the proportion that is estimated			x	

Category	Information to disclose	Pre-contractual	Website	Periodic report
Limitations to methodologies and data	description of any limitations to the methodologies and the data sources used to measure the attainment of the E/S characteristics promoted by the financial product or the sustainable investment objective as well as how such limitations do not affect the attainment of the E/S characteristics promoted by the financial product or the sustainable investment objective, including the actions taken to address such limitation		x	
Use of derivatives	information on how the use of derivatives meets each E/S characteristic or the sustainable investment objective	x		
Website reference	reference to product information available on the website	x		
Benchmark (where a product has a designated index as a reference benchmark. If no index has been designated, an explanation on how the objectives/characteristics to be attained should be provided)	explanation of how the reference benchmark is continuously aligned with each E/S characteristic or the sustainable investment objective and the investment strategy	x		
	Website reference	x		
	benchmark (where a product has a designated index as a reference benchmark. If no index has been designated, an explanation on how the objectives/characteristics to be attained should be provided)	x		
	indication whether an index is designated as a reference benchmark, including the input data, the methodologies used to select that data, the rebalancing methodologies, the underlying components, how the index is calculated and the effect of leverage within the index; (may be hyperlink to the benchmark administrator website)		x	
	an explanation of how the index designated as a reference benchmark differs from a broad market index, including at least the performance during the reference period of the sustainability indicators deemed relevant by the financial market participant to determine the alignment of the index with the sustainable investment objective and the sustainability factors referred to in the benchmark statement of the benchmark administrator			x
	a comparison of the performance during the reference period of the financial product with regard to the indicators measuring the sustainability factors of the index (table or graphical)			x
	if the number of investments constituting on average 50 percent of the investments of the index during the reference period is less than 25, the section referred to in point (c) of Article 43 shall contain a list of those investments, in descending order of size, including the sector and location of those investments			x
Products with a CO2 emissions reduction objective	a statement that the reference benchmark qualifies as a CTB/PAB[3] Benchmark	x	x	
	products with a CO2 emissions reduction objective			x
Financial products with underlying investment	summary list of those investment options with a clear distinction between options qualifying as products with E/S characteristics or the sustainable investment objective and options with a sustainable investment objective and cross references to the disclosures required by sectoral legislation	x		
	information provided by those options with a clear indication to which options the information relates to	x		
	summary of information required for periodic report by selected investment that qualify as a product with E/S characteristics or have a sustainable investment objective, with a clear indication to which options the information relates			x

[3] Climate Transition Benchmarks and EU Paris-Aligned Benchmark, as defined in Regulation (EU) 2019/2089 of 27 November 2019

Practical considerations

Investment fund managers ("IFMs") should carefully consider the final RTS but also review, decide and formalise whether and to what extent they have to or wish to comply with the disclosure principal adverse impacts of their investment decisions. Factors to consider include, *inter alia*:

- Whether the funds managed by the IFM qualify as light green, dark green or other funds
- The greater transparency arising from other mandatory requirements applicable to all IFMs such as the establishment of a policy on the integration of sustainability risks in the investment decision-making process and the consistency of such policy with the remuneration policy

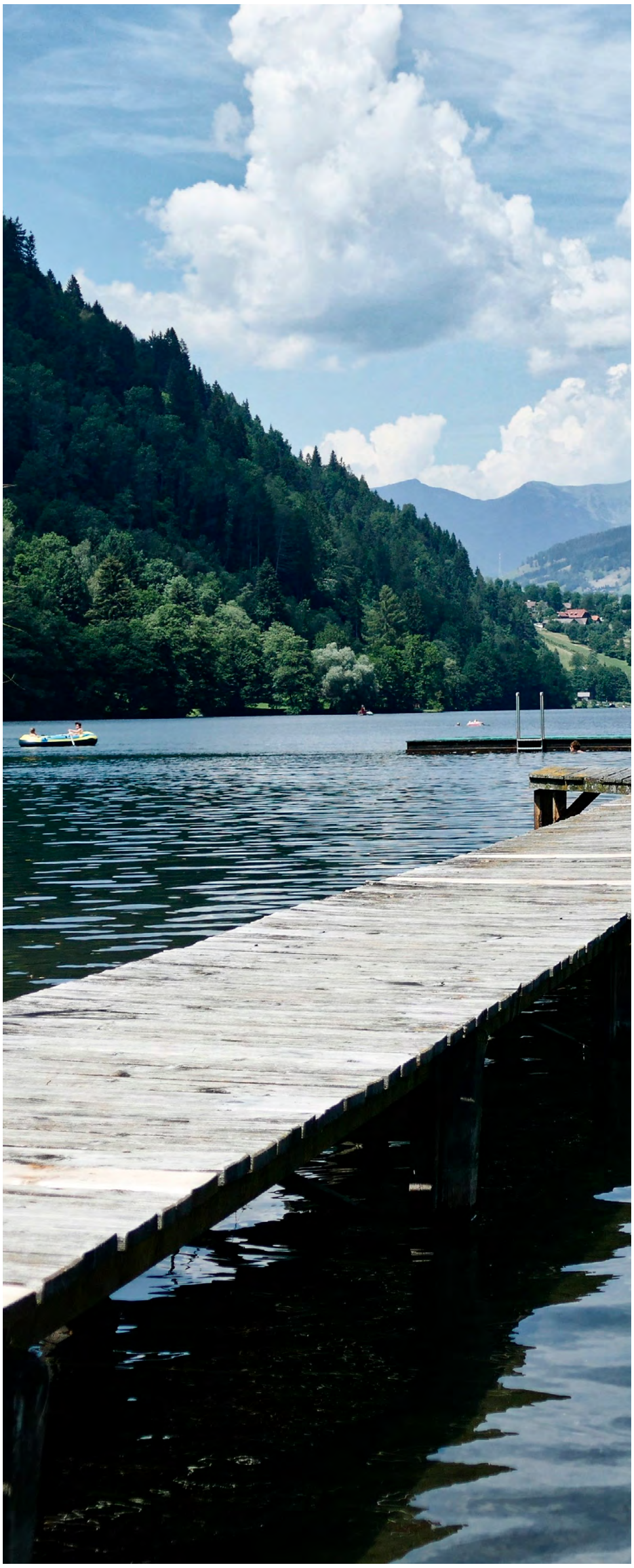
Where they comply with the disclosure of PAIs, a comprehensive action plan should be launched to create or update the policies, the procedures, the data flows, the methodologies, the systems and disclosures which have to be implemented both at entity and product level. Should they decide not to disclose PAIs, IFMs will still need to review their documentation to ensure that the mandatory SFDR requirements which are not covered by these draft RTS are met.

