Asset Management & Investment Funds Update

July 2023

Key Dates & Deadlines: Q3 2023

Date	Source	Summary	Action/Impact
2023 (date dependent on publication date of relevant financial report)		SFDR Level 2 – fund annual report disclosures SFDR Level 2 financial report disclosure rules, effective 1 January 2023, must be addressed in annual reports published after that date irrespective of the relevant financial or reference period.	Fund managers must ensure annual financial statements published after 1 January 2023, for funds subject to SFDR Article 7, 8 or 9, incorporate the relevant disclosures and using the Level 2 templates where applicable.
Q3 (exact date TBC)		ESMA Guidelines on Fund Names – publication of final report Guidelines on use of ESG or sustainability-related terms in the name of funds are expected to be finalised and published with an application date of 3 months post publication and a 6-month transition period for existing fund names. See here for further details.	Draft Guidelines set out quantitative thresholds for investment in E/S aligned or sustainable investments for Article 8 and 9 funds which use ESG/sustainability-related terms in the fund name.
27 June		Taxonomy – delegated acts adopted by the Commission Technical screening criteria (**TSC**) for four non-climate environmental objectives adopted and now subject to legislative scrutiny with a scheduled date of effect of 1 January 2024. See here for further details.	The TSC, once finalised, will facilitate fund managers assessment of investments in non-climate environmentally sustainable activities as aligned with the Taxonomy.
4 July		SFDR Level 2 – Consultation response deadline	SFDR Level 2 amendments are currently anticipated to take effect in, or around, 1 January 2025. Amendments are likely to trigger

		Included for consultation are proposals for an extended list of social PAI indicators and refinement of existing indicators, decarbonisation targets, further specification of the DNSH disclosure rule, simplification of the templates and other technical adjustments. See here for further details.	updates to pre-contractual disclosure templates and consequential regulatory filings, possibly in Q4 next year.
6 July		Sustainable Finance CSA for Funds – launched ESMA announced a CSA on compliance with SFDR, the Taxonomy and sustainability-risk and impact rules under UCITS and the AIFMD. See article on topic in this month's edition for further details.	Fund managers may anticipate follow-on communication from the Central Bank in respect of the CSA.
7 July		CSRD – consultation on reporting standards closes Four-week consultation on CSRD reporting standards closes with standards to apply from 1 January 2024 (first effective date of CSRD). See here for further details.	Fund managers should scope activities against the CSRD thresholds to determine application of reporting standards. CSRD applies to companies in scope of NFRD from 1 January 2024 and to all large companies from 1 January 2025.
16 July		South Africa & Nigeria added to EU High Risk Third Countries list Enhanced customer due diligence (**CDD**)measures must be applied to business relationships and transactions involving South Africa and Nigeria from this date. Cambodia and Morocco removed from the list. See here for further details.	Fund managers should ensure CDD frameworks take account of this update for the relevant countries.
28 July		Retail Investment Strategy – consultation response deadline UCITS, AIFMD and PRIIPs amendments are under consultation which target increased value for money for investors and digitalisation of PRIIPs KIDs. See here for further details.	Value for money proposals and amendments to PRIIPs Regulation in Retail Investment Strategy likely to be highly impactful for fund managers, once finalised.
30 August		ESG Ratings Regulation – consultation response deadline EU and non-EU providers of ESG ratings distributed or publicly disclosed in the EU will be subject to authorisation and ongoing supervision by ESMA under EU proposals subject to consultation until 29 August 2023. See article on topic in this month's update for further details.	Fund managers that publish or distribute publicly ESG ratings should scope activities against the proposals in prepare for any forthcoming authorisation obligations.

3 September		Updated MiFID Suitability Guidelines – in effect Updated Guidelines were published in April 2023 taking account of the sustainability preference rules with an effective date of 6 months post publication. See here for further details.	MiFID firms and fund managers with a MiFID top-up licence must ensure compliance with the updated guidelines ahead of the effective date.
11 September		DORA – consultation on Level 2 closes First set of Level 2 standards are available for consultation covering ICT risk management framework, classification criteria for ICT-related incidents, outsourcing register, ICT third-party providers. See here for further details.	UCITS managers and AIFMs are in scope of DORA which is effective from 17 January 2025. In addition to progressing compliance preparations for DORA, fund managers must also prepare to comply with the Central Bank's Cross-Industry Guidelines on Operational Resilience for which action plans/evidence of action taken are expected by 1 December 2023.
14 September		IAF & SEAR – second consultation response deadline CP154 on reforms to the Central Bank's Administrative Sanctions procedure to support and underpin the IAF closes to comment. See here for further details.	Consultation response deadline.
15 September		Call for Evidence – sustainability preferences in MiFID II suitability and produce governance ESMA is seeking contributions by this date on challenges in addressing the sustainability preference rules, the impact of these rules on investor choices and complying with the updated Suitability Guidelines effective 3 September 2023. See here for further details.	MiFID firms have the opportunity to highlight the various challenges experienced in implementing the sustainability preference rules to ESMA.

