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// ASSET MANAGEMENT & INVESTMENT FUNDS

Asset Management & Investment Funds Update

February 2022

Key Dates & Deadlines: Q1 / Q2 2022

DATE	SOURCE	SUMMARY	ACTION/IMPACT
1 February		CSDR Settlement Discipline Regime (**SDR**) in effect. The controversial mandatory buy-in rules are to be de-coupled from the rest of SDR (settlement fails reporting and cash penalties) and ESMA issued a 'no-action' letter on 17 December 2021 advising NCAs not to prioritise supervisory actions on the application of the buy-in regime. See here for further details.	• Engagement with depositaries should be prioritised to agree processes for debiting/crediting SDR cash penalties for settlement fails. • Operational procedures and contractual arrangements, including service level agreements may require review to take account of SDR cash-penalties process agreed with depositary.
3 February		ESMA Guidelines on Marketing Communications in effect. See here for further details.	Review UCITS and AIF marketing materials for compliance with the guidelines for identifiability; equality of risks and reward descriptions and clear, fair and not misleading disclosures.
18 February		End of Central Bank consultation on macroprudential measures for property funds. See here for further details.	Consider responding to consultation on leverage and liquidity measures for property funds before the end of the consultation period.
3 March		Feedback period for Commission's AIFMD Review proposal published on 25 November 2021 ends. See here for further details.	Consider responding to consultation on legislative proposals for amendments to the AIFMD and UCITS regimes before the end of the consultation period.
31 March		Central Bank deadline for completion of compliance review by MiFID firms	Firms providing portfolio management and advisory services (including UCITS managers and AIFMs with

		with client suitability rules. See here for further details.	MiFID top-up licences) should review suitability practices against CSA findings and ensure compliance with MiFID suitability rules in line with Central Bank's expectations.
30 April		Expiration date for interim company law flexibility measures introduced under the Companies (Miscellaneous Provisions) (COVID-19) Act. See here for further details.	If availing of flexibility measures, consider any adjustments necessary ahead of the expiry of measures.
30 June		Transposition deadline for UCITS amendments allowing the preparation of a PRIIPs KID in satisfaction of UCITS KIID rules with effect from the application of PRIIPs rules to UCITS on 1 January 2023. See here for further details.	Advance preparations for compliance with the PRIIPs deadline for UCITS of 1 January 2023, at which point UCITS must produce: • a PRIIPs KID for retail investors • either a PRIIPs KID or UCITS KIID for professional investors • a UCITS KIID for any UK investors

ESMA Launches UCITS and AIF Valuation Compliance Review

On 20 January 2022, ESMA launched a common supervisory action (**CSA**) to review compliance by fund managers with the valuation-related provisions in the UCITS and AIFMD frameworks, in particular the valuation of less liquid assets. No timeline or methodology for the CSA has yet been published but we expect the Central Bank will shortly engage with relevant firms.

The focus of the CSA will be on:

- managers of UCITS and open-ended AIFs investing in less liquid assets i.e., unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, emerging markets, listed equities that are not actively traded, bank loans;
- ensuring consistent and effective supervision of valuation methodologies, policies and procedures of fund managers to ensure that less liquid assets are valued fairly both during normal and stressed market conditions, in line with applicable rules; and
- assessing valuation risks which may pose a potential threat to financial stability at EU level.

Next Steps

As was the case with ESMA's first two UCITS CSAs (liquidity risk management and costs and fees), in-scope fund managers (see first bullet above) are likely to receive requests for information to support the Central Bank's review of compliance with relevant rules and requirements. The focus of such information requests, which may initially take the form of a questionnaire issued on terms similar to the questionnaires for the liquidity and costs CSAs, is likely to be on the valuation methodologies, policies and procedures adopted in respect of funds under management. While the launch notice does not reference a specific timeline for the valuation CSA, other than to note that regulators will share knowledge and experiences throughout 2022, fund managers should prepare for near-term engagement by the Central Bank and ensure valuation policies and procedures are in line with applicable rules and regulatory expectations to avoid being subject to any risk mitigation actions which may form part of the post-information gathering phase of the CSA.

ESMA Consults on Revised MiFID Suitability Guidelines

On 27 January 2022, ESMA published for consultation a revised set of guidelines for the MiFID suitability rules (the **Guidelines**) which rules require investment firms providing investment advice and portfolio management (including UCITS managers and AIFMs with MiFID top-up licences) to assess the suitability of a given investment or service before recommending it to clients. In addition to reflecting the sustainability preference rules, the revised Guidelines also include a new annex setting out good and bad practices identified during the ESMA 2020 common supervisory action.