Fund managers should notably:

- Determine whether the products they manage qualify as a light green or dark green product
- Assess how the product promotes E/S characteristics or contributes to a sustainable investment objective
- Establish the list of the sustainability indicators to be used, the data sources, and the methodologies (including the use of benchmarks) for monitoring and reporting purposes
- Prepare disclosures and ensure their consistency with any marketing material

For more information, please visit:

[ESA consultation on draft RTS]



European Public Consultation on the revision of the non-financial reporting directive[1] ("NFRD")

Background

Disclosures of non-financial information by fund managers are set to increase significantly in the future in order to meet the demand from investors and the requirements of the regulation on sustainability disclosures in the financial services sector[2]. Based on the statement that publicly available non-financial information is inadequate for users but also difficult to determine, complex and costly to produce for companies, the European Commission ("EC") launched a public consultation. Stakeholders were invited to provide feedback before 11 June 2020 on the policy options envisaged to address the short comings of the current NFRD regime applicable to Public Interest Entities ("PIEs") which include large listed companies and large banks and insurance companies, listed or not, provided that they have more than 500 employees.

Primary Change

One of the objectives of the revision of the directive is to ensure investors have better access to adequate non-financial information from investee companies to be able to take account of sustainability-related risks, opportunities and impacts in their investment decisions. Going beyond the current approach of non-binding guidelines, the EC explores the endorsement of existing or possible future standards and a broader strengthening of the provisions of the NFRD.

[1] Directive (EU) 2014/95, amending the Accounting Directive (EU) 2013/34
[2] Regulation (EU) 2019/2088

Key Points

The high-level policy options summarised below are being discussed to address current pain points for asset managers.

Issue	Policy option under discussion to address the issue
Mismatch between information provided and information needed by users	▸ More detailed specification of information reported ▸ Use of a reporting standard ▸ Scope extension of the NFRD
Lack of information reliability and comparability	▸ More detailed specification of information reported ▸ Use of a reporting standard ▸ Strengthening provision on assurance of information reported ▸ Strengthening enforcement regime and supervisory convergence
Information is difficult to find/access/use	▸ Clarification and harmonization of information location (management report vs separate report) ▸ Provision of information in a digital/machine-readable format

Stakeholders are invited to provide feedback, *inter alia*, on whether:

- current **NFRD requirements** are sufficient to enable them to meet their own new non-financial information disclosure requirements
- environmental disclosures should be aligned with the six objectives set-out in the **taxonomy regulation**
- any additional **new metrics** (e.g., scenarios, analyses, targets, more forward-looking information, contribution to society) required should be reported
- additional disclosure on **intangible assets** (e.g., intellectual property, software, customer retention, human capital) or related factors should be made
- a **common standard** is needed, if it should contain sector-specific elements and to what extent existing standards and frameworks[3] meet the current NFRD requirement or should be incorporated
- a **simplified standardised approach** is needed to bring proportionality **for Small and Medium Enterprises** and if it should be mandatory or voluntary
- **a contribution to the development of common standard** is needed, and to what extent, from investors, preparers of financial statements, auditors, accountants, civil society representatives, NGOs, academics, European and national public bodies and authorities to ensure connectivity or integration between financial and non-financial information
- an alternative definition of the **materiality principle** or additional guidance is needed in the context of non-financial reporting
- **assurance of non-financial reporting** is justifiable, appropriate[4], dependent on companies reporting against a specific non-financial reporting standard, and if it should be performed based on a common assurance standard
- assurance providers should perform **reasonable or limited assurance engagements** in this respect, if they should assess the company's materiality assessment process, identify and publish the key engagement risks, their response to these risks and any related key observations
- the **costs of** introducing **tagging[5] of non-financial information** would be proportionate to the benefits
- non-financial statements should be included and consolidated[6] in the **management reports** or, in case they are allowed to be published separately, if information should be subject to appropriate supervision, filed in Officially Appointed Mechanisms[7] and published at the same date[8]
- **the scope** of NFRD should be extended to PIEs with more than 250 employees, subsidiaries of parent companies subject to NFRD, large EU companies listed outside the EU, large non-EU companies listed in the EU, other large unlisted entities or all limited liability companies regardless of their size
- banks should be subject to different thresholds since they have larger balance sheets than non-financial corporations

The consultation also aims to gather information on the costs, time and resources associated with the current reporting regime and the uncertainties, pressures, complexities and difficulties faced by the reporting entities.

For more information, please visit:

EC Consultation

[3] Both holistic frameworks (Global Risk Initiative, Sustainability Accounting Standards Board, International Integrated Reporting Framework) or frameworks focusing on a limited set of non-financial issues (recommendation of the Task force on Climate-related Financial Disclosures, United Nations Guiding Principles Reporting Framework, Carbon Disclosure Projects questionnaires, standards of the Carbon Disclosure Standards Board, the Organisation Environmental Footprint and reporting under the Eco-management and Audit Scheme) are considered

[4] Non-Financial reporting is explicitly excluded from the audit scope by art 34 of the Accounting directive

[5] Listed companies are required to submit their annual financial statements in XHTML format, according to European Single Electronic Format ("ESEF") since 1 January 2020 and the XHTML document should be tagged using iXBRL elements specifies, allowing the information to be machine-readable

[6] Non-financial information is also already required in the corporate governance statement

[7] They are out of the legal mandate of the national competent authorities and are not required to be filed in the OAM at the moment

[8] Currently, companies can be allowed by national legislation to publish non-financial information up to six months after the balance sheet date

European Commission report assessing the application and the scope of the AIFMD

Background

Most provisions of the Alternative Investment Fund Managers Directive (AIFMD) have been applicable since mid-2013. The European Commission has been mandated to establish the degree to which the objectives pursued by the AIFMD have been achieved and report to, *inter alia*, any shortcomings impacting investors, alternative investment funds (AIFs) and their managers (AIFMs) as well as financial system stability.

Based on input from various sources and stakeholders, the European Commission provided a report to the European Parliament and the Council on 10 June 2020 including the results of the AIFMD framework assessment and possible areas for improvement.

Primary Change

The report recognises the role of AIFMD in creating an internal EU market, reinforcing the regulatory and supervisory framework and enhancing transparency for both investors and supervisors on AIFM activities. The issues raised in the report mainly relate to distribution aspects, the depositary regime, reporting, supervision, valuation and remuneration rules.

Some responses to certain issues have already been implemented recently or are being subject to consultation processes while further legislative, regulatory or supervisory actions might be expected for the others, most probably by the first quarter 2021.

