PRIVATE CAPITAL CONFERENCE SERIES

Breakfast Briefing

Navigating European and U.S. Regulatory Trends and Developments

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Agenda

- U.S. Regulatory developments and trends
- ESG Regulation: State of Play and Horizon-Scan
- Greenwashing: The U.S. regulator’s focus
- AIFMD 2.0

U.S. Regulatory – Developments and Trends

U.S. Regulatory

- **How does U.S. regulation apply to UK / European Sponsors?**
  - Regulation of the Manager
  - Regulation of the Fund
  - Regulation of the Offering to U.S. Investors

- **Regulation of the Manager**
  - **Investment Advisers Act:** Governs investment advice, including management and recommendations.
  - **SEC Registration:** Where required, manager is subject to substantive rules and active oversight (significant burden).
  - **Exemption Regimes** for Non-U.S. Managers:
    - **Foreign Private Adviser:**
      - No U.S. offices.
      - <$25m from U.S. investors, <15 U.S. investors, across all funds.
      - No filing required.
    - **Exempt Reporting Adviser:**
      - Can have U.S. offices but no investment decision-making from U.S.
      - Unlimited capital from unlimited U.S. investors.
      - Filing required (Form ADV).
  - **Requirements for All Advisers:** Even exempt advisers are subject to some requirements, but not as many as registered advisers (RIAs) – See Appendix 1.
  - **Practical takeaways**.

U.S. Regulatory

- **Regulation of the Fund**
  - **Investment Company Act:** Primarily intended for retail-focused products.
  - **SEC Registration:** Very onerous and restrictive, if required.
  - **Exemptions for Privately-Offered Funds:**
    - Targeting HNW and institutional investors; more favorable if non-U.S. domiciled.
  - **Primary Exemptions:**
    - **3(c)(1):** <100 U.S. owners; "look-through" may apply to count owners' owners.
    - **3(c)(7):** Unlimited owners, but all U.S. owners must be "qualified purchasers" (>$5m for HNW, >$25m for institutions); "look-through" may apply for QP status.
    - No filing required for either exemption.
  - **Practical takeaways.**
- **Regulation of the Offering to U.S. Investors**
  - **Securities Act:** Governs U.S. securities offerings.
  - **SEC Registration**: Very onerous and restrictive, if required.
  - **Private Placement Exemptions**: Regulation D, Rule 506(b).
    - Restrictions on soliciting new investors.
    - All U.S. investors must be "accredited investors" (>$1m for HNW, >$5m for institutions).
    - Filing required (Form D).
  - **Practical takeaways.**

ESG – Developments and Trends

ESG Developments

- EU
  - Fund focus:
    - SFDR 2.0
    - ESMA Fund Name Rules
  - Portfolio company focus:
    - CSRD
    - CSDDD
    - EU Deforestation Regulation
  - Manager reminders:
    - EU ESG Ratings Regulation
    - ESMA Greenwashing Paper
- UK
  - Fund focus:
    - SDR fund level – voluntary labels
    - TCFD fund reports if as manager/advisor have £5bn AUM
  - Portfolio company focus:
    - ISSB endorsement scheduled for next year