The consultation on the revised Guidelines is open until 27 April 2022. ESMA expects to collate feedback from the consultation and issue final revised Guidelines in Q3 2022, for application two months after the publication of the translated versions on ESMA's website. The revised Guidelines, once applicable, will replace the existing 2018 Guidelines.

Reason for updating the 2018 Guidelines

The 2018 Guidelines are principally being revised to take account of the new MiFID sustainability preference rules which will amend the MiFID suitability rules once they come into effect on 2 August this year. Once effective, the sustainability preference rules require firms to assess, as a second step following the assessment of clients' knowledge, experience, financial situation and other objectives, clients' potential sustainability preferences using a self-assessment style model. Under the MiFID sustainability preference rules, a client's sustainability preferences are its choice between investing in:

1. products or instruments with a minimum proportion of sustainable investments as defined under the Sustainable Finance Disclosures Regulation (**Sustainable Investments**),
2. products or instruments with a minimum proportion of Sustainable Investments that comply/align with the Taxonomy Regulation (**Taxonomy-aligned Sustainable Investments**); and/or
3. products that consider the principal adverse sustainability impacts (**PAIs**) of investment decisions

(together the **Sustainability-Related Products**).

In acknowledgement of the likely limited availability of Sustainability-Related Products once the new rules come into effect next August and in a departure from the existing suitability assessment rules and guidelines, a firm may recommend products other than Sustainability-Related Products if it cannot meet a client's sustainability preferences. Such a recommendation is only permitted if the client, on being advised of the lack of available Sustainability-Related Products, elects to adapt its sustainability preferences. Only after a client has adapted their sustainability preferences, which adaptation is only applicable to the suitability assessment in question, can a firm recommend products other than Sustainability-Related Products.

Retail and professional investor services

While the Guidelines apply principally to retail client services, they should also be applied, where relevant, in respect of professional clients.

Wider impact of MiFID sustainability preference rules and the revised Guidelines

A key objective of the revised Guidelines is to avoid greenwashing in the distribution of sustainable investment products by specifying the features of those products suitable for recommendation to MiFID clients with sustainability preferences. However, those specified product features are more prescriptive than the features used to classify sustainable products under SFDR. Under SFDR there are two types of sustainable products, those in scope of Article 8 SFDR which promote environmental and/or social characteristics (so-called light green products) and those in scope of Article 9 SFDR with Sustainable Investment objectives (so-called dark green funds). In effect, the MiFID sustainable preference rules create a sub-set of sustainable products when compared to SFDR by excluding Article 8 SFDR products which promote environmental or social characteristics other than by investing in Sustainable Investments or integrating PAIs. Such Article 8 SFDR products are not suitable for MiFID clients with sustainability preferences unless there are no Sustainability-Related Products available and the client elects to adapt its initial sustainability preferences.

Revisions to the 2018 Guidelines

The proposed revisions to the Guidelines will, once finalised, require firms to review and adjust their suitability assessment processes and procedures and adopt 'robust and objective procedures, methodologies and tools' to assess the sustainability features of products recommended to clients.

One of the key difficulties in implementing the MiFID sustainability preference rules and once finalised, the Guidelines, is how to adequately, yet concisely and in a non-technical manner, explain the features of Sustainability-Related Products and obtain the necessary information from clients to make suitable recommendations. Industry initiatives, including the update of the FinDatEx European MiFID template, are underway to streamline firms' and distributors' requests for client sustainability preferences. Such initiatives have keenly anticipated the publication of the revised Guidelines and will be focussed on the following suggested step approach to collecting information as outlined in the revised Guidelines:

STEP 1: qualitative assessment of sustainability preferences

Collect information on the degree of clients' sustainability expectations by reference to one or more Sustainability-Related Product features	For example, using yes/no questions, ask whether the clients would prefer one, more or all of these features included in its preferences

STEP 2: assess environmental, social or governance focus

Collect information on whether the client's sustainability preferences are focussed on environmental (E), social (S) or governance (G) criteria

STEP 3a: assess minimum sustinable investment preference

Collect information on the preferred minimum investment in Sustainable Investments and Taxonomy-aligned Sustainable Investments	For example, by requesting specific percentages or ranges presented in a neutral and sufficiently granular way

STEP 3b: assess PAI appetite

Collect qualitative and quantitative information on the client's appetite for PAI integration	For example, by asking as to any E, S or G focus and using categories of PAI indicators under SFDR rather than individual indicators	A qualitative evaluation could then be done of each preferred category based on products' PAI integration approach e.g. exclusionary screening, controversies or voting/engagment policies