Key Points

Supervision

Shortcoming reported	Legislative/regulatory action
Lack of clarity, harmonisation of the NCAs'[1] possibility to impose leverage limits or suspend redemptions in the public interest	ESMA[2] consultation on guidance to assess leverage risk and operationalisation of leverage limits under Art.25 of AIFMD
Lack of cooperation between NCAs in cases where suspensions of redemption have cross-border implications	May be subject to further action

Valuation

Shortcoming reported	Legislative/regulatory action
Combined use of internal and external valuers is excluded and there is uncertainty around the liability of external valuers, determined under national law	May be subject to further action

Depositary

Shortcoming reported	Legislative/regulatory action
Lack of clarity in situations where AIFMs use tri-party collateral management	May be subject to further action
Lack of clarity where CSDs[3] act as custodians	May be subject to further action
Concentration risk due to the lack of a depositary passport in smaller markets	May be subject to further action

Reporting

Shortcoming reported	Legislative/regulatory action
Reporting overlaps with other sectorial law requirements	May be subject to further action
Missing data reporting on leveraged loans, CLOs[4] and indirect linkages between banks and non-banks	May be subject to further action
Adjustments may be required on leverage calculation methods	May be subject to further action
Lack of harmonisation of forms, processes and central management of databases	May be subject to further action

Remuneration

Shortcoming reported	Legislative/regulatory action
Lack of harmonisation of remuneration rules with regimes provided in banking legislation (smaller institutions and small variable amounts may be exempted from payment deferral[5])	Directive 2019/878[5], providing that AIFMs belonging to a corporate group in scope of CRD only have to apply AIFMD rules on remuneration May be subject to further action

[1] National competent authorities
[2] European Securities and Markets Authority
[3] Central securities depositaries
[4] Collateralised loan obligations
[5] Directive 2019/878 of 20 May2019 amending directive 2013/36/EU (CRD IV)

Distribution

Shortcoming reported	Legislative/regulatory action
Efficiency of the EU AIFM impaired by national marketing rules, particularly detrimental for smaller AIFMs unable to bear compliance cost	Cross-border Fund Distribution package Directive (EU) 2019/1160 Regulation (EU) 2019/1156
Limitation of AIFM passport to marketing to professional investors	May be subject to further action
AIFs offered to retail investors predominantly through banks and insurance companies promoting mainly in-house funds	May be subject to further action
Investors unable to access non-EU AIFs in member state without NPPR	May be subject to further action
Un-level playing field created by NPPR between non-EU AIFMs subject to lighter requirements and EU AIFMs	May be subject to further action
National barriers encountered by private equity fund managers who do not adhere to AIFMD or EuVECA[6] regulation	Regulation (EU) 2017/1991 opening up the use of the designation EuVECA and expanding investment parameters May be subject to further action

The report confirms there was no evidence found that the AIFMD was not technology neutral or preventing the automation of operations or the application of innovative technologies. However, further regulatory development or supervisory actions are not excluded to respond to new technological developments.

Practical considerations

The overall assessment and potential outcomes may present opportunities in the longer term:

- to reduce overly burdensome requirements of the current framework, notably in terms of cross-border distribution and reporting
- to foster cross-border distribution of AIFs to non-professional investors
- to set more flexible remuneration rules
- to enhance legal certainty around depositary, prime broker and CSD liability
- to have a more robust valuation process

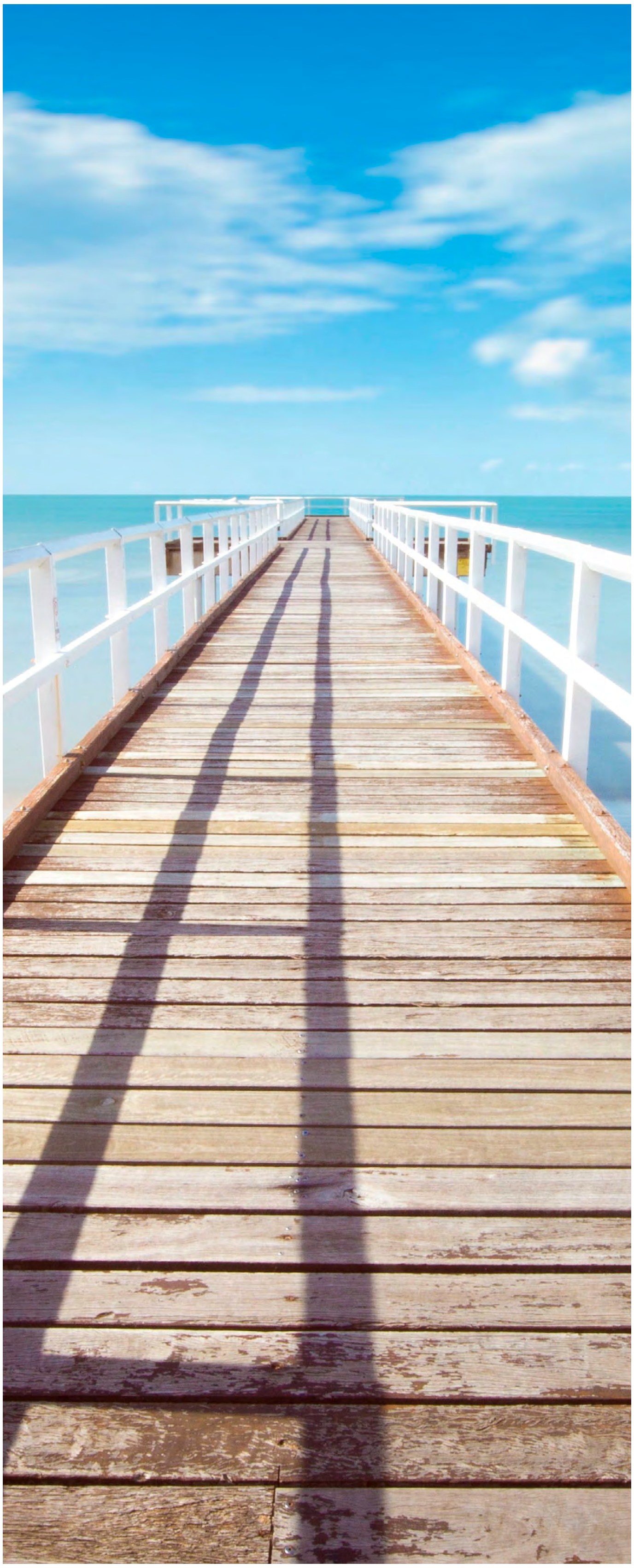
However, increased scrutiny and additional or revised reporting for supervisory purposes could generate additional compliance costs.

For more information, please visit:

European Commission Report

[6] The European Venture Capital Fund Regulation, 345/2013, as amended

European Systemic Risk Board considerations regarding the Alternative Investment Fund Manager Directive



Objective

The AIF market represents 40% of the EU fund market and is due to grow further with the Capital Market Union's ambitious target to increase non-bank financing. In a letter issued on 3 February 2020, the European Systemic Risk Board ("ESRB") provided the European Commission with a list of shortcomings identified in the Alternative Investment Fund Manager Directive ("AIFMD") from a financial stability perspective. Although other stakeholders' views will be expressed and might conflict with ESRB recommendations, they are likely to influence the legislative proposals the European Commission ("EC") is mandated to make to the European Parliament and Council in the context of the AIFMD review conducted this year.

Primary Change

Building upon ESRB experience with the scope and application of AIFMD, recommendations aim (i) to improve the suitability of the reporting framework for monitoring systemic risk, (ii) to operationalise existing macro prudential policy instruments, and (iii) to improve the macroprudential policy framework.

