

Client alert:

Summary of proposed ESG-related changes to AIFMD, UCITS and MiFID

On 8 June 2020, the European Commission published draft amendments to the MiFID, AIFMD and UCITS regimes, as part of the EU Action Plan on Financing Sustainable Growth. The proposed amendments focus on the integration of sustainability into existing organisational rules and conduct of business rules under the three regimes. This note summarises the key changes which will be relevant for fund managers and asset managers.

What was published?

The Commission has published four draft delegated acts which will – once implemented – amend certain of the Level 2 measures which sit underneath the Level 1 MiFID, AIFMD and UCITS Directives. (Other delegated acts were also published on the same date relating to insurance business, which are beyond the scope of this note).

- **AIFMD: [draft delegated regulation](#)**, to amend the [AIFMD Delegated Regulation](#) ((EU) 231/2013). This relates to the sustainability risks and sustainability factors to be taken into account by AIFMs.
- **UCITS: [draft delegated directive](#)**, to amend the [UCITS Commission Directive](#) (2010/43/EU). This relates the sustainability risks and sustainability factors to be taken into account by UCITS management companies.
- **MiFID2: [draft delegated regulation](#)**, to amend the [MiFID Commission Delegated Regulation](#) ((EU) 2017/565). This relates to the integration of sustainability into organisational requirements, and the integration of sustainability preferences into the suitability process.
- **MiFID2: [draft delegated directive](#)**, to amend the [MiFID Commission Delegated Directive](#) ((EU) 2017/593). This relates to the integration of sustainability preferences into product governance requirements.

In each case, the Commission has published a short draft delegated act, along with certain explanatory text. These drafts build on public consultation work carried out during 2018, and on ESMA's final report and draft delegated acts published in April 2019.

The drafts were open for public consultation for a four-week period to 6 July 2020, following which the Commission's proposals to amend the Level 2 measures will be submitted to the Council of the EU and the European Parliament for agreement before the text is published in the Official Journal.

When will these changes come into force?

It is expected that these draft acts would come into law by late Q3 or early Q4 2021, depending on a number of factors (including the impact of the COVID-19 pandemic on the legislative timetable generally).

Who will be affected by this?

These changes will be relevant to EU firms which are currently subject to any or all of the AIFMD, UCITS or MiFID2 regimes – in other words, EU AIFMs, UCITS management companies, and MiFID investment firms. The changes to the MiFID regime will also be relevant to fund managers with “top up” permissions to perform MiFID services such as portfolio management and investment advice.

These changes will not be relevant to non-EU AIFMs which are caught by the AIFMD marketing rules as a result of marketing under national private placement rules (NPPRs). This is because non-EU AIFMs are not subject to the organisational or conduct rules in AIFMD, simply as a result of marketing under NPPRs.

How will AIFMD, UCITS and MiFID be amended to take account of ESG?

The draft delegated acts do not propose new organisational rules or conduct rules. Instead, the general approach is to amend existing organisational / governance rules, or existing conduct of business obligations, which already apply under the three EU regimes. The amendments will generally require that firms expressly take into account sustainability risks as part of compliance with the existing rules.

To assist clients with reviewing the proposed amendments (which can be a little difficult to follow in the draft delegated acts), we have produced a consolidated “redline” document which highlights the specific changes to the existing regulatory requirements. This is available on our [website](#).

As a practical matter, these changes should also be understood as supplementing or underlying certain of the external or client-facing disclosures required under the separate Sustainable Finance Disclosure Regulation (**SFDR**) (also known as the Disclosures Regulation). The SFDR assumes, in part, that in-scope firms are subject to an obligation to integrate sustainability into their organisational structure and decision-making processes, and it is these delegated acts (and their amendments to AIFMD, UCITS and MiFID) which give effect to that.

Please see [here](#) for all our ESG briefing notes, including on the SFDR and the Draft RTS.

What are the key changes proposed?

While there are technical differences between the proposals to the three regimes, the key changes include:

- **Organisational structure:** existing rules require firms to implement documented decision-making procedures, organisational structures, reporting lines and control mechanisms. These rules will be updated to require that firms take into account sustainability risks when complying with these organisational requirements. In practice, this will require firms to embed a consideration of sustainability risks in their existing governance and organisational structure.
- **Identification of conflicts of interest:** existing rules require firms to identify conflicts of interest, as part of broader rules requiring firms to manage conflicts. These rules will be updated to require firms also to identify conflicts which may arise from the integration of sustainability, or a client's sustainability preferences. These could include, for example, conflicts arising from the risk of greenwashing, or the mis-selling of investment strategies. In practice, this will require firms to update existing conflicts registers, policies and processes to take account of conflicts relating to sustainability.
- **Due diligence when investing [AIFMD and UCITS]:** existing rules under AIFMD and UCITS require firms to implement due diligence processes when making investment decisions. These rules will be updated to require firms to take into account sustainability risks when investing. In addition, for those firms which are within scope of Article 4 of the SFDR and which have implemented principal adverse impact policies, such firms must also update their investment due diligence processes to specifically take account of their Article 4 principal adverse impact policies. In practice, this will

require firms to update their investment processes to take account of sustainability risks (and, for some firms, to do so in a way which is aligned with principal adverse impact policies).