Sustainable Finance CSA For Funds Launched

On 6 July 2023, ESMA launched a common supervisory action (**CSA**) to assess the investment fund sector's compliance with SFDR, the Taxonomy and sustainability risk and impact rules under UCITS and AIFMD.

The CSA will run throughout 2023 and until Q3 2024. CSA preliminary findings of greenwashing will be included in ESMA's Final Report to the Commission on greenwashing due by end- May 2024. Our June 2023 briefing on ESMA's progress report on greenwashing is available here.

The stated aim of the CSA is to promote improved comprehensibility of ESG disclosures. It will focus on:

- assessing adherence to applicable rules and standards in practice;
- gathering further information on greenwashing risks in the investment management sector; and
- identifying further relevant supervisory and regulatory intervention to address the issue.

The CSA announcement is accessible here.

Next Steps

While the CSA is due to run for an extended period of approximately one year, fund managers can expect a follow-on communication from the Central Bank in the near term, most likely in the form of a questionnaire to kick-start data gathering for analysis using the agreed ESMA methodology.

EU ESG Ratings Regulation Published

Last month saw the publication of yet another extensive and highly impactful EU package of sustainable finance measures. The package includes a proposal for authorising and regulating EU and non-EU providers of ESG ratings in the EU (**ESG Ratings Regulation**). Under the proposal, ESG ratings providers would have 6 months to apply for authorisation following entry into force of the ESG Ratings Regulation. SME ESG ratings providers would have 24 months to do so. The ESG Ratings Regulation is under consultation until 29 August 2023.

ESG ratings in scope of the ESG Ratings Regulation

ESG ratings that are disclosed publicly or distributed to EU companies or authorities are in scope of the ESG Ratings Regulation. ESG ratings produced on request, provided exclusively to the relevant person and which are not intended for public disclosure or distribution are not in scope. ESG ratings produced for internal purposes are also out of scope as is ESG data which does not include a rating or scoring element.

Authorisation obligation for ESG ratings providers

EU ESG ratings providers must be authorised by ESMA and the proposal provides for the adoption of delegated measures detailing requirements for the authorisation application.

Borrowing heavily from the third country provisions of the Benchmarks Regulation, the ESG Ratings Regulation permits non-EU ESG ratings providers to operate in the EU if (i) the Commission has issued an equivalence decision in respect of the relevant third country regime under which the provider is authorised, or (ii) the provider is part of a group and has been endorsed by an EU group entity authorised under the ESG Ratings Regulation, or (iii) the provider's turnover is <€12m for three consecutive years and it has been recognised by ESMA to provide ESG ratings to regulated EU entities.

Ongoing supervision of ESG ratings providers

The ESG Ratings Regulations sets down organisational, governance and transparency requirements for ESG ratings providers, which requirements seek to regulate the provision but not the content of ESG ratings. To guard against conflicts of interest, ESG ratings provides may not also provide consulting activities to investors or companies, issue or sell credit ratings, develop benchmarks, undertake investment, audit, banking, or (re)insurance activities. Other organisational requirements include in respect of resourcing, record-keeping, complaints-handling, conflicts of interest management and outsourcing.

Transparency requirements under the ESG Ratings Regulation mandate the disclosure of methodologies, models, and key rating assumptions as well as the submission of information for inclusion on the European Single Access Point, once developed.

In respect of ESG ratings, methodologies are required to be rigorous, systematic, objective, continuous, of adequate quality and subject to validation. Methodologies should also be reviewed on an ongoing basis and at least annually.

Sanctions

ESMA will have the power under the ESG Ratings Regulation to investigate ESG ratings providers and to compel an end to an infringement, supply complete and correct information, or to comply with an investigation. Fines of up to 10% of an ESG ratings provider's net turnover may be levied by ESMA for intentional or negligent infringement of the regulation's requirements.

Next Steps

The proposed ESG Ratings Regulation is under consultation until 29 August 2023.

New Taxonomy/SFDR FAQ

Last month saw the publication of yet another extensive and highly impactful EU package of sustainable finance measures. The package includes a Commission FAQ clarifying the tests for Taxonomy-aligned investments and SFDR sustainable investments.

Taxonomy clarifications

For an investment in an economic activity to qualify as Taxonomy aligned, the activity must satisfy the four criteria of (i) contributing substantially to one or more of the Taxonomy's environmental objectives (ii) not significantly harming any of those objectives, (iii) complying with minimum safeguards and (iv) complying with the relevant Taxonomy technical screening criteria.