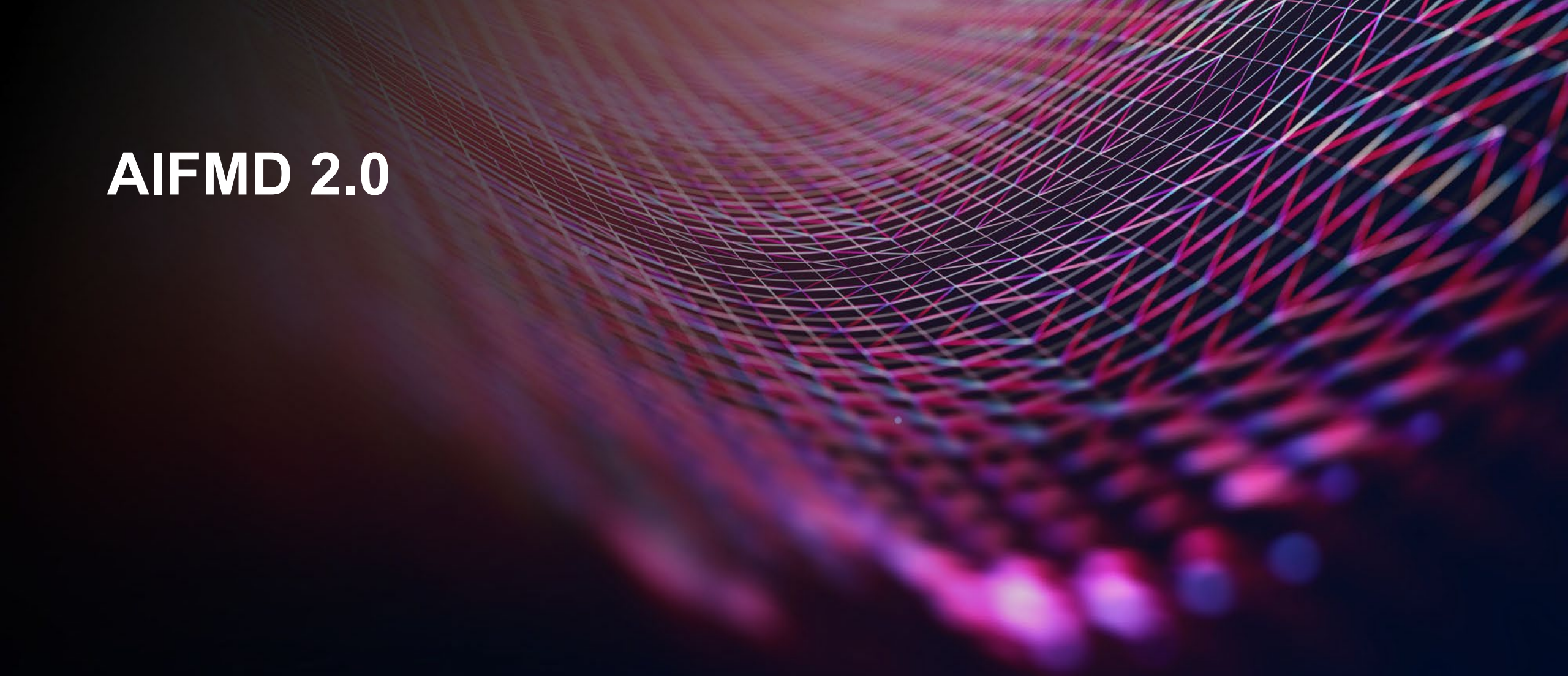
  Manager reminders:
    - SDR entity level – including TCFD reporting
    - Anti-greenwashing rule (wide application beyond managers to all authorized firms and appointed representatives)