Contingent step: no Sustainability-Related Product preference

Firms should establish a process for clients which have suitability preferences but do not indicate a preference for any Sustainability-Related Products	For example, firms could consider of any of the Sustainability-Related Products' features, a combination thereof and would not be subject to any minimum proportion of sustainability-related expection

Next steps and compliance challenges

While industry continues to lobby for a delay, the effective date of the MiFID sustainability preference rules is currently fixed for 2 August 2022. Based on ESMA's indicative timeline for final Guidelines, firms are unlikely to have the benefit of Level 3 guidance when preparing for compliance with the sustainability preference rules. There is also the data issue arising from the delayed finalisation and application of the SFDR Level 2 measures until 1 January 2023. Article 8 and 9 product disclosures required under SFDR Level 2 will provide investment firms with the minimum Sustainable Investment and PAI integration data necessary to allow for the assessment of products suitable for recommendation to clients with sustainability preferences. Without this data firms are very likely to struggle to identify available Sustainability-Related Products for recommendation. This is an issue which may, in the short term, result in a not insignificant number of firms relying on clients' adaption of initial sustainability preferences to allow firms recommend products other than Sustainability-Related Products.

Cayman Islands to be Listed as High-Risk Third Country

In the coming weeks, the EU will finalise proposals to include the Cayman Islands on its list of high-risk third countries for AML purposes. Once included, EU obliged entities are required to apply enhanced customer due diligence when establishing business relations or carrying out transactions involving the Cayman Islands. The following amendments to the EU list of high-risk third countries are also proposed:

- Burkina Faso, Haiti, Jordan, Mali, Morocco, the Philippines, Senegal, and South Sudan are, in addition to the Cayman Islands, to be added to the list of high-risk third countries.
- The Bahamas, Botswana, Ghana, Iraq and Mauritius are to be removed from the list.
- Turkey is under review but will not be added to the list subject to the implementation of relevant mitigating measures.

Next Steps

Fund managers should review AML processes and procedures to ensure compliance with enhanced due diligence rules in respect of the Cayman Islands.

ESMA Guidance on UCITS Issuer Concentration and Marketing Rules

On 17 December 2021, ESMA published a revised draft of its UCITS Q&A document with new clarifications of the issuer concentration rules and the share class marketing rules introduced by the Cross-Border Distribution of Funds (**CBDF**) regime. In what is likely a disappointing, albeit not entirely unexpected clarification of the share class marketing rules, ESMA has confirmed the CBDF requirement for one month's prior notice to home and host authorities of the cross-border marketing of a UCITS share class. As previously reported (see here)., the one-month advance notification requirement represents a material departure from the pre-CBDF market practice for passporting a new share class and, since coming into effect on 2 August 2021, has had a significant and unwelcome impact on UCITS managers marketing processes and procedures.

UCITS RULE	ESMA Q&A CLARIFICATION
ISSUER CONCENTRATION	
UCITS may invest up to 100% of assets in transferable securities and money market instruments issued or guaranteed by any Member State, its local authorities, a third country or public international bodies of which one or more Member States are members provided the UCITS: • holds securities from at least 6 different issues but securities from any one issue does not account for more than 30% of its assets;	UCITS may not invest up to 100% of assets in transferable securities or money market instruments that are not issued nor guaranteed by a Member State one or more of its local authorities, a third country or a public international body to which one or more Member States belong. If a UCITS holds more than six issues all the issues should respect the 30% limit.

• complies with relevant constitutional and offering document disclosure requirements.	
The risk exposure to a counterparty of a UCITS in an OTC derivative transaction shall not exceed - • in case the counterparty is a credit institution established in the EU or an equivalent third country, 10% of its assets, • in any other case, 5% of its assets. In the case of a currency hedged share class, the exposure to any counterparty of a derivative should be in line with the above limits based on the net asset value of the share class.	Where a UCITS invests in FX forwards for share class currency hedging purposes, it should comply with the UCITS counterparty exposure rules and any unrealised FX profits and losses should be counted towards the NAV of the UCITS hedged share class when calculating when calculating the counterparty risk limits.
SHARE CLASS MARKETING	
In the event of a change to the information in a UCITS cross-border marketing notification letter or a change regarding the share classes to be marketed, the UCITS shall provide written notice to the home and host competent authorities at least one month in advance of implementing the change.	If a UCITS intends to market a new share class in a Member State where it has already been notified for marketing, the UCITS should give written notice to the home and host competent authorities at least one before the marketing of the new share class starts.

