A&L Goodbody

Asset Management & Investment Funds: EU & International Developments – June 2024

Performance fees, greenwashing, SFDR, Investment Firms' prudential framework, AI, MiFID II marketing requirements, AML/CFT/FS.

25 June 2024

ESMA Q&As on performance fees for UCITS and AIFs

The European Securities and Markets Authority (**ESMA**) published new UCITS and AIFMD Q&As on the calculation of performance fees.

UCITS Q&A 2173 and AIFMD Q&A 2174 consider whether, where a manager applies an additional reference indicator to the performance fee model, the minimum performance reference period should be applied to the additional reference indicator. In response ESMA notes:

- The minimum performance reference period in accordance with paragraph 40-42 of the guidelines [ESMA guidelines on performance fees] should be applied to the performance fee model.
- However, the manager is not required to apply the minimum performance reference period to the additional reference indicator, considering that: the final combination (i.e. the performance fee model plus the additional reference indicator) does not result in increased fees for investors compared to the use of the performance fee model alone and the performance fee model (excluding the additional reference indicator) is consistent with the fund's investment objectives, strategy and policy, in line with guideline 2
- In line with paragraph 46 of guidelines, appropriate disclosure should be provided in the prospectus.

UCITS Q&A 2175 and AIFMD 2176 consider whether the manager of a Fund of Funds (**FoF**) can charge performance fees. In response ESMA notes:

- The manager of a FoF will need to be able to demonstrate to its National Competent Authority (**NCA**) that the performance fee model of a fund it manages constitutes a reasonable incentive for the manager and is aligned with investors' interests.
- As a general principle, where the investment policy of a FoF requires the active management of the FoF and the determination of the allocation in the underlying funds has a material impact on the FoF performance, performance fees for the manager of the FoF could be considered as justified.
- The manager of a FoF should be able to demonstrate to the NCA that the performance fee model of a fund it manages constitutes a reasonable incentive for the manager and is aligned with investors' interests.
- The assessment on how performance fees are justified in light of the investment policy of the FoF should be reflected in the fund documentation, including the fund rules or the instruments of incorporation and may be reviewed, where needed, by the NCA on a case-by-case basis.

Where relevant, this update may impact prospectus and marketing disclosures and related policies.

ESMA's final report on greenwashing

The European Supervisory Authorities (EBA, EIOPA and ESMA – ESAs) published their final reports on greenwashing in the financial services sector. This follows the European Commission's request for input on greenwashing risks and the supervision of sustainable finance policies.

The supervision of sustainability-related claims has become a priority for NCAs. NCAs and ESMA are taking steps to monitor and detect greenwashing and to critically scrutinise sustainability-related claims. The ESA's final reports investigate the current supervisory response to mitigating greenwashing risks in their respective remits and provide a forward-looking view of how supervision could be gradually enhanced.

In their reports, the ESAs confirm the high-level understanding of greenwashing as:

> *A practice whereby sustainability-related statements, declarations, actions or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, financial product or final service. This practice may be misleading to consumers, investors, or other market participants.*

The ESAs stress that financial market players have a responsibility to provide sustainability information that is fair, clear and not misleading.

In a related press release, ESMA indicates priority actions to enable supervisors to better mitigate greenwashing risks:

- NCAs are expected to gradually deepen their critical scrutiny of sustainability-related claims. To achieve this, they are invited to continue increasing human resources and expertise, making investments in supervisory tools such as SupTech solutions and further embed greenwashing risks in their respective supervisory work programmes.
- ESMAwill continue to support the monitoring of greenwashing risks, the deployment of SupTech tools, and capacity building. In addition, ESMA will prompt Common Supervisory Actions (**CSA**s) where needed. ESMA may produce additional guidance for market participants and supervisors in high-risk areas of greenwashing.
- The European Commission is invited to reinforce NCAs' and ESMA's mandates in certain areas, such as for benchmarks, and make sure all NCAs have the powers to promote retail investors' financial education. Whenever possible, the Commission should ensure the legislative framework supports NCAs' access to data.

ESMA's final report is relevant to market participants involved in the sustainable investment value chain (**SIVC**). This includes fund managers, financial advisers, credit rating agencies, benchmark administrators, and issuers of securities.

The investment management section of ESMA's final report describes the current NCA various supervisory practices and challenges. It also notes that ESMA's complete assessment on its ongoing CSA to assess the compliance of supervised entities with relevant provisions of the SFDR, the Taxonomy Regulation and the UCITS Directive and AIFMD can be expected towards the end of 2024.

Annex I of ESMA's final report provides a list of actions to be considered by market participants confirming those set out in its progress report on greenwashing. It also reminds market-participants to have regard to the high-risk areas identified in ESMA's progress report, as these will continue to be a supervisory priority.

In terms of next steps, ESMA will continue monitoring greenwashing risks and supervisory progress, including via the ongoing Union Strategic Supervisory Priority on "ESG Disclosures".

ESMA will also publish an Opinion on how the EU regulatory framework for sustainable finance can be enhanced.

You can read more on ESMA's final report on greenwashing here.

ESA opinion on improvements to SFDR

The ESAs published a Joint Opinion on the assessment of the Sustainable Finance Disclosure Regulation (**SFDR**). The Opinion has been issued by the ESAs on their own initiative to provide the Commission with some overarching principles and policy considerations for the Commission to consider when setting up a product classification system, as proposed in its targeted consultation and public consultation on the comprehensive review of the SFDR.