Key points

Reporting framework

ESRB outlined the following considerations:

- **Legal Entity Identifier** should not be an optional item in AIFM reporting template. Such inconsistency limits the understanding of complex group structures and the interaction with other regulatory reporting such as under EMIR or SFTR.
- The approach to **fund classification** should be revised to better reflect the type of funds registered as AIFs and where the "Other" category is reduced in size.

- A **more complete portfolio breakdown**, using international identifiers (e.g. ISIN, LEI) and going beyond current reporting of aggregate holdings and top five instruments, would enhance systemic risk analysis.
- The **geographical breakdown** of investment exposures by asset classes, investors, counterparties and sponsorship arrangements could be reported at country level rather than at continental level in order to allow for a more comprehensive assessment of potential contagion risks.
- AIFMD reporting should provide sufficient data to enable **computation of leverage** by national competent authorities ("NCA") in order to facilitate comparisons and data quality assessments. Reporting of **additional metrics** capturing potential losses and liquidity demands stemming from leverage would facilitate identification of vulnerabilities.
- Reporting of the **liquidity** management tools that are available to fund managers and under which conditions. The objective is to allow supervisors to better understand contagion risk in crisis scenarios. The measurement of the liquidity of investments and investors' ability to redeem their shares/units should be harmonised and more objective.
- The **reporting frequency** should be harmonised and the lag for data provision could be reduced in order to improve timely monitoring of risks. The ESRB also suggests to build upon the EC's recent fitness check to align further data reporting requirements and improve data quality.
- Access to AIFMD reporting datasets should be granted to all ESRB member institutions with a financial stability mandate.

Operationalisation of existing policy instruments

In order to mitigate the risk of regulatory arbitrage, the ESRB:

- reiterates the recommendation made to ESMA on 30 April 2018 to operationalise **leverage limits** by providing guidance on how NCAs should apply article 25(3) AIFMD. ESMA has launched a consultation on this topic on 27 March.
- suggests to define **"public interest"** in the context of the power granted to NCAs to suspend redemptions in the public interest provided for by article 46(2) AIFMD, with the objective of helping NCAs to consider this legal instrument as a macroprudential tool.
- calls for the extension of the **liquidity management tools** available across Member States.

Further policy proposals

The ESRB suggests that IOSCO's ongoing peer review on liquidity risk management should contribute to the reflection of policymakers on the appropriate **alignment between portfolio assets and redemption terms**.

Practical considerations & next steps

The European Commission provided a report to the European Parliament and the Council on 10 June 2020 (see also Page 25 of this publication). It should be followed by a consultation and the publication of a legislative proposal in the first quarter of 2021.

Development of additional metrics (e.g. leverage) or reporting fields (e.g. exposures) would drive significant compliance costs across the alternative investment fund value chain. Increasing the frequency of reporting would also bring additional burden and costs, in particular for smaller firms.

It is likely that the fund industry will advocate for progressive, technical updates rather than the introduction of new reporting methodologies and requirements during the consultation process.

Implementation of the public interest suspension could make the risk of suspension more difficult to quantify since interventions imposed by the supervisors might be difficult to anticipate by investors. Public interest needs also to be delineated where institutional investors (such as pension funds and insurance companies which are mandated to manage the interests of a significant portion of the "public") are investors in a fund.

For more information, please visit:

ESRB letter

ESMA consultation on guidelines on Article 25 of AIFMD: Assessment of leverage-related systemic risk and leverage limits

Background

In response to a recommendation from the European Systemic Risk Board[1], ESMA has issued a consultation on proposed guidance aimed to improve assessment of leverage-related systemic risk and operationalisation of risk limits by national competent authorities ("NCA"). The objective is to identify as early as possible and mitigate potential spill-over effects, such as the amplification of price movements, the contagion to the banking sector and the interruption in direct credit intermediation, resulting from the funds deleveraging during a financial crisis. The closing date for submissions to ESMA was 1 September 2020.

Primary Change

While leverage data is already reported by AIFMs, the proposed guidelines promote a consistent approach to be taken by NCAs when assessing whether the conditions for imposing leverage limits are met. The guidelines under consultation include a common minimum set of indicators, of which calculation instructions are based on the currently reported data as well as qualitative and quantitative descriptions of the interpretation of the indicators. The guidelines also draw a macroprudential framework with a description of the leverage limits and the principles to be considered when calibrating and imposing leverage limits.

Key Points

Assessment of leverage-related systemic risk

The risk assessment should be performed by NCAs on a quarterly basis and follows the two-step approach described below:

Step 1: Level, source and different usages of leverage

All AIFs

- Gross leverage
- Commitment leverage
- Adjusted gross leverage
- Financial leverage
- Regulatory AuM

Indicators →

AIFs qualifying for step 2

A. AIFs employing leverage on a substantial basis (commitment leverage > x3)
B. AIFs employing leverage, but not on a substantial basis and whose regulatory AuM > EUR 500mn
C. Other AIFs employing leverage, whose use of leverage differs significantly from:
- The median or average value of leverage of AIFs of the same type
- The AIF's historical median or average of leverage value

Step 2: Assessment of leverage-related systemic risk

AIFs in scope of in-depth assessment

- Net exposure
- Market footprint on the underlying market
- Investor concentration
- Liquidity profile
- Share of less liquid assets
- Potential liquidity demands resulting from market shock
- Other potential liquidity demands
- Linkages to financial institution via investments
- Counterparty risk
- Linkages to financial institutions via investor base
- Fund investments in credit instruments of non-financial institutions

← *Indicators*

AIFs/AIFMs possibly in scope of leverage limits

- AIF(s) whose deleveraging could have a market impact (size)
- AIFMs whose fire sales could contribute to a downward spiral in the prices of assets in a manner that threatens such assets' viability
- AIF(s) whose exposures could constitute an important source of market, liquidity or counterparty risk to a financial institution (spill-over)
- AIF(s) which are funding the real economy whose deleveraging could cause interruption in direct credit intermediation

Leverage limits imposed by NCAs

When deciding to impose leverage limits, NCAs should consider.

I. risks posed by funds according to their type and risk profile as defined by the risk assessment

II. risks posed by common exposure. Where a group of funds of the same type and similar risk profiles may collectively pose leverage-related systemic risks, NCAs should apply similar limits to all funds in that group

NCA should carefully implement leverage limits, both in terms of timing and phasing in and out. Limits should be:

I. maintained as long as the risks do not decrease

II. released when the change in market conditions or fund behaviour stop being procyclical, when measures have been implemented to limit the build-up of risks

III. implemented progressively in a way which avoids procyclicality

IV. cyclical limits, where appropriate, in order to dampen the build-up and materialisation of risks in the upswing and downswing of the financial cycle

When setting the level of leverage limits, NCAs should assess their effectiveness in addressing the relevant systemic risks.