FAQ: Corporate Sustainability Reporting Directive (CSRD)

What is the EU Corporate Sustainability Reporting Directive or CSRD?

CSRD is proposed as the new non-financial reporting regime for EU-based and EU-listed companies. It will replace the existing regime (the Non-Financial Reporting Directive or NFRD) and is slated to come into effect for reporting periods starting on or after 1 January 2023. The CSRD proposal, first published in April 2021, is currently proceeding through the EU legislative process and is expected to be adopted early this year.

Why the need for a new corporate reporting regime?

In short, the EU needs private capital markets to help bridge the funding gap for energy-related investments. The EU estimates that annual investment to 2030 will need to increase by €350bn to achieve climate neutrality and by providing private investors with reliable non-financial information, it expects to stimulate sustainable investing in support of EU climate and energy targets.

As well as supplying customers/investors with comprehensive and reliable sustainability information, CSRD will also ensure the availability of information necessary for the financial sector (asset managers, banks, insurers etc) to comply with their non-financial reporting obligations under other EU sustainability-related rules. For example, recently introduced EU rules for the financial sector require investor disclosure of the sustainability impact of investment decisions; disclosures which would not be possible without data on the sustainability impact of investee companies' economic activities.

How will CSRD impact funds and fund managers?

The CSRD proposes removing the 500-employee reporting threshold under the NFRD which has to date been the reason for most funds and fund managers falling outside the scope of NFRD reporting. Under CSRD proposals, all large and listed companies are in scope of sustainability reporting including large fund managers and corporate investment funds and all listed corporate investment funds. Large companies under NFRD/CSRD are those which exceed two out of three criteria of balance sheet total >€20,000,000; net turnover: €40,000,000, avg. employees: 250. Under current proposals, in-scope companies would apply the CSRD sustainability reporting standards for the first time to reports published in 2024, covering financial years beginning on or after 1 January 2023. In addition, following replacement of the NFRD with the CSRD, the scope of companies subject to Article 8 EU Taxonomy disclosure rules will automatically be extended to include those in scope of the CSRD. Industry is actively lobbying for the exclusion of funds from the scope of CSRD on the basis that reporting under CSRD would be a duplication of effort given funds existing reporting obligations under the Sustainable Finance Disclosures Regulation (**SFDR**) and the Taxonomy Regulation.

How does CSRD reporting compare to the existing regime for non-financial reporting?

By comparison to the existing NFRD regime, CSRD extends both the level and scope of sustainability reporting. Draft CSRD sustainability reporting standards, which will provide further clarity on the enhanced level of reporting required under the CSRD, are expected to be published in June this year before being finalised ahead of the anticipated deadline of October 2022.

What are the key requirements under CSRD?

CSRD will mandate machine-readable reporting against new, directly effective, EU standards by all large EU companies (including parent companies of large groups) and EU listed companies. The EU standards will require companies to identify and report on their most significant sustainability risks, dependencies and impacts and how they manage them including qualitative and quantitative, forward-looking and retrospective information about their strategy, targets, risk governance structures, supply and whole value chains, and intangibles (R&D, intellectual/human/social and relationship capital). Sustainability information will initially need limited assurance but CSRD makes provision for moving to reasonable assurance at a later date.

What are the key impacts of CSRD?

As its principal objective is for a broader spectrum of companies to provide more detailed, harmonised sustainability reporting, the first and obvious impact of CSRD will be on companies' reporting processes and procedure. In particular, given the much-publicised dearth of accurate and reliable sustainability data, companies may need to establish new data sourcing, accumulation and monitoring processes in order to comply with the enhanced reporting rules. However, as with many EU sustainability initiatives, CSRD is also likely to drive more fundamental change by reporting entities seeking to avoid the myriad of risks associated with disclosing sustainability risk exposures and/or a negative impact on ESG factors.

Central Bank Outsourcing Guidance for all Regulated Firms

On 17 December 2021, the Central Bank published final guidance for the governance, risk management and business continuity management of outsourcing activities by regulated firms, including fund management companies (the **Guidance**). The Guidance, published with immediate effect, includes measures for each stage of the outsourcing lifecycle and is additional to, but does not supersede, existing relevant sectoral rules applicable to fund management companies' delegation of activities under the UCITS and/or AIFMD regimes. The Guidance, published in support of the Central Bank's strategy for maintaining financial stability, should be read in conjunction with the Central Bank's Operational Resilience Guidelines published on 1 December 2021. Our client briefing on the Operational Resilience Guidelines is available here and our December 2021 briefing on the Outsourcing Guidance is available here.