U.S. Anti-Greenwashing

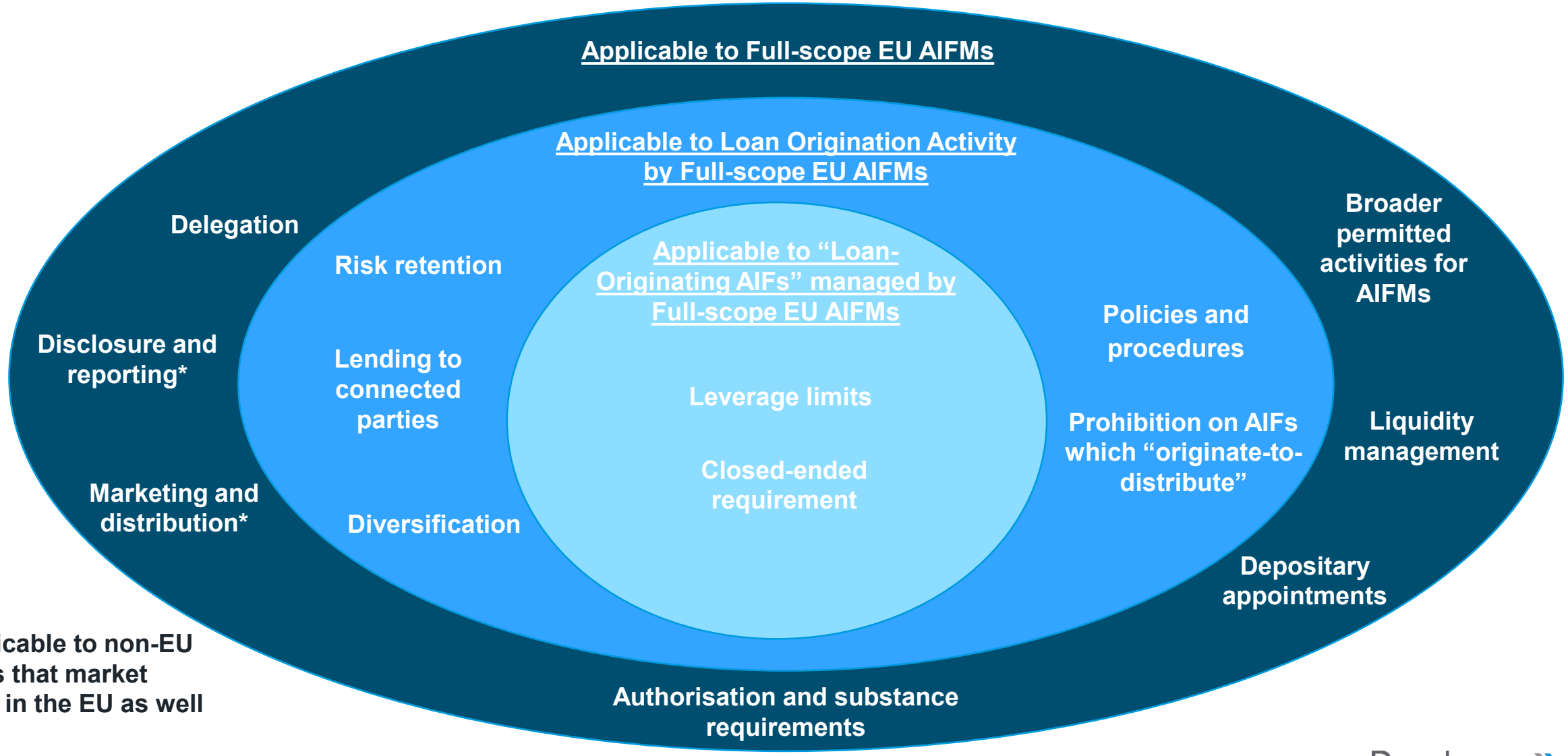
U.S. Greenwashing

- **SEC General Approach**
  - Proposed rulemaking
  - Scrutiny by three SEC Divisions (Enforcement, Exams, Corp Fin)
- **Sources of Inquiry**
  - Routine exams/reviews
  - Referrals from other Divisions
  - Targeted sweeps, ESG Taskforce
  - Civil lawsuits, press reports
  - Whistleblower complaints
- **Cases/Current Investigations**
  - Disclosure focused
    - *Are you doing what you say and saying what you do*
    - *Focus on strict compliance with the facts that are disclosed*
  - Materiality is presumed
  - No requirement for investor harm
  - Also focused on ESG-specific policies and procedures
  - Scrutiny of ESG policies and disclosures may expand into other issues

AIFMD 2.0



AIFMD II on the Horizon (in force from April 2026) – Overview of Requirements



*Applicable to non-EU AIFMs that market funds in the EU as well

Key Questions – AIFMD II

- **Are we in-scope?**
  - Applies to EU full-scope AIFMs (including Third Party AIFMs) and certain requirements will apply to funds which are marketed in EEA Member States.

- **Will AIFMD II have a big impact?**
  - Biggest impact on EU credit funds and their managers. Likely to also impact non-EU credit funds which are marketed in EEA Member States. Otherwise it is an “evolution rather than a revolution”.

- **Will AIFMD II introduce a cross-border lending “passport”?**
  - Maybe! While it is not explicitly provided for within AIFMD II, the inclusion of “originating loans on behalf of an AIF” as an ancillary AIFM activity means that this may be the case, although it is too early to tell.

- **Will AIFMD II impact UK AIFMs?**
  - No, unless the UK AIFM markets its fund(s) in the EEA.

- **Is “reverse solicitation” dead under AIFMD II?**
  - No, it remains possible to rely on “reverse solicitation” to raise capital from EEA investors where this is supported by the underlying facts.


Questions?