I. when risks are directly related to size, leverage limits should reduce the risks accordingly

II. when risks are partially related to size and leverage limits are not sufficient, NCAs should consider imposing other restrictions on investment policy, redemption policy or risk policy

III. when leverage limits may temporarily result in an increase of risks, NCAs should impose restrictions on the proportion of certain assets to avoid sales of lower risk assets to meet the new requirement. In order to address liquidity mismatches, NCAs should impose a reduction of the frequency of redemptions or impose notice periods

NCAs should evaluate the efficiency of leverage limits by taking into consideration the:

I. proportionality of the limits to ensure that the sector remains able to provide valuable services to the economy

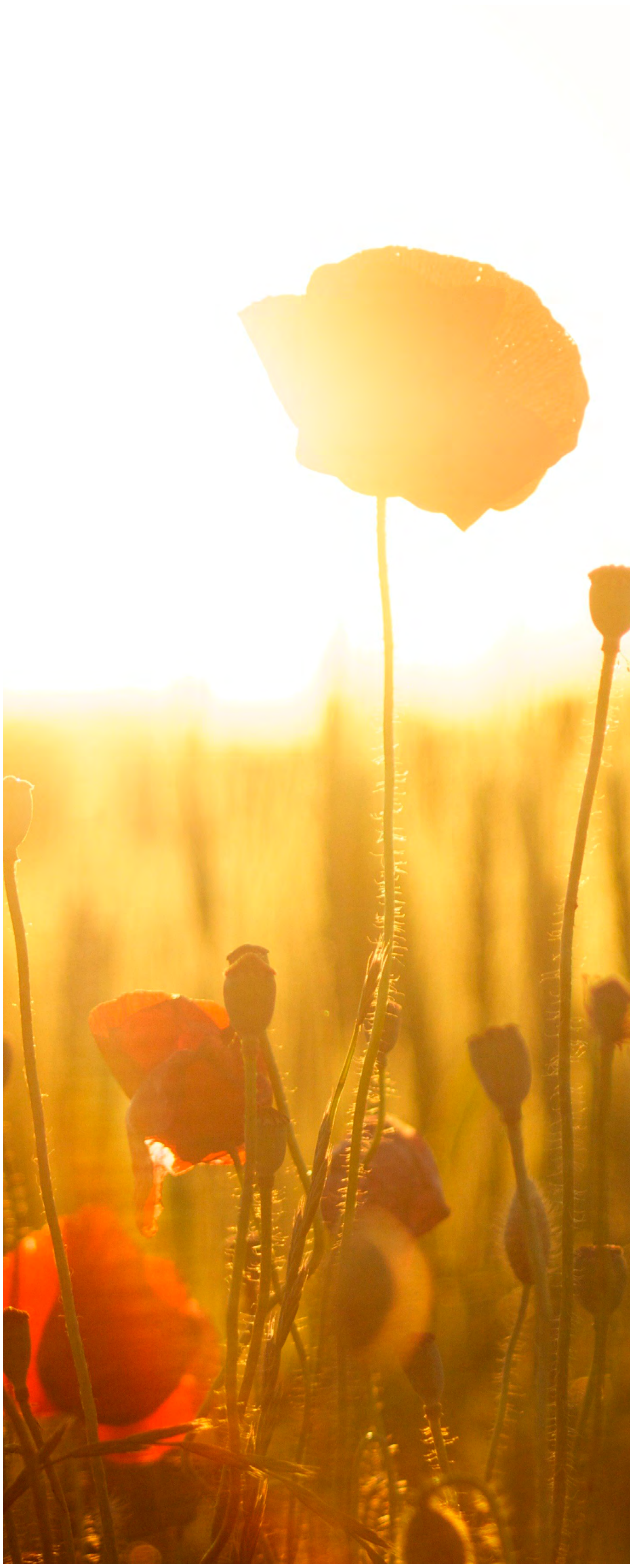
II. robustness to gaming and arbitrage

Practical considerations

The ESMA guidelines under consultation aim at providing NCAs enhanced supervisory tools to assess the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system, and impose macroprudential leverage limits on AIFs where and when needed to prevent leverage from contributing to procyclicality, especially in times of economic cycle-downturn or increase in market volatility.

On the one hand, cyclical limits could dampen the implementation of certain investment strategies and packages of measures could reduce the flexibility left to managers to adjust their fund strategies in case of supervisory intervention. On the other hand, the lack of visibility on the negative spill-overs which could result from leverage used by other AIFs may limit the ability of managers to anticipate systemic risks caused by collective behavior eventually detrimental to all financial market participants.

Fund managers employing leverage should carefully consider the criteria, indicators and methodologies to be used by NCAs for the purpose of imposing leverage limits. Notably they should integrate contingency plans in their investment policy, redemption policy and risk policy in order to retain control of the way they conduct their activities to the largest extent possible, should a leverage limit be imposed.



For more information, please visit:

[ESMA Consultation]

ESMA recommends priority topics in AIFMD review

Background

On 18 August 2020, ESMA wrote a letter to the European Commission in advance of the commission's review of Directive 2011/61/EU, the Alternative Investment Fund Managers Directive (AIFMD), to highlight some areas of AIFMD where improvements could be made.

ESMA notes that the AIFMD has provided a solid framework for alternative investment funds in Europe in particular for the supervision of alternative managers in the EU, which in turn provides reassurance to investors and the world that alternative investment funds are grounded in a credible regulatory framework.

ESMA also acknowledged that since the original publication of AIFMD in 2011 ESMA has had significant exchanges with National Competent Authorities on their practical experience in supervising firms in accordance with the rules. ESMA notes that this has led to them observing many areas of the framework that could be improved during the impending review, including those highlighted by Covid-19.

In the letter, ESMA share the key topics of the AIFMD review where they see the need to consider amendments to the framework. ESMA point out that the suggestions also require consideration of changes to the UCITS framework.

Key points

ESMA makes recommendations across 19 areas of AIFMD, including the harmonisation of AIFMD and UCITS, delegation and substance including third country delegation, liquidity management, leverage, reporting, harmonising the supervision of cross border entities, rules for reverse solicitation and more. Overall the proposals made by ESMA could lead to significant changes to the AIFMD framework with a significant impact on how alternative fund managers operate. The proposals could also have an impact on UCITS.

Practical considerations

The letter provides insight into ESMA's views on the areas of AIFMD that could be improved and will likely factor into the European Commission's review of the directive. Fund managers should make themselves aware of the proposals and consider the impact on their current operating model and strategic decision making.

For more information, please visit:

https://www.esma.europa.eu/press-news/esma-news/esma-recommends-priority-topics-in-aifmd-review

ESMA Guidelines on Performance Fees in UCITS and certain types of AIFs

Background

The value for money delivered by actively managed funds has come under increased scrutiny over recent years. While requirements are becoming stricter in terms of disclosure of performance against benchmarks, ESMA released its Guidelines on performance fee in UCITS and certain types of AIFs on 3 April 2020. The guidelines are more prescriptive than the principle-based 2016 IOSCO good practices applied by most national competent authorities, notably in terms of consistency between the performance fee model used and the fund's investment objective, where a fund is managed by reference to a benchmark index, or as regards to the minimum performance reference period.

