ESG FOR FUNDS MANAGERS: BRIEFING 3

Integrating Sustainability Risks and Factors into the AIFMD and UCITS Frameworks

September 2020

This briefing in our ESG series for Irish funds and fund management companies focuses on the European Commission's proposals to integrate sustainability risks and factors into the AIFMD and UCITS legislative frameworks.

As detailed in our other ESG briefings, with the aim of furthering sustainable finance and ESG integration, the European Commission (the "**Commission**") introduced a package of legislative measures in 2018 that includes three key Regulations: the Taxonomy Regulation, the Disclosures Regulation, and the Low Carbon and Positive Impacts Benchmarks Regulation. The underlying impact assessment to this legislative package also demonstrated that it was necessary to make clear that UCITS management companies (including self-managed UCITS) and AIFMs (together "Management Companies") should take sustainability risks and factors into account as part of their duties towards investors. Accordingly, Management Companies should be assessing not only all relevant financial risks on an ongoing basis, but also all relevant sustainability risks. In addition, their internal processes, systems and controls should also reflect these risks. Therefore, following the publication of its legislative package, the Commission requested ESMA to provide technical advice on integrating sustainability risks and factors into both the AIFMD and the UCITS Directive.

ESMA delivered its final report to the Commission in April 2019, recommending that its proposals should be implemented using a principles-based approach and having regard to the nature, scale and complexity of the relevant entity and its activities. Based on this technical advice, the Commission subsequently published on 8 June 2020 the draft texts of the delegated regulation and delegated directive to integrate sustainability risks and factors into the AIFMD and the UCITS legislative frameworks. The Commission conducted a short consultation on this draft legislation, which closed on 6 July 2020.

Once adopted, the delegated acts will amend the UCITS Organisation Directive and the AIFMD Level 2 Regulation, respectively, and will introduce requirements to integrate sustainability risks and factors in compliance with existing rules in three key areas: organisational requirements; operational requirements; and risk management.

The key requirements and corresponding legislative amendments are set out below:

DEFINITIONS

"sustainability risk" and "sustainability factors" as defined according to the Disclosures Regulation.

"sustainability risk" means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment;

"sustainability factors" mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

	Requirement	Organisation Directive (UCITS)	AIFMD Level 2 Regulation (AIFM)
Organisational	Management Companies must take sustainability risks into account when complying with organisational requirements. Therefore, Management Companies should be assessing not only all relevant financial risks on an ongoing basis, but also sustainability risks, and their processes, systems and controls should reflect these risks.	Article 4(1): new subparagraph to clarify that sustainability risks must be taken into account. New Article 5(a) to require self-managed UCITS to integrate sustainability risks into the management of the UCITS	Article 57: new subparagraph to clarify that sustainability risks must be taken into account.
Resources and expertise	Management Companies must retain the necessary resources and expertise for the effective integration of sustainability risks. They must also ensure that senior management is responsible for the integration of sustainability risks in the investment strategy and decision-making process.	New Article 5(5) New point (g) added to Article 9(2) to clarify senior management responsibility for the integration of sustainability risks.	New Article 22(3) New point (i) added to Article 60(2) to clarify senior management responsibility for the integration of sustainability risks.
Due Diligence	Management Companies must include the consideration of sustainability risks in the investment due diligence process.	New Article 23 (5)	New Article 18 (5)
	Further, where Management Companies consider the principle adverse impacts of investment decisions on sustainability factors, the due diligence requirements must also take account of them.	New Article 23 (6)	New Article 18 (6)
Conflicts of Interest	When identifying conflicts of interest that may harm the interests of the UCITS/AIF, Management Companies must include conflicts that may arise as a result of the integration of sustainability risks in their processes, controls, and systems. Those conflicts could include conflicts arising from remuneration or personal transactions of relevant staff, conflicts that could give rise to "greenwashing", mis-selling or misrepresentation of investment strategies, and conflicts of interests between different funds managed by the same Management Company.	New Article 17 (3)	Article 30 – new subparagraph.
Risk Management	Management Companies must ensure that their risk management policies include procedures for assessing sustainability risks.	Article 38(1) – subparagraph 2 is replaced with new wording to include sustainability risks.	Article 40(2) is replaced with new wording to include sustainability risks.

NEXT STEPS

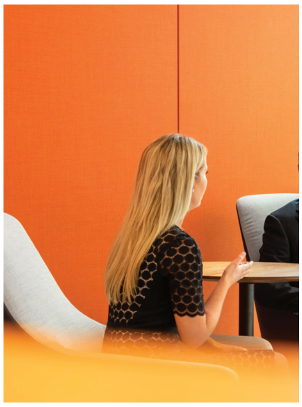
The next steps are for the delegated acts to be formally adopted by the Commission and published in the Official Journal of the EU ("OJ"). The delegated acts will enter into force on the day following their publication in the OJ and will apply 12 months later. The delegated regulation amending the AIFMD Level 2 Regulation is directly effective, however the delegated directive amending the UCITS Organisation Directive will have to be transposed into national law.

Although the exact timing remains uncertain, it is likely that these measures will apply in late Q3 or early Q4 2021. Management Companies should now be preparing to comply with the requirements by reviewing their:

- organisational requirements;
- senior management and board-level expertise;
- risk framework and risk management policies;
- due diligence policies; and
- conflicts of interest policies.

For more information on the impact of the EU's ESG initiative on asset managers, see our overview briefing here.

If you would like to discuss the foregoing, or require any assistance assessing these or any other sustainable finance related requirements, please feel free to contact a member of our team.



ARTHUR COX & ESG

Arthur Cox is very mindful of its own ESG responsibilities. We have actively reduced our carbon footprint through energy efficiency, waste management and sustainable procurement. Our Dublin HQ was awarded the highest energy efficiency standard ISO 50001:2018, which we only retain through a continuing reduction of energy use each year. We address our social and governance responsibilities though active CSR and D&I programmes. We aim to achieve improvements in all these aspects each year.

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