Appendix 1 - U.S. Regulatory - Further Information

U.S. Regulatory – Investment Advisers Act Fiduciary Duties for All Advisers

- **Anti-Fraud Provisions and Fiduciary Duty**
  - **Section 206(1) and (2)**: Prohibits advisers from defrauding clients, covering all conduct within the advisory relationship (even if unrelated to securities)
  - **Fiduciary Duty**: Duty of care and duty of loyalty, breached by intentional acts or by negligence
  - Fiduciary duties under the Advisers Act cannot be waived or altered by contract
  - Only the SEC can enforce these duties through lawsuits
  - Separate fiduciary duties under the law of the fund's domicile can be modified (if allowed) and enforced by LPs through private lawsuits
- **Application to Private Fund Advisers**:
  - The fund is the client of the adviser
  - **Rule 206(4)-8** extends Section 206 anti-fraud protections to cover dealings with the fund's investors
  - This rule is frequently cited in SEC enforcement against private fund advisers for duty breaches

U.S. Regulatory – Advisers Act Requirements for All Advisers

- **Principal Transactions and Cross Transactions**
  - **Principal Transaction:** Purchase or sale of securities between an adviser and a client
    - Prohibited without informed client consent on a transaction-by-transaction basis (pre-consents not allowed)
    - For private funds, GPs cannot cause the fund to consent; LPACs are typically empowered to do so
  - **Cross Transaction:** Transaction between two different funds or client accounts managed by the same adviser
    - Not always a “principal transaction,” but often raises conflicts of interest in illiquid strategies, affecting the duty of loyalty (Advisers Act Sec. 206)
    - Typically managed through disclosure and consent from each “client” (i.e., LPAC)
- **Political Contributions Rule**
  - **Rule 206(4)-5:** Prohibits advisers from receiving compensation for two years from a U.S. public pension plan if:
    - A "covered associate" (including control persons and marketers)
    - Makes a political contribution
    - To an official or candidate overseeing the pension plan
  - Allows de minimis contributions, but thresholds are low ($150–$350)
  - Easy to violate if not monitored, with severe consequences due to the potential fees from these investors.

U.S. Regulatory – Advisers Act Requirements for RIAs

- **Advisory Contracts: Consent to Assignment**
  - **Advisers Act Sec. 205:** Prohibits assignment of advisory contracts without client consent
  - For private funds, the LPA and Management Agreement are treated as "advisory contracts“
  - A change in control of the adviser is considered an indirect assignment
  - The GP cannot consent on behalf of the fund; consent typically comes from the LPAC or by LP majority/super-majority vote.
- **Performance-Based Compensation**
  - **Advisers Act Sec. 205 and Rule 205-3:** Prohibit performance-based fees (including carried interest) unless the investor is a "qualified client":
    - $2.1m net worth, or >$1m AUM with the adviser, or
    - Fund is a 3(c)(7) fund
  - Compliance is generally straightforward for fund managers unless dealing with smaller investors

U.S. Regulatory – Advisers Act Requirements for RIAs

- **Marketing Rule**
  - **Advertisement Definition:** Very broad, covering most communications related to marketing, including social media and re-postings
  - **General Prohibitions:**
    - False/misleading statements
    - Unsubstantiated material claims
    - Failure to provide "fair and balanced" presentation
  - **Testimonials and Endorsements:**
    - Trigger disclosures and requirements
    - Placement agents are considered compensated endorsers
- **Performance Advertising Requirements:**
  - Performance must be shown net of fees (including individual investments/subsets)
  - Model fees allowed; required if advertising performance of assets managed without fees
  - Special rules for "hypothetical performance" (e.g., projected returns):
    - Disclosure of assumptions and adoption of policies
    - Additional requirements for performance achieved at other firms
    - Must maintain records of advertised performance

U.S. Regulatory – Advisers Act Requirements for RIAs

- **Custody Rule**
  - **Rule 206(4)-2:** Requires specific procedures for client assets when an adviser has custody
    - Custody includes authority to take possession of assets or pay from client accounts
    - Most GPs/Managers of private funds have this authority
  - **Safekeeping:** Client cash and securities must be held with "qualified custodians" (e.g., banks, brokers)
  - **Third-Party Verification:**
    - Annual audit by an external firm is required to verify custody
    - For private funds, an annual U.S. GAAP audit within 120 days of FYE satisfies this requirement