- **Suitability assessment [MiFID]:** existing rules require firms to carry out a suitability assessment, when giving investment advice or making a portfolio management decision, including to take account of how the recommendation or decision meets the client's investment objectives. This requirement will be updated so that firms must also take account of the client's "sustainability preferences". This concept is aligned with the specific categories of sustainability-focused funds identified under Articles 8 and 9 of the SFDR, either: (a) a financial product that has sustainable investment as its objective, or (b) a financial product that promotes environmental or social characteristics. In practice, this will require firms to change their investment advisory and management processes, to ensure that they properly reflect a client's sustainability preferences.
- **Product governance [MiFID]:** existing rules require manufacturers and distributors of financial products to take account of the needs of an identified target market. These rules will be updated to require such firms also to take account of the sustainability preferences of the target market. In practice, this will require firms to update their product origination and marketing / distribution strategies, to ensure that they take account of the sustainability preferences of the target market.

A more detailed summary of the changes proposed, and the types of firm to which they will apply, is set out in the **Appendix** to this note.

What should firms be doing next?

The draft delegated acts were open for feedback until **6 July 2020**. The Commission's formal proposals will be considered by the Council of the EU and the European Parliament and, when agreed, the text will be published in the Official Journal.

Firms should review the amendments proposed by the draft delegated acts, and put in place an appropriate project plan covering at least the following actions (so far as applicable to the firm):

- conduct an analysis of existing organisational / governance rules, or existing conduct of business obligations, and determine what amendments are required to be made;
- review and update internal policies and processes such as the firm's conflicts of interest policy and due diligence processes; and
- organise internal processes, including responsibilities, to implement changes made as a consequence of taking into account sustainability risk and sustainability preferences.

How can Simmons & Simmons help?

Simmons & Simmons would be pleased to assist with scoping, advising on decision-making, advising on application, project plans and preparing policies. We are preparing templates for our clients to use.

We can support asset managers and investors seeking to draw on Simmons' ESG expertise in a number of ways. Please contact us to discuss your needs.

Appendix

Summary of amendments proposed to AIFMD, UCITS and MiFID regimes

Topic	Existing requirement	Amended requirement	AIFMD	UCITS	MiFID
Defined terms	N/A	“sustainability risk” : 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	✓	✓	✗
Defined terms	N/A	“sustainability factors” : environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters	✓	✓	✓
Defined terms	N/A	“sustainability preferences” means, in summary, a client's choice as to whether either: (a) a financial instrument that has sustainable investment as its objective, or (b) a financial instrument that promotes environmental or social characteristics, should be integrated into their investment strategy	✗	✗	✓
Organisation requirements – general	<i>General organisational requirements require documented decision-making procedures, organisational structures, reporting lines and control mechanisms</i>	A new obligation for firms to expressly take into account sustainability risks when complying with these requirements	✓	✓	✓
Organisation requirements – senior management	<i>Requirement for a firm's senior management to be responsible for various key organisational matters</i>	A new responsibility for senior management to ensure the integration of sustainability risks into all identified key organisational matters	✓	✓	✗
Adequate resources	<i>Requirement to employ sufficient personnel, with skills, knowledge and expertise to discharge their responsibility</i>	A new requirement to retain the necessary resources and expertise for the effective integration of sustainability risks	✓	✓	✗
Identification of conflicts of interest	<i>Requirement to identify conflicts of interest</i>	New requirement to include conflicts of interest that may arise as a result of the integration of sustainability risks in a firm's processes, systems and internal controls [AIFMD or UCITS] or a client's suitability preferences [MiFID]	✓	✓	✓
Investment due diligence	<i>Requirement to apply due diligence when selecting and monitoring investments, and to implement due diligence investment policies</i>	Firms must take into account sustainability risks as part of the due diligence process. In addition, for a firm in-scope of the “principal adverse impact” rules (under article 4 of the SDFR, the firm must also consider the principal adverse impacts as part of its investment due diligence.	✓	✓	✗
Suitability assessment	<i>Requirement to obtain sufficient information on the client's investment objectives and risk tolerance, to perform the suitability assessment</i>	Firms must also expressly obtain information on the client's sustainability preferences, for the purposes of the suitability assessment	✗	✗	✓
Suitability assessment	<i>Requirement for firms to understand the features of investments selected for their clients</i>	Firms must also expressly understand the sustainability factors for products or services	✗	✗	✓
Suitability reports	<i>Requirement to provide retail clients with a suitability report to explain how the recommendation is suitable for the client</i>	Firms producing a suitability report must also explain how the recommendation meets the client's sustainability preferences	✗	✗	✓
Risk management policy	<i>Requirement to establish a documented risk management policy, which manages exposure to (amongst others) market, liquidity and counterparty risks</i>	Firms must also expressly consider sustainability risks as part of risk management policies	✓	✓	✓
Product governance	<i>Manufacturers and distributors must identify the target market for financial instruments</i>	Firms must take into account sustainability preferences, when determining the client types for whom the instrument is compatible or carrying out distribution activities	✗	✗	✓
Product governance	<i>Manufacturers must examine whether certain elements of a product meet the identified needs of the target market</i>	The elements to be assessed for this purpose will be expanded to include the financial instrument's sustainability factors	✗	✗	✓

Topic	Existing requirement	Amended requirement	AIFMD	UCITS	MiFID
Product governance	<i>Manufacturers and distributors must conduct regular reviews to ensure that products remain compatible with the target market</i>	Firms must take into account sustainability preferences, when conducting such a review	x	x	✓

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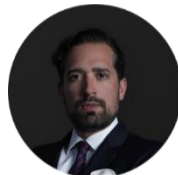
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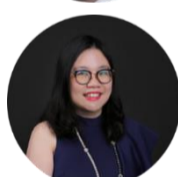
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