The FAQ clarifies that the minimum safeguards at (iii) above are met when investee companies implement due diligence and remedy procedures to ensure their activities align with the OECD guidelines for Multinational Enterprises (**MNE Guidelines**), the UN Guiding Principles on Human Rights (**UNGP**) and do not significantly harm (**DNSH**) minimum social standards.

However, an investment in company which fails to achieve alignment with the MNE Guidelines and UNGP will not necessarily result in the investment failing the minimum safeguard test. As set out in the FAQ, an investee company can satisfy the minimum safeguard requirement provided it has implemented the appropriate due diligence and remediation procedures and discloses actual and potential adverse impacts along with an explanation of what it did to identify, prevent, mitigate or remediate them and why it could not eliminate the impacts.

To satisfy the above-mentioned DNSH test, activities should be assessed, at a minimum, against the mandatory SFDR principal adverse impact (**PAI**) indicators for social and employee matters, respect for human rights, anti-corruption and anti-bribery matters set out at Annex I to the SFDR Delegated Regulation (**Level 2**).

SFDR clarifications

The FAQ clarifies that investments in Taxonomy-aligned activities automatically qualify as sustainable investments. This is because each limb of the SFDR sustainable investment test is met by activities which comply with the requirements of the Taxonomy.

However, where an investee company carries on more than one activity and only one or more, but not all of those activities are aligned with the Taxonomy, the whole company can only qualify as a SFDR sustainable investment if the remainder non-Taxonomy aligned activities satisfy the SFDR test for sustainable investments i.e., only an investment in the Taxonomy-aligned activities of an investee company automatically qualify as SFDR sustainable investments, not the whole/all of the activities of the investee company.

If the sustainable investment in question is specifically for Taxonomy-aligned activities e.g., a bond which specifies the use of proceeds for Taxonomy-aligned activities, then the whole investment can automatically qualify as a SFDR sustainable investment. However, if it is a general debt or equity investment then the non-Taxonomy aligned activities must be assessed against the SFDR test of (i) contribution to the environmental objective(s) and (ii) DNSH compliance using the environmental PAI indicators, before the whole equity or debt investment can qualify as a SFDR sustainable investment.

Are You In Scope of CSRD?

The Commission consultation on CSRD Level 2 measures, detailing the sustainability reporting standards for in-scope companies, closed on 7 July 2023. Level 2 will be finalised in the coming months, ahead of its first application on 1 January 2024 for companies subject to the previous EU sustainability reporting regime under the Non-Financial Report Directive.

CSRD compliance plans are advancing however, a fundamental first step is determining the scope of these obligations. A potentially challenging task requiring careful consideration given the expansive scope of CSRD and the complex nature of the governing legislative provisions.

Summarised below are the key categories of companies in scope of the CSRD, along with the thresholds, possible exemptions, and relevant deadlines for reporting using the Level 2 standards. CSRD is principally applicable to limited liability companies although there are some exceptions to this rule (e.g., for credit institutions and insurers). A company must exceed or cease to exceed the thresholds below on two consecutive balance sheet dates before it will be taken to have exceeded/not exceeded the relevant threshold.

Category 1: Large EU listed (EU/non-EU) companies and (EU/non-EU) parents of a large group

From 1 January 2025 (f/y 2024), these companies must publish CSRD sustainability reports in the management report.

- **Threshold:** the threshold for this category is met if a company has more than 500 employees and either:
  a) exceeds two of the thresholds for large companies of €40m net turnover; €20m balance sheet total, 250 employees; or
  b) exceeds, on a consolidated basis (including EU and non-EU subsidiaries), two of the thresholds for large groups of €40m net turnover, €20m balance sheet total, 250 employees.

Category 2: Large EU companies (not EU listed and with <500 employees)

From 1 January 2026 (f/y 2025), these companies must publish CSRD sustainability reports in the management report.

- **Threshold:** the threshold for this category is met if a company exceeds two out of the thresholds of €40m net turnover; €20m balance sheet total, 250 employees.
- **Exemptions:**
  a) UCITS and AIFs are specifically exempt
  b) A large EU subsidiary of an EU parent (which is not a large and EU listed subsidiary) is exempt if the subsidiary, along with its subsidiaries (if any), are included in the CSRD consolidated sustainability report of its EU parent, subject to conditions including that the subsidiary's management report links to the consolidated sustainability report.
  c) A large EU subsidiary of a non-EU parent (which is not a large and EU listed subsidiary) is exempt if the subsidiary, along with its subsidiaries (if any), are included in the CSRD (or equivalent non-EU) consolidated sustainability report of its non-EU parent. CSRD provides for the adoption of equivalence decisions in respect of non-EU standards. This exemption is subject to the publication of the consolidated sustainability report and assurance opinion in accordance with CSRD rules and the inclusion of disclosures required by the Taxonomy Regulation, either in the consolidated sustainability report or the management report of the subsidiary.
  d) Until 6 January 2030, a large EU subsidiary (which is not a large and EU listed subsidiary) of a non-EU parent may publish a consolidated sustainability report covering all large or EU listed EU subsidiaries of the non-EU parent, including the required disclosures under the Taxonomy Regulation for such subsidiaries, provided the subsidiary is one of the parent's EU subsidiaries that generated the greatest turnover in the EU in at least one of the preceding five financial years (on a consolidated basis, if applicable).