- **Form PF:**
  - Requires RIA private fund advisers to file confidential reports with the SEC
  - Applies to RIAs with at least $150m in private fund AUM
  - Provides data on private fund risk exposures, leverage, and liquidity
  - Quarterly filing for large hedge fund advisers, annually for smaller advisers and closed-end fund managers
  - Also requires notice filings:
    - Large hedge fund managers: Within one business day for certain significant events, such as large losses, margin or default events or key operational disruptions
    - Private equity fund managers: On a more delayed basis, adviser-led secondary transactions, GP removals and early termination of investment period or fund

U.S. Regulatory – Advisers Act Requirements for RIAs

- **Compliance Program**
  - **Rule 206(4)-7** requires RIAs to:
    - Adopt written compliance policies tailored to prevent Advisers Act violations
    - Designate a Chief Compliance Officer (CCO) to oversee the program
    - Conduct and document annual reviews of the program's effectiveness
  - **Code of Ethics Rule (206(4)-7):** Requires RIAs to adopt a code of ethics, including standards for personal trading and reporting by "access persons"
- **Chief Compliance Officer Requirements**
  - Must be "knowledgeable and competent" on the Advisers Act and rules
  - Must have authority within the firm to enforce the compliance program
  - Acts as the primary SEC contact
  - Often a dual-hatted role in smaller firms, not necessarily dedicated

U.S. Regulatory – Advisers Act Requirements for RIAs: Limited Application to "Offshore" Advisers

- **SEC's Limited Extraterritorial Application of Advisers Act**
  - Most substantive requirements do not apply to advisers with principal offices outside the U.S. advising non-U.S. clients
  - All provisions apply when advising U.S. clients
  - For private funds, domicile determines U.S./non-U.S. status, regardless of investor nationality
- **Requirements Not Applicable to Offshore Advisers Advising Offshore Clients**
  - Client consent for principal transactions
  - Marketing Rule
  - Custody Rule
  - Client consent for adviser assignments
  - Performance-based fee prohibition (non-qualified clients)
  - Form PF (for non-U.S. funds with no U.S. investors)
  - Compliance Program and Code of Ethics (limited applicability)
    - Some recordkeeping still required
    - Must collect/retain personal securities reports from "access persons"

Appendix 2 – ESG Regulatory & Greenwashing – Further Information

Contents

Greenwashing

An uptick in regulatory risk for greenwashing

Fertile ground for greenwashing

- Even when unintentional, which translates into the following key risks, both of which have potential to pose financial risk:
  - **Legal risk** (such as litigation and regulatory enforcement)
  - **Reputational risk**

FCA anti-greenwashing rule

- In force from 31 May 2024 – applicable to all FCA authorized firms – must be a UK nexus to the communication
- Very broad range of communications – even pictures and imagery within the FCA's sights
- Extension of existing clear, fair and not misleading requirements – with a specific Rule the FCA could enforce

ESMA Final Paper on Greenwashing

- Request for NCAs to supervise more closely – call for scrutiny and challenge with the following areas, in particular focus:
  - Claims about product level sustainability, real-world impact or engagement activities
  - Entity-level net zero targets and transition plans
  - Sustainability-based remuneration systems

SEC investigation and enforcement

- Lack of formal rules, but with the highest rate of enforcement
- Investigations focus on misalignment between marketing materials and underlying fund documentation or policies and procedures
- Investigations have also focused on establishing disclosures, such as on screening, are not misleading in terms of impact on the portfolio construction

SEC's Climate and ESG Task Force

Sept. 12, 2024, 1:48 PM EDT; Updated: Sept. 12, 2024, 3:17 PM EDT

SEC Abandons ESG Enforcement Group Amid Broader Backlash (1)

EXCLUSIVE

Andrew Ramonas
Senior Reporter

Listen

- SEC ended task force within past few months, spokesperson said
- Agency launched group in 2021 with nearly two dozen staffers

The SEC has quietly disbanded a group of enforcement lawyers who helped bring litigation fighting misleading environmental, social and governance disclosures for more than three years.