Scope

All UCITS are in scope of the guidelines. The guidelines will also apply to open-ended AIFs marketed to retail investors. It should be noted that RIAIFs come within the scope of ESMA's Guidelines, unlike the Central Bank of Ireland's (CBI) rules on performance fees for UCITS products.

Primary Change

In May 2019, the CBI published its rules on performance fees for UCITS products and these generally align with ESMA's Guidelines, however, the Guidelines are more prescriptive and fund managers therefore need to consider what additional measures may need to be introduced in order to comply with them. For example;

- Guideline 1 contains an explicit list of elements which must be included in the performance fee calculation method which are not included in the CBI rules;
- Guideline 2 contains a broad requirement for a fund manager to ensure that the performance fee model is consistent with the fund's investment objectives, strategy and policy. In contrast, Regulation 40 of the CBI rules only requires consistency with the fund's investment objectives where performance fees are payable on the basis of out-performance of an index; and
- Guideline 5 requires more prescriptive disclosures to be included in the prospectus including detailed examples of how performance fees are calculated. In addition, the ESMA Guidelines introduce new disclosure requirements in the KIID and annual and half-yearly reports.

Key Points

ESMA's report comprises five guidelines:

1. The calculation of a performance fee should be verifiable and the method should include at least:
    - a performance reference indicator, i.e. an index, a high-water mark ("HWM"), a hurdle rate or a combination
    - the crystallisation frequency and the crystallisation date
    - the performance reference period
    - the performance fee rate
    - the calculation methodology
    - the computation frequency which should match with the NAV calculation frequency

    Performance fees should be proportionate to the fund's performance. Artificial increases arising from new subscriptions should not be taken into account when calculating fund performance.

    Managers should be able to demonstrate that managers' and investors' interests are aligned.

    It is permissible to calculate performance fees on a single investor basis.

2. The performance fee model implemented must be and remain consistent with the fund's investment objectives, strategy and policy.
    - The manager should implement and maintain a periodic review process to ensure that the performance fee model is consistent with the fund's investment objectives, strategy and policy
    - As a general principle, a fund which is managed by reference to a benchmark, or where the fund's portfolio does not deviate materially from a benchmark index portfolio, should use the same benchmark in the performance fee model
    - Where the fund is managed by reference to a benchmark, but the fund's holdings are not based upon the holdings of the benchmark index, the benchmark used for the calculation of the performance should be consistent with the benchmark used for the portfolio composition, according to a non-exhaustive list of consistency indicators:
        - Expected return
        - Investment universe
        - Beta exposure to an underlying asset class
        - Geographical exposure
        - Sector exposure
        - Income distribution of the fund
        - Liquidity measures (e.g. daily trading volumes, bid-ask spreads, etc)
        - Duration
        - Credit rating category
        - Volatility and/or historical volatility

- Performance should be calculated net of all costs but may be calculated without deducting the performance fee as long as this would be in the investor's best interest
- If the reference indicator changes during the performance reference period, the performance should be calculated by linking the benchmark index that was previously in force until the date of the change and the new reference indicator used afterwards.

3. Crystallisation frequency
    - It should allow for the alignment of the managers "and the investors" interests
    - It should not be more than once a year, except for the high water-mark model or high-on-high model where these cannot be reset during the whole life of the fund and fulcrum fee model and other models which provide a symmetrical fee structure
    - It should be the same for all share classes of a fund with a performance fee
    - Performance fee should crystallise in due proportion in case of closure/merger of funds or upon investor's redemption. However, where both merging and receiving funds are managed by the same manager, crystallisation should be presumed to be contrary to investors' best interests, unless justified otherwise by the manager
    - Generally, it should coincide with the end of the financial year of the fund

4. Loss recovery
    - Any loss or underperformance previously incurred during the performance reference period should be recovered before a performance fee becomes payable
    - A performance fee could be payable in case the fund outperformed the benchmark but had a negative performance
    - The performance reference period should be, as far as possible, consistent with the recommended investor holding period. Where the performance reference period is shorter than the whole life of the fund, it should be set equal to at least five years (on a rolling basis for funds using a HWM)

5. Disclosures
    - Investors should be adequately informed about the performance fees and their impact on return
    - All ex-ante documents (prospectus, KIID, marketing documents) should clearly set out all information necessary to understand the performance fee model and the computation methodology, including the main elements and parameters, the payment date. Concrete computation examples should be included in the prospectus
    - Where a performance fee model uses a different but consistent benchmark, the explanation of the choice of benchmark should be included in the prospectus
    - Where a performance fee is payable in times of negative performance a prominent warning must be included in the KIID
    - Where applicable the KIID and the prospectus should display the name of the benchmark index and disclose past performance against it
    - The annual and semi-annual reports and any other ex-post information should indicate for each relevant share class the amount of performance fees and the percentage of the share class NAV they represent

Timeline

The CBI must notify ESMA of its intention to comply within two months of the date of publication of the official translations of the Guidelines into all EU official languages. At the end of this period the Guidelines may become immediately applicable in Ireland for all in scope funds introducing a performance fee after the application date. Managers of funds with a performance fee existing before the application date should comply by the beginning of the financial year following six months from the application date.

Given that the CBI's policy is to comply in full with ESMA guidelines and opinions, it is expected that the CBI's rules on performance fees will need to be amended or supplemented in order to comply with the Guidelines.

Practical Considerations

Fund managers may need to review the way they design the charging structure of their funds. On the one hand, the introduction of a minimum performance reference period, combined with tighter requirements in terms of benchmark index selection and disclosure could incentivise managers to increase their fixed remuneration. On the other hand, the comparison with cheaper, passively managed funds should limit such an increase to maintain the attractiveness of actively managed products.

In practice, a benchmark index used in a performance fee model may need to be changed to align with the benchmark index used for performance objective or portfolio composition. In the case where a fund is managed by reference to a benchmark but the fund's holdings are not based upon the holdings of the benchmark index, a different benchmark may still be used in the performance fee model, but specific governance arrangements and processes will be required to demonstrate the ongoing consistency of that benchmark versus the prescribed consistency indicators.

Investor Outcomes: The supervision of costs in UCITS and AIFs

In June the European Securities and Markets Authority (ESMA) published a non-binding supervisory briefing on fund costs in UCITS and AIFs.

The guidance builds on the UK's Value Assessments, enshrined in their Senior Manager and Certification Regime. It is likely that the Central Bank of Ireland (CBI) will regard the ESMA guidance as best practice; it builds on the CBI's focus on Investor Outcomes, is a natural extension of the CBI's CP86 Organisational Effectiveness thinking and will likely dovetail with the upcoming Senior Executive Accountability Regime.