Category 3: Large/SME EU listed (EU and non-EU) companies (with <500 employees)

These companies must publish CSRD sustainability reports in the management report from 1 January 2026 (f/y2025) if large and EU listed (see thresholds in Category 2 above for large companies) or 1 January 2027 (f/y 2026) if EU listed SME.

- **Threshold:** the threshold for this category is met if a company is listed on an EU regulated market and it is not a micro company. A company is a micro company if it does not exceed at least two of the criteria of €700k net turnover, € 350k balance sheet total, and 10 employees
- **Exemptions:**
  a) UCITS and AIFs are specifically exempt
  b) Until 1 January 2028, EU listed SMEs can comply or explain non-compliance with CSRD and thereafter, can comply with limited CSRD sustainability reporting standards currently under development and due to issue by 30 June 2024
  c) An EU listed subsidiary of an EU parent (which is not a large and EU listed subsidiary) is exempt if the subsidiary, along with its subsidiaries (if any), are included in the CSRD consolidated sustainability report of its EU parent, subject to conditions including that the subsidiary's management report links to the consolidated sustainability report.
  d) An EU listed subsidiary of a non-EU parent (which is not a large and EU listed subsidiary) is exempt if the subsidiary, along with its subsidiaries (if any), are included in the CSRD (or

equivalent non-EU) consolidated sustainability report its non-EU parent. CSRD provides for the adoption of equivalence decisions in respect of non-EU standards. This exemption is subject to the publication of the consolidated sustainability report and assurance opinion in accordance with CSRD rules and the inclusion of disclosures required by the Taxonomy Regulation, either in the consolidated sustainability report or the management report of the subsidiary.

Category 4: EU parents of large groups (not EU listed and with <500 employees)

From 1 January 2026 (f/y 2025), these companies must publish CSRD consolidated sustainability reports in the consolidated management report.

- **Threshold:** the threshold for this category is met if a company exceeds, on a consolidated basis (including EU and non-EU subsidiaries), two out of the three criteria of €40m net turnover, €20m balance sheet total, 250 employees
- **Exemptions:**
  a) An EU parent of a large group, which is a subsidiary, is exempt if the EU parent, along with its subsidiaries, are included in the CSRD consolidated sustainability reporting of another.
  b) An EU parent of a large group (which is not a large and EU listed subsidiary) which is a subsidiary of a non-EU parent, is exempt if the parent, along with its subsidiaries, are included in the CSRD (or equivalent non-EU) consolidated sustainability reporting of the non-EU parent. This exemption is subject to the publication of the consolidated sustainability report and assurance opinion in accordance with CSRD rules and the inclusion of disclosures required by the Taxonomy Regulation, either in the consolidated sustainability report or the management report of the EU parent.
  c) Until 6 January 2030, a large or EU listed EU subsidiary (which is not a large and listed EU subsidiary) of a non-EU parent may publish a consolidated sustainability report covering all large or EU listed EU subsidiaries of the non-EU parent, including the required disclosures under the Taxonomy Regulation for such subsidiaries, provided the subsidiary is one of the parent's EU subsidiaries that generated the greatest turnover in the EU in at least one of the preceding five financial years (on a consolidated basis if applicable).

Category 5: Ultimate non-EU parents (not EU listed and with <500 employees) of one or more large or EU listed subsidiaries

From 1 January 2019 (f/y 2028), these companies must publish CSRD sustainability reports at the group level of the ultimate non-EU parent in accordance with CSRD reporting standards for non-EU entities to be adopted by 30 June 2024 or CSRD (or equivalent non-EU) consolidated sustainability reporting standards.

- **Threshold:** the threshold for this category is met if the ultimate non-EU parent has net turnover in the EU >€150m for each of the last two financial years and the subsidiaries meet the threshold for either large companies or EU listed companies (see categories 2 and 3 above for large and EU listed thresholds)
- **Exemptions:** if the information is not available to comply, the subsidiary must request all information to allow for compliance with its obligations under categories 1-3 above. If that information is not provided, the subsidiary may publish, alongside its CSRD sustainability report, a statement confirming the information that was not made available by the ultimate non-EU parent.