The Securities and Exchange Commission shut down its Enforcement Division's Climate and ESG Task Force within the past few months, an agency spokesperson told Bloomberg Law Thursday.

- Enforcement's ESG Task Force launched in March 2021
- Nearly two dozen staff members
- Announced focus: public company disclosures of climate risks.
- Actual cases: more focused on Investment Advisers

SEC's ESG Timeline

- 2019-2020: ESG-focused "sweep" examinations of advisers
- March 2021: Division of Enforcement launched Climate and ESG Task Force
- April 2021: Division of Examinations ESG Risk Alert for Investment Advisers
- March 2022: Enforcement action filed against Vale S.A.
  - Brazilian mining company, U.S. ADR issuer
- May 2022: ESG Enforcement case against BNY Mellon Investment Adviser
- May 2022: SEC proposes ESG Reporting and Disclosure Rules for Advisers
  - No final rule (yet)
- September 2023: Names Rule Amendments (RICs and BDCs)
- 2024: ESG Task Force dissolved

Sample SEC Exam Requests with ESG Focus

Pertaining to ESG:

i. state the internal definition of any terms that relate to ESG that are also used in disclosure or marketing materials provided to prospective or current clients or investors;

ii. list and provide a description for all ESG criteria that are utilized (e.g., environmental, social, governance, etc.); and

iii. provide copies of any written policies and procedures relating to the application of ESG criteria to the investment process. Include versions currently in use and any previous versions utilized during the Examination Period.

State whether Registrants adhere to, or is a signatory to, any ESG industry standard(s) (e.g., UN Principles for Responsible Investment, Equator Principles, etc.). If so, please:

i. Provide written documentation of any consideration of the standard(s) in its investment/manager selection, portfolio management processes and proxy voting/issuer engagement practices.

ii. Provide copies of any initial application and subsequent periodic reports transmitted during the Examination Period by Registrants to the applicable ESG industry standard association(s), as well as any comments or evaluations received from the industry standard association(s), as applicable.

iii. Provide any policies and procedures associated with compliance oversight of adherence such ESG frameworks/standards.

Sample SEC Exam Requests with ESG Focus

For ESG Funds, state whether a proprietary scoring system (or scoring by an affiliated entity) is used. If so:

i. indicate whether the proprietary scoring system is based, in whole or in part, on ESG criteria;

ii. provide a written explanation describing the methodology used to derive the score;

iii. describe the factors underlying each score level;

iv. state how often the score is evaluated;

v. state whether prospective or current clients or investors are provided with the score(s); and

vi. provide copies of any formal, written procedures pertaining to the scoring system. If not included in the formal written procedures, please include or identify existing records that contain the explanations and descriptions sought in this request.

Similar questions for third-party ESG scoring systems or sub-advised strategies.

SEC Enforcement Actions – Investment Advisers

BNY Mellon Investment Adviser (May 2022)

- Adviser (and sub-adviser) didn't conduct written ESG quality reviews for all fund investments
- Misleading practices under the Advisers Act (and 40 Act prospectus violations).

Goldman Sachs Asset Management (Nov 2022)

- Failure to adopt written ESG policies and procedures, then later failure to routinely follow the procedures as to ESG questionnaires for ESG SMA strategies and mutual funds.
- Compliance Rule violations only.

DSW Investment Management (Sep 2023)

- Failure to fully implement written statements and policies, including considering ESG aspects in recommendations or documenting those reviews. Funds and SMAs.

Inspire Investing (Sep 2024)

- "Biblical values" ETF manager – failed to consistently apply its disclosed investment criteria.

SEC Enforcement Approach – Current Status

- The politicized term “ESG” may be falling out of favor …
  - “Red state” issues:
    - AG investigations
    - Divestment
- Current Investigations:
  - ESG-related concerns regarding disclosure obligations are alive and well.
  - “Do what you say and say what you do”
  - Focus is on complying strictly with facts that are disclosed.
  - Enforcement path: fiduciary obligations of U.S. Investment Advisers
  - ESG-Specific Policies and Procedures (required?)