It is worth noting that a number of Irish Fund Management Companies are already exploring whether to provide a voluntary attestation, perhaps in response to UK distributor pressure and/or to ensure that standards of governance across a firm's UK and Irish fund ranges are consistent.

What can we learn from the UK's experience with Fund Value Assessments?

1. *What are fund value assessments and why have they been introduced?*

   UK consumers spend over £1bn each year buying investment management services from UK Authorised Fund Managers (AFMs). In its 2018 Asset Management Market Study (AMMS), the FCA reported that market forces in the industry are weak, leading to many overpriced and low-quality products. From the end of September 2019, AFM directors – known as Authorised Corporate Directors or ACDs – must now publicly attest that their funds offer value to investors or take corrective action if any do not.

2. *What is the role of ACDs in fund value assessments?*

   The FCA sees fund value assessments as a catalyst for major change and not a 'tick box' exercise. The ACD must pay greater attention to the outcomes delivered to their customers. The new rules reinforce an existing duty to act on behalf of customers; and value attestations need to demonstrate high standards of board review and challenge. AFMs need to show they are trustworthy as well as competitive and the renewed focus on the agency responsibilities of AFMs is accompanied by new standards for personal accountability and independence for directors. This means that AFMs must change from supportive subsidiaries of asset managers into challenging clients.

3. *What role does competition play in fund value assessments?*

   The FCA observed that one objective of the AMMS is to boost competition between firms. AFMs oversee the spending of consumers' money and must now compete on the quality, cost and comparable prices of all services purchased on behalf of investors. Some services are highly standardised such as custody and fund accounting where AFMs need to show costs and service standards align with market norms. Others are highly differentiated such as customer support, the provision of advice and investment management - here asset managers must bring out what makes them different. Charging market prices does not amount to delivering value; what matters is how AFMs differentiate the services they provide.

4. *What effect will fund value assessments have on different share classes?*

   The FCA found that new customers often pay less for the same service than established consumers; and that retail customers often pay more for the same investment service than comparable institutional customers. AFMs must ensure all services charged to customers pass the quality, cost and comparable market price tests discussed above: and the process of defining competitive features requires AFMs to justify any differential in costs; and address any that cannot be justified.

5. *Why will fund value assessments lead to product rationalisation?*

   As agents acting for investors, AFMs must clearly define and describe the services offered to their investors. The FCA has identified major shortcomings in AFM's descriptions of services, highlighting some as vague or unmeasurable and others as simply inaccurate. AFMs should now ask for regular confirmation from asset managers that each fund accurately describes an investment service that meets identified consumer needs. Over time, in response to changing circumstances and markets, creativity and innovation has resulted in a proliferation of funds and share classes. Because of the attestation requirements, asset managers should now provide AFMs with coherent product strategies which, when combined with an assessment of product line competitiveness, will result in rationalisation of many product lines. In addition, there are also increasing commercial drivers for rationalisation.

6. *How should AFMs assess economies of scale?*

Well-established rules govern conflicts of interest between the asset manager and the customer; and the AMMS now requires AFMs to consider how efficiency savings from growing funds should be shared between customers and asset managers. At present, many asset managers argue they currently lack effective mechanisms to allocate costs to specific funds and therefore cannot accurately assess economies of scale. Pending resolution of this data problem, AFMs can still assess whether the allocation of risk and reward between consumers and the asset manager is fair - one interim solution is to measure, over a time period highlighted in the fund objectives, what proportion of the total return generated by a fund is allocated to the consumer and what proportion the industry keeps as fees and charges. If the split disproportionately favours industry, some adjustment may be appropriate.

7. *What sort of information should a value attestation contain?*

The attestations are aimed at consumers to help stimulate competition between AFMs. AFMs should not treat them as a tick box checklist and can go further to highlight competitive features or the quality of governance arrangements. Comments from the FCA, early in the process, suggest that some of the initial fund value assessments may not have delivered what the FCA expects. While AFMs who have already published may simply be asked to resubmit better work next year, the remainder should not bank on similar forbearance. We have identified four topics that fund value attestations might usefully address:

1. A description of the fund (or range if a composite report) setting out why the AFM considers it competitive.
2. A description of the governance process setting out how the AFM as a trustworthy agent is acting in consumers best interests.
3. A report summarising the status of the fund (or fund range) relative to the FCA criteria, perhaps in the form of a RAG report.
4. A summary of the actions the AFM is taking to address any problem issues identified in the attestation process.

Firms may also usefully supplement the attestation with additional data on key points such as fund performance, fund size, fees etc.

8. *What will be the long-term impact of value assessments?*

Assessments of value are a harbinger of structural change for the UK funds industry and beyond. The first stages feel bureaucratic as AFMs recruit independent directors, request reports on value from asset managers and prepare public attestations. As a result of value assessments, asset managers have begun to address cases of poor value, in some cases reducing near term revenues. But looking forward, it is likely that competition to deliver value will require highly differentiated offerings, improved service levels and lower prices, and delivering these will need new business models with clear external propositions to customers and enhanced operational efficiency.

With the delegated model again under scrutiny from ESMA, and in order to get ahead of this guidance, it would be prudent to be able to evidence that your existing (delegated) operating model delivers both challenging oversight of the investment managers to the funds and positive investor outcomes. We'd be happy to share our learning gained from assisting UK AFMs put in place their Value Assessment processes – please reach out if you have a question.

AML Update

Implementation of the 5th Anti-Money Laundering Directive and the Future of AML Regulation

Financial crime across the globe has risen as a result of the uncertainty caused by the Covid-19 pandemic. Whilst regulators have shown some flexibility during this unprecedented time, there has also been increased focus on high risk issues stemming from the crisis. Consequently, regulators around the world have stressed the importance of remaining vigilant, now more so than ever.

5th Anti-Money Laundering Directive

In the meantime, and against the backdrop of its open consultation on the future of AML regulation in Europe, the European Commission fined Ireland (along with Romania) for its failure to fully implement the 5th Anti-Money Laundering Directive. The fine was announced by the European Court of Justice in July, some 6 months after the January 2020 deadline for the implementation of the Directive. Although legislation to transpose the remainder of the Directive has been drafted, it remains to be seen when the it will be fully implemented in the state. To date, the only aspect of the Directive that has been implemented is the requirement to bring greater transparency with respect to the beneficial ownership of corporate and certain other legal entities.