Category 6: Non-EU entities with EU branches and no large or EU listed subsidiaries

From 1 January 2029 (f/y 2028), these companies must publish CSRD sustainability reports at the group level or, if not part of a group, at the individual level of the non-EU entity in accordance with the CSRD reporting standards for non-EU entities to be adopted by 30 June 2024 or CSRD (or equivalent non-EU) consolidated sustainability reporting standards.

- **Threshold:** the threshold for this category is met if the EU branch had net turnover >€40m in the preceding financial year and the non-EU entity had net turnover in the EU >€150m for each of the last two financial years.
- **Exemptions:** if the information is not available to comply, the branch must request all information to allow for compliance with its obligations under categories 1-3 above. If that information is not provided,

the branch may publish, alongside its CSRD sustainability report, a statement confirming the information that was not made available by the non-EU entity.

UCITS Eligible Asset Rules Up For Review

The Commission is planning a wide-ranging review of UCITS rules governing eligible investments as set out under the UCITS Eligible Assets Directive (the **EAD**).

To support its review, the Commission has tasked ESMA with the provision of technical advice, including recommendations for legislative amendments, by 31 October 2024. It is likely that ESMA will engage with industry prior to issuing that advice to the Commission, whether to garner industry feedback on proposed amendments and/or gather data to inform the review. A call for evidence and/or consultation may be expected later this year or early next year from ESMA.

Once ESMA's advice has issued, the Commission intends carrying out a 'comprehensive public consultation', most likely in Q4 2024/early 2025, ahead of finalising any EAD amendments.

This is very much the start of the process and, taking account of the above, industry is likely to have at least two opportunities to feedback on any proposals to amend the EAD.

Current scope of EAD review

As part of its request to ESMA, the Commission outlined the following areas for review, which may give rise to EAD amendments or new UCITS Level 2 measures:

1. divergence between UCITS rules and other relevant EU frameworks and possible solutions to enhance consistency including by linking definitions and concepts with those under other legislation e.g., MiFID II, EMIR, the Benchmark Regulation or MMFR;
2. criteria for the assessment of eligible assets including the presumption of liquidity for transferable securities;
3. risks and benefits of UCITS' exposure to ineligible assets e.g., through delta-one instruments, (embedded) derivatives and financial indices;
4. efficient portfolio management techniques and legislative clarifications necessary to address findings from the 2018 ESMA peer review on the Guidelines on ETFs and other UCITS issues and the 2021 CSA on costs and fees; and
5. assets which may give risk for retail investors e.g., structured/leveraged loans, catastrophe bonds, emission allowances, commodities, crypto assets, unlisted equities, and other relevant asset classes. The review will cover the absolute and relative size of UCITS' exposures to such asset classes and their appropriateness, taking account of underlying market characteristics e.g., availability of valuation, liquidity, safekeeping etc.

Individual Accountability for Fund Managers – Latest Developments

The introduction of an individual accountability framework (**IAF**) has been a key agenda item for the Central Bank since 2018, when it was recommended to address behaviour and cultural issues identified during a regulatory review of Irish retail banks.

Following the removal of the so-called participation hurdle by legislation signed into law on 9 March 2023 (the **IAF Act**), the Central Bank moved swiftly to publish its first consultation on the IAF Framework (**CP153**) on 13 March 2023. The consultation closed on 13 June 2023 and feedback is awaited.

On 21 April 2023, further implementation steps were taken with the publication of updated Central Bank regulations and guidance for F&P investigations, suspensions and prohibitions (the **updated F&P procedures**). The updated F&P procedures amend and replace the previous version and set out the Central Bank's approach to investigating controlled function (CF) role holders, including former CFs (for a period of up to 6 years following departure from the role subject to a back-stop date of 19 April 2023). Our briefing on the updated F&P procedures is available here.

A further consultation (**CP154**) was published by the Central Bank on 22 June 2023, this time dealing with reforms to the Central Bank's Administrative Sanctions Procedure which will underpin and support the IAF framework. The consultation is open until 14 September 2023 and our briefing on this development is available here.

What is the IAF framework?

As the name suggests, the IAF seeks to hold individuals accountable for their responsibilities in regulated firms. The framework includes:

- a senior executive accountability regime (**SEAR**) for banks, insurers and certain MiFID firms;
- conduct standards for individuals in all regulated firms and firms themselves;
- enhancements to the Fitness & Probity (**F&P**) regime; and
- enhanced Central Bank powers of enforcement to ensure individuals' and firms' compliance.

What's the timeline for introduction of the IAF?