Common greenwashing actions and locations

How greenwashing can occur

- ❑ Cherry-picking the most “ESG friendly” information to report on
- ❑ Omission, through being partial, selective, unclear, unintelligible, vague
- ❑ Oversimplistic, ambiguous or untimely information and unsubstantiated statements
- ❑ Empty or unsubstantiated claims (including exaggeration) where it is false, deceives or is likely to deceive including mislabelling, misclassification, mis-targeted marketing and inconsistent information
- ❑ Misleading use of ESG terminology such as naming
- ❑ Outdated information
- ❑ Focus on ESG process, without being clear on what the ESG result is
- ❑ Greenbleaching – playing down ESG profile

Where greenwashing can occur

- ❑ PPM/pre-contractual disclosures
- ❑ Fund periodic reports
- ❑ Annual reports at entity level
- ❑ Press releases
- ❑ Reporting under frameworks
- ❑ Marketing materials – website, social media, presentations to investors
- ❑ Pictures and colours - non-textual imagery or excessive imagery
- ❑ Placement agent/distributor material

Key anti-greenwashing takeaways

Very broad range of materials in scope of UK regulatory perimeter – must be substantiated claims on an ongoing basis

Regulatory action leads to higher litigation risk e.g. side letter, contractual review following parties alerted to regulatory scrutiny

European/UK regulators to gear up to enforce over coming years – SEC rules for funds tbc, whilst investigations continue apace

ESMA Fund Names Guidelines

ESMA Final ESG Fund Name Guidelines (1)

Which funds are in scope?

- **All AIFs and UCITS managed by EU AIFMs/UCITS management companies**
- **Transition, social, governance, environmental, impact, sustainability-related named funds – no exhaustive list**
- No confirmed direct coverage of non-EU managers marketing funds into the EU under NPPR
- Closed funds that are no longer marketed are technically also in scope – expecting regulators to take a proportionate approach and for re-naming not to be required in all cases

What do the Guidelines require?

- **Asset allocation:** All funds with ESG-related name: Asset allocation thresholds – 80% minimum – as part of binding elements of strategy
- **Climate Transition Benchmark exclusionary criteria:** for transition, social and governance-related named funds
- **Paris-aligned exclusionary criteria:** for environmental, impact and sustainability-related names funds
- **Additional requirement for sustainability-related name:** also must invest "meaningfully" in sustainable investments – not specified
- **Additional requirement for transition-related or impact-related name:** also must have a clear and measurable path to social or environmental transition, with the objective to generate a positive and measurable social or environmental impact alongside a financial return

ESMA Final ESG Fund Name Guidelines (2)

Are the Guidelines mandatory? When do they apply?

- **For new funds from 21 Nov 2024 and for existing funds from 21 May 2025 (BaFin already applying)**
- Within two months of the publication on ESMA's website in all EU official languages, local regulators must confirm if they (i) comply; (ii) do not comply but intend to; (iii) do not comply and do not intend to
- Expectation that closed funds that are no longer marketed will have to comply nine months after the ESMA publication – but consider proportionate approach and how the regulators choose to embed them
- If possible, factor into strategy considerations now