The Directive also aims to:

- Extend the list of "designated persons" covered by the AML regime to include art dealers, tax advisors, letting agents and crypto currency exchanges;
- Increase the circumstances where enhanced customer due diligence must be and introducing additional CDD measures prior to establishing a business relationship;
- Ceasing the anonymity of virtual currencies such as bitcoin and requiring virtual currency exchange platforms to exercise CDD requirements with such exchanges;
- Creation of national centralised automated mechanisms to identify holders of bank and payment accounts and safe-deposit boxes;
- Improve the identification of politically exposed persons ("PEPs"); and
- Give expanded powers to EU financial intelligence units to request information from any firm

European Commission's Action Plan on the Future of AML Regulation

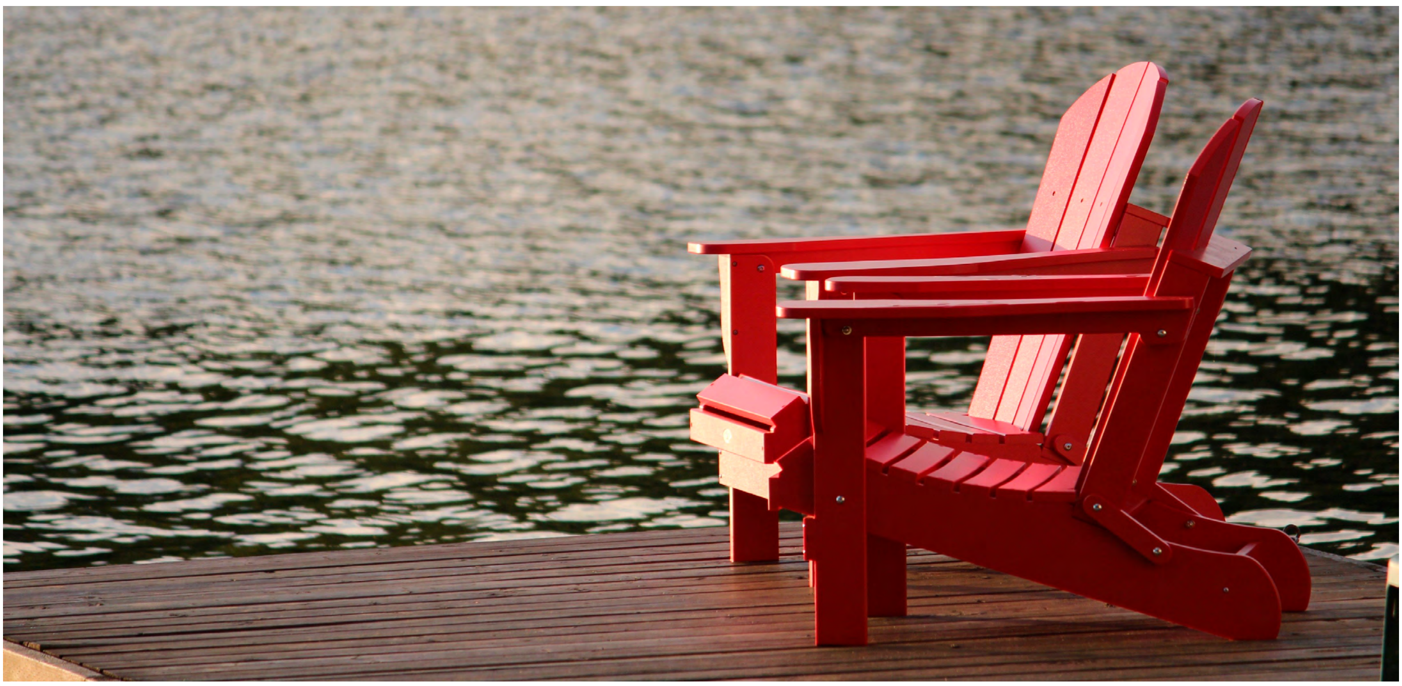
Despite an extensive and well-established regulatory regime, there is an increasingly held view that the current industry approach to AML and the Countering the Financing of Terrorism (CFT) is inadequate. Financial service providers are spending millions, but still getting it wrong. A number of high-profile AML-related cases in Europe in the last two years have prompted European legislators and regulators to reassess financial crime regulation. In May, the Commission published a six-point action plan aimed at further strengthening the regime and narrowing the scope for 'weak links'. The action plan covers the following areas:

- Effective implementation of existing rules
- A single EU rulebook
- EU-level supervision
- A support and cooperation mechanism for financial intelligence units
- Better use of information to enforce criminal law
- A stronger EU in the world

While the prospect of a consolidated rulebook and harmonised standards has considerable appeal for large, multi-national financial service providers currently operating under nuanced regimes in member states, there are some concerns that increased harmonisation will fail to adequately address the circumstances of individual member states. The consultation window for the action plan closed in July and the Commission has indicated that it intends to publish its proposed course of action in early 2021.

Central Bank of Ireland

The Central Bank published its own submission in response to the Commission's action plan, welcoming its aims and providing measured commentary on the specific points laid out in the Action Plan. In the interim, the Central Bank has continued it supervisory agenda, with inspections activity continuing unabated through 2020, switching quickly to remotely based 'on-site' inspections in March. The Central Bank's inspections reflect its prioritisation of risk assessment and transaction monitoring, as highlighted by Derville Rowland when she laid out the CBI's 2020 regulatory priorities last January.



Update on distribution and third-country investment

ESMA consults on standardised information to facilitate cross-border funds distribution

On 31 March 2020, the ESMA issued a consultation paper on the standard forms, templates, and procedures that National Competent Authorities (NCAs) should use to publish information on their websites to facilitate cross-border distribution of funds.

The deadline for providing comments was 30 June 2020.

ESMA invites external stakeholders and interested parties to comment on implementing technical standards (ITS) regarding:

- the determination of standard forms, templates and procedures for the publication and notification that NCAs are required to make in relation to national provisions concerning marketing requirements applicable within their jurisdictions (article 5(3) of Regulation (EU) 2019/1156 of 20 June 2019)
- the specification of the information to be communicated, as well as the standard forms, templates and procedures for the publication and notification that NCAs are required to make in relation to national provisions concerning fees and charges levied by them in relation to activities of AIFMs, EuVECA managers, EuSEF managers and UCITS management companies (article 10(3) of Regulation (EU) 2019/1156 of 20 June 2019)
- the specifications of the information to be communicated, as well as the standard forms, templates and procedures for communication of the information by the NCAs which is necessary for the creation and maintenance of the central database on cross-border marketing of AIFs and UCITS, and the technical arrangements necessary for the functioning of the notification portal into which each NCA shall upload all documents necessary for the creation and maintenance of such central database (article 13(3) of Regulation (EU) 2019/1156 of 20 June 2019)

ESMA will consider the feedback it receives to this consultation and expects to publish a final report by 2 February 2021.

Your EY contacts

Lisa Kealy
Wealth and Asset Management
Sector Leader
+353 1 221 2848
Lisa.Kealy@ie.ey.com

Paul Traynor
Wealth and Asset Management
Consulting Leader
+353 1 425 5121
paul.traynor@ie.ey.com

Dean Phillips
Wealth and Asset Management
Associate Partner, Alternatives
+353 1 221 2617
dean.phillips@ie.ey.com

Muntasir Khaleik
Wealth and Asset Management
Director, ESG
+353 1 2212 735
Muntasir.Khaleik@ie.ey.com

Ailbhe MacManus
Wealth and Asset Management
Director, Alternatives
+353 1 221 2023
ailbhe.macmanus@ie.ey.com

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