20 April 2023:	updated F&P investigation regulations and guidance published
13 June 2023:	CP153 closed to comment
22 June 2023:	CP154 published for comment
Q4 2023:	updated Business standards to be published as part of the Central Bank's separate review and consultation on the update of the Consumer Protection Code (**CPC**)
31 December 2023:	F&P enhancements and conduct standards to enter into effect
1 July 2024:	SEAR to take effect for certain firms

Pillar 1: SEAR – Effective 1 July 2024

The IAF imposes an enforceable legal duty on pre-approval controlled function (**PCF**) holders to take reasonable steps to avoid a firm breaching those legal obligations relating to activities for which the PCF is responsible. The consultation includes draft rules for the scope of this legal duty, PCF responsibilities and firms' documentation of those responsibilities along with draft regulatory guidance for assessing 'reasonable steps' and complying with the draft rules.

Are fund management companies in scope of SEAR?

Initially, SEAR will only apply to banks, insurers and MiFID firms carrying out bank-like activities. Fund managers are therefore, not in scope of SEAR. However, the Central Bank confirms, as per previous indications, that it intends to extend SEAR's application once lessons have been learned from the first wave. As this briefing is for fund managers it does not focus on SEAR however, further details of this pillar of the IAF can be found on our dedicated IAF & SEAR site.

Conduct Standards – Effective 31 December 2023

The IAF imposes an enforceable legal duty on CF holders to take reasonable steps (further details below) to meet the conduct standards and requires regulatory reporting by firms of CF disciplinary action relating to breaches of those standards.

Common conduct standards for all CFs, including PCFs

The common conduct standards apply to all CF holders in any regulated firm including NEDs, INEDs and those exempt from the F&P regime e.g., outsourced CF roles and intra-group arrangements.

The IAF includes detailed guidance on the regulatory expectations for compliance with each of the common conduct standards (see Chapter 5 of the draft guidance under consultation) of acting with honesty and integrity; acting with due, skill, care and diligence; cooperating in good faith and without delay with regulators; acting in the best interests of customers and treating them fairly and professionally; and operating in compliance with standards of market conduct and trading venue rules.

Additional conduct standards for PCFs and CF1s

The additional conduct standards apply to PCFs and CF1s in any regulated firm, including temporary PCF appointments. However, unlike the common standards, the additional standards do not apply to those PCF roles which are exempt from pre-approval under the F&P outsourcing exemption, unless of course the holder is also a CF1.

The IAF includes detailed guidance on the regulatory expectations for compliance with each of the additional conduct standards (see Chapter 6 of the draft guidance under consultation) of ensuring that the firm's business is controlled effectively, is conducted in accordance with applicable legislation, that delegated tasks are assigned to an appropriate person with effective oversight and that any information that the Central Bank would reasonably expect notice of is disclosed promptly and appropriately.

Firms' obligation to embed conduct standards

Firms are obliged to:

- **Notify CFs of the common and additional conduct** standards**, as appropriate, and make a record of such notifications.**
- Establish and maintain **policies** for the **integration** of the standards into the conduct and culture of the firm e.g., as part of performance and promotion reviews, and ensure they are kept under review and subject to senior management oversight and challenge.
- **Adopt a framework to identify, monitor and action potential breaches of the conduct** standards **and report to the Central Bank on formal disciplinary actions (formal warning, suspension, dismissal, pay reduction) for actual breaches of these standards.**
- Establish a **training programme**, subject to senior management oversight and challenge, for the provision of initial (post-IAF implementation), pre-appointment and ongoing CF training on the conduct standards so that role holders are aware of their obligations vis-à-vis the standards and what is expected of them in their role.

What are reasonable steps in the context of SEAR and the conduct standards?

In the case of both SEAR and the conduct standards, the IAF operates a 'reasonable steps' principle i.e., if these have been taken to achieve an outcome, that will be sufficient to discharge the relevant obligation.

In assessing the steps that an individual took in any given circumstance, the Central Bank will consider what steps an individual could reasonably have been expected to take in that position and at that point in time.

F&P Enhancements – Effective 31 December 2023

(i) Additional CF certification process

Currently, firms must satisfy themselves of CF holders initial and ongoing compliance with the F&P standards and must obtain CF holders agreement to abide by those standards. The IAF introduces an additional step for firms of issuing a certificate of compliance in respect of each CF.

The form of certification is a matter for individual firms however, it must document (i) the firm's satisfaction as to the CF's compliance with the F&P standards and the steps taken to be satisfied, (ii) the CF's agreement to abide by the standards, (iii) the relevant CF role(s) held, (iv) an outline of the parts of the business in which the CF will be involved and (v) whether the role(s) is outsourced to an unregulated entity (in which case the firm retains responsibility for F&P compliance). One individual should be assigned overall responsibility for CF certification which, in the case of non-SEAR firms, should be the CEO or equivalent.