The ESAs call for a coherent sustainable finance framework that caters for both sustainable finance transition and investor protection, taking into account the lessons learned from the functioning of the SFDR and building on the proposals of the Retail Investor Strategy to enhance investor's trust, confidence, and participation in financing the economy.

The main focus of the Opinion is on ways to introduce simple and clear categories for financial products that would help to address greenwashing risk from the misuse of disclosures under Article 8 and 9 of the SFDR and generate clarity for investors. The simplifications consist of two voluntary product categories of "sustainable" and "transition", that could be used to ensure that consumers understand the purpose of the products. In addition, the ESAs recommend that the European Commission consider the introduction of a sustainability indicator that would grade financial products.

Summary of the ESA's recommendations for the Commission

- the introduction of a product categorisation system, based on regulatory categories and/or sustainability indicators to help consumers navigate the broad selection of sustainable products and to support the transition to sustainable finance
- the categories should be simple with clear objective criteria or thresholds, with (at least) categories of 'sustainability' and 'transition'
- a sustainability indicator could refer to environmental sustainability, social sustainability, or both, illustrating to investors the sustainability features of a product using a grading scale
- product categorisation options and/or sustainability indicators should be consumer tested and consulted on. If they are clear, sustainability disclosures would not need to be as detailed and extensive
- revisit the coexistence of the parallel concepts of "sustainable investment" as defined by SFDR and Taxonomy-aligned investment as defined in the EU Taxonomy. Prioritise completing the EU Taxonomy and extend it to social sustainability
- ensure that sustainability disclosures cater to different investor needs, and distribution channels, including digital ones, to ensure consistency of information provided. Prioritise only essential information for retail investors, while professional investors may benefit from more detailed information
- consider if other products should be brought in scope of the SFDR to ensure harmonised disclosures for products currently in scope and any other products that could be brought into scope
- information on key adverse impact indicators could be considered for all financial products
- evaluate the introduction of a framework to assess the sustainability features of government bonds

The Opinion also includes:

- appropriate disclosures for products outside the two categories to reduce greenwashing
- improvements to the definition of sustainable investments

- simplification of disclosures
- technical suggestions on which products fall under SFDR and how to improve disclosures regarding the negative impact of investments on people and the environment
- the ESAs strongly encourage the Commission to undertake consumer testing when developing policy options.

EBA / ESMA discussion paper on the investment firms' prudential framework

The EBA and ESMA published a discussion paper on the potential review of the investment firms' prudential framework to gather feedback to inform a response to a European Commission's call for advice on the topic. The discussion paper is open for response until 30 August 2024.

The discussion paper considers many aspects including the adequacy of the current prudential requirements, the existing methodology, and risks not covered by the current framework. Section 9 analyses the interaction between the IFD / IFR and UCITSD / AIFMD as regards the capital requirements, noting that where UCITS management companies or AIFMs have a top-up authorisation for individual portfolio management service, the own funds requirements established in UCITSD/ AIFMD may not take due account of the investment service performed.

Section 10 covers aspects related to remuneration in relation to investment firms, AIFMs and UCITS management companies, including the scope of application, remuneration policies, the requirements on variable remuneration, their oversight, disclosure and transparency.

ESMA guidance to firms using AI when they provide investment services to retail clients

ESMA issued a Statement providing initial guidance to firms using artificial intelligence technologies (**AI**) when they provide investment services to retail clients. ESMA expects firms to comply with relevant MiFID II requirements when using AI, particularly when it comes to organisational aspects, conduct of business, and their regulatory obligation to act in the best interest of the client.

Potential uses of AI by investment firms which would be covered by requirements under MiFID II include customer support, fraud detection, risk management, compliance, and support to firms in the provision of investment advice and portfolio management.

In terms of next steps, ESMA and the NCAs will continue to monitor the use of AI in investment services and the relevant EU legal framework to determine if further action is needed in this area.

ESMA report on 2023 CSA and mystery shopping exercise on MiFID II marketing requirements

ESMA published a report on its 2023 Common Supervisory Action (**CSA**) and its accompanying mystery shopping exercise on marketing disclosure rules under MiFID II.

ESMA (and NCAs) found that generally marketing communications (including advertisements) comply with MiFID II requirements, and investment firms generally have procedures in place to ensure compliance with MiFID II in respect of marketing materials. Some concerns were raised by NCAs regarding sustainability claims in marketing communications. ESMA identified several areas for improvement such as the need for marketing communications to be clearly identifiable as such and to contain a clear and balanced presentation of risks and benefits. ESMA also states that, in cases where products and services are marketed as having "zero cost", they should also include references to any additional fees.

IOSCO publishes good practices for leveraged loans and CLOs

The International Organization of Securities Commissions (IOSCO) announced publication of its final report on good practices in the leveraged loan and collateralised loan obligation (CLO) markets. The report sets out twelve good practices for market participants, designed to support them in their decision-making when operating in these markets. The final report reflects the results of the public consultation launched by IOSCO on 14 September 2023

AML / CFT

AML Regulation, AMLA Regulation and 6AMLD

The final elements of the European Commission's proposed legislative package of enhanced anti-money laundering and counter-terrorist financing (**AML/CFT**) rules were adopted by the European Parliament. Subsequently, the Council of the EU published a *press release* announcing that it had adopted the legislative package following legislation. You can read more here.

For more information on these topics please contact any member of A&L Goodbody's Asset Management & Investment Funds team.

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