Firms must certify CF holders (including PCF holders) pre-appointment, annually and in advance of any appointment to a new CF role. For new firms, CF certificates must issue within 5 days of authorisation and existing firms will have a two-month transition period (from the date of implementation of the IAF) in which to certify current CFs, where a single certificate will be sufficient for those with multiple CF roles.

Firms' CF certificates are not required to be filed with the Central Bank, however the existing CF register should be updated to reflect certification and the register is required to be available, on request, to the Central Bank. The Central Bank's annual PCF return will be extended to include confirmation of the certification of CFs, including PCFs, and a firm must report to the Central Bank if it revokes or does not renew a certificate or on any formal CF disciplinary action relevant to F&P compliance.

(ii) Additional CF due diligence

Currently, PCF and CF1 and CF2 holders are subject to additional levels of due diligence under the F&P regime. The IAF applies this higher level of due diligence to all CFs meaning that, instead of relying on self-certification, firms are expected to carry out regulatory sanctions checks, director restriction/disqualification checks, and judgement searches as well as carrying out professional body checks and any other role/firm-specific checks on all CFs.

(iii) Holding companies now in scope

The F&P regime is to be extended to include holding companies established in Ireland and CF holders in those companies.

Next steps

Following publication of the IAF Act, Central Bank IAF consultations, and updated F&P procedures, fund managers should progress compliance plans and work programmes taking account of the proposed timeline for implementation of the IAF set out above.

AI and Investment Funds

The growth and proliferation of generative Artificial Intelligence (AI) in recent months brings with it new risks (and opportunities) for the Financial Services (FS) sector. Regulated entities, including funds and fund service providers, should be preparing now.

AI will introduce new regulatory obligations and shareholder considerations and will have an impact for example on risk assessments, governance frameworks, sustainability assessments, data protection and anti-money laundering.

The new EU Artificial Intelligence Act (**AI Act**) will introduce a new regulatory framework and obligations on both developers of AI systems and their users, for example funds and/ or their service providers. It will serve as a framework around which organisations can base their AI regulatory policies, in areas such as transparency, accuracy, risk management, data governance, and human oversight.

The potential impact of AI on FS entities is already underway and causing stirs among regulators, and FS entities should take actions now to address the bearing of AI on their operations and stakeholders. For instance, in October 2022 the **UK Financial Conduct Authority** and the Bank of England published a report on the state of machine learning (**ML**) in the UK financial services sector. The report highlighted the growing trend in the use of ML applications across the FS sector and suggested that the largest changes over the coming years are likely to be in the investment and capital markets sector, which has the largest proportion of ML applications in test stages. More recently, in February 2023, **ESMA** published an article on AI in EU securities markets, noting that the use of AI in finance is under increasing scrutiny from regulators, who are beginning to develop AI-specific governance principles or guidance for FS firms.

The deployment of AI in the FS sector presents numerous legal challenges. It is critical that FS entities navigate these challenges in collaboration with legal and tech experts, ensuring the innovative use of AI while remaining compliant with the regulatory landscape in the EU.

New Regulatory Obligations

The main piece of governing regulation will be the new AI Act proposed by the European Commission, the first law on AI by any major regulator. The AI Act will regulate the providers of AI systems, and entities making use of them in a professional capacity. Following its approval by the EU Parliament on 14 June 2023, the AI Act is expected to come into effect before June 2024, with a two-year transition period, and is expected to become a global standard in the field.

Entities will need to be aware of their responsibilities and obligations under the AI Act, including evaluating the risk level of their AI systems, conducting risk assessments, and considering transparency, accountability and robustness measures to meet the AI Act's obligations.

Risk Assessments

While the use of AI technologies may offer firms opportunities in automation, productivity, and efficiency, it can also bring risks.

Under the AI Act, all operators will be required to make their best efforts to develop and use AI systems in accordance with principles such as human oversight, privacy and data governance, social and environmental well-being. Developing a Responsible AI Framework and incorporating AI risks into risk registers and governance practices will become critical for verifying that an AI system is properly and ethically employed for shareholders.

Risks associated with AI systems can be difficult to assess, particularly given their potential for unpredictability and the complex risks associated with ML models. Risks may include for example algorithmic risks (the risk that the AI system behaves unpredictably or makes poor decisions) and data risks (the risk of bias in the training data or misuse of data). AI Impact Assessments will be central to ensuring that risk management obligations, including under UCITS and AIF rules, are complied with when AI is being used.

Some of the risks that AI poses to the fund industry may include:

1. Conflicts of interest between the fund manager's initial investment strategy and the AI system's investment strategy. That is, because ML algorithms learn based on 'rewards' or 'punishments' they may potentially select investments that don't offer the best returns for the investor. Alternatively, the AI system may stock-pick profitable stocks as opposed to adhering to the initial portfolio strategy.
2. Data accuracy is critical for AI models to perform efficiently. As such, service providers may use incomplete or inferential data that has not been properly anonymised, with a resulting possibility that the AI model could make incorrect investments.
3. From the perspective of investors and stakeholders, the lack of disclosure of some AI systems when applied to investments may not be transparent or easily explainable.

To mitigate these risks, FS entities including fund managers should be developing robust governance frameworks for AI, investing in AI ethics, and actively involving their legal teams in the AI deployment process. It is also essential to maintain transparency about how AI is used and to ensure that the systems are auditable and accountable.

Governance Frameworks / Outsourcing and Delegate Oversight

Under the AI Act, entities using AI systems must ensure data governance and managerial best practices are in place before running their AI system. Specific operational and governance impacts for FS entities may include:

- **Compliance with MiFID obligations.** AI systems may be used for automated trading decisions or providing investment advice and must comply with regulatory obligations including MiFID requirements of transparency, record-keeping, and ensuring best execution policy for algorithmic trading. AI systems used for automating trading decisions or providing investment advice may be considered high-risk under the AI Act and therefore subject to heightened transparency, robustness, and accountability requirements.
- **Compliance with UCITS/ AIFMD obligations**, including fiduciary and depositary duties for managing conflicts of interest and disclosure to investors.
- **Appropriate outsourcing and delegate oversight**, where AI systems are utilised by service providers.

Sustainability Assessments

FS entities, including fund managers, are subject to ESG-related obligations including under the Sustainable Finance Disclosure Regulation (**SFDR**), and will need to consider the impact of the use of AI and the new AI Act on these existing activities.

The SFDR requires financial market participants to make disclosures related to sustainability risks and the impact of their investments on sustainability factors. The introduction of AI in this context could have certain implications, including for example:

- **Accuracy of Disclosures**: AI systems could be subject to bias or error in assessing ESG (Environmental, Social, and /or Governance) risks or impacts.
- **Transparency and Explainability**: The transparency or explainability of the AI system may be impeded if the methodologies or decision-making processes (e.g., the data inputs/outputs) of the AI system are convoluted, not clear, or are difficult to explain.

Firms will need to consider the implications of AI in assessing sustainability risks and impacts for compliance with the sustainability-related regulation including the SFDR.

Data Protection

Any data processed by AI systems, including data used in marketing and profiling activities, must be protected in accordance with data protection law including the General Data Protection Regulation (**GDPR**).

AI systems are already regulated by Article 22 of the GDPR if they are used to make automated decisions that could have legal or similarly significant effects on individuals. Such systems would be subject to the AI Act's provisions for high-risk AI systems, including requirements for transparency, robustness, and accountability.

Moreover, under the GDPR, individuals have the right not to be subject to a decision based solely on automated processing, such as shareholder profiling, or decisions which produce legal effects concerning them. The data controller, such as the fund or fund manager, must implement suitable measures to safeguard the data subject's rights, freedoms and legitimate interests. This includes the right to obtain human intervention, to express one's point of view, and to contest the decision. Furthermore, Article 35 of the GDPR requires those processing personal data "*using new technologies*" to carry out an assessment of the impact of the processing where that processing is "*likely to result in a high risk to the rights and freedoms of natural persons*".

Anti-Money Laundering (AML)

Under the EU's Fifth Anti-Money Laundering Directive (**5AMLD**), AI can be used to enhance transaction monitoring and flag potential money-laundering activities. These AI systems must adhere to 5AMLD's requirements for reporting suspicious transactions and maintaining adequate records. AI systems used for transaction monitoring and identifying potential money-laundering activities might be considered high-risk under the AI Act if they have significant control over decisions with serious legal implications. Their classification as high-risk would require them to meet the AI Act's requirements for transparency, robustness, and accountability.

How William Fry Can Help

William Fry are at the forefront of the AI evolution and are monitoring developments daily, advising clients on the wide range of legal and practical implications. We can advise on best practices for implementing safeguards and ensuring compliance with relevant laws and regulations.

For instance, we can help with:

1. **Training**, providing overviews of AI developments, requirements, and potential impacts.
2. **Assessments** on the use of AI technologies which may impact on an FS entity or its stakeholders, in particular by using William Fry's AI Impact Assessment process.
3. **Analysis** of potential risks and areas requiring remediation and suggesting recommended actions.
4. **Audit** of contracts and policies for cover of the use or development of AI.
5. **Application**, including developing frameworks, updating contracts and policies to account for AI risks and obligations, and drafting new AI policies.

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