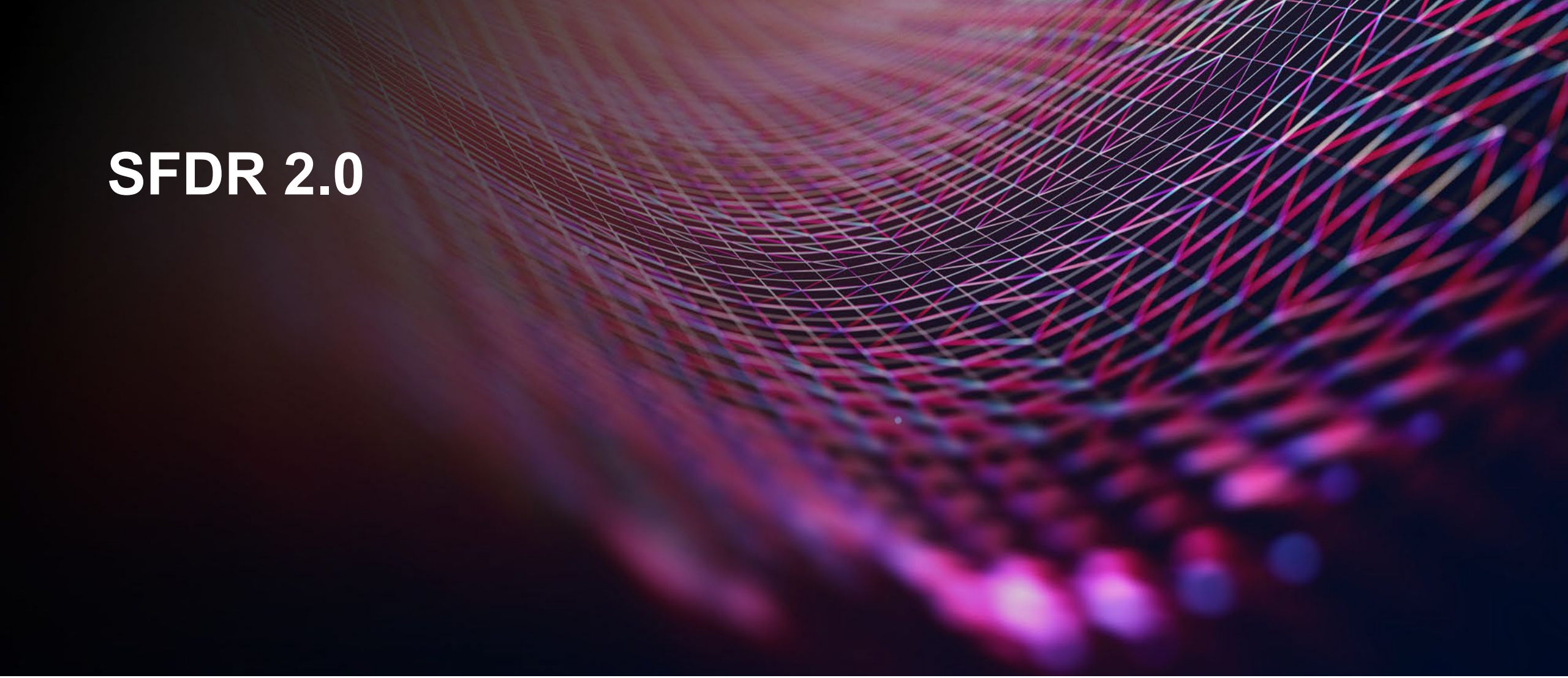
What are the supervisory expectations?

- **No specific enforcement action or penalties recommended**
- Fund name changes may trigger a material change notification to EU regulators
- Temporary breach that is corrected in the best interests of investors should be considered a passive breach
- "Further investigation" and "supervisory dialogue" recommended, such as where there is a quantitative asset allocation breach and it is not a passive breach or even where the regulator considers an investor might be misled

Quick Reference Guide: ESMA Final ESG Fund Name Guidelines

The Fund Name Contains	80% Asset Allocation: Share of Investments in accordance with Binding Elements of the Investment Strategy	Minimum Exclusions according to the Climate Transition Benchmark (fossil fuels “allowed”)	Minimum Exclusions According to the Paris-Aligned Benchmark (very limited fossil fuels possible)	Obligation to "meaningfully" invest in Art. 2 (17) SFDR sustainable investments (no threshold set)
Transition, social or governance-related terms	•	•		
Environment- or impact-related terms	•		•	
Sustainability-related terms	•		•	•

SFDR 2.0



SFDR 2.0

- ***On course for change***
- Two consultation papers launched in Sept 2023 seeking feedback on fundamental redesign and repurposing of SFDR.
- Feedback window ended 15 December 2023 - 50/50 on whether should develop or scrap SFDR.

Joint ESAs' Opinion

Suggested 'Sustainability' label

- Already e/s sustainable investments.
- For environmentally sustainable – minimum % of Taxonomy-aligned.
  - For non-Taxonomy aligned must follow DNSH (PAIs, minimum safeguards + good governance).
  - SFDR Article 2(17) sustainable investment only to be used if activity not included in Taxonomy Regulation.
- For socially sustainable – social metrics could be social PAI indicators.

Suggested 'Transition' label – could be Transition Impact sub-category

- Investments aiming to become sustainable over time.
- Mix of Taxonomy-alignment, transition plan reliance, decarbonisation trajectories, mitigation of PAIs and exclusions.
- Quantitative short, intermediate and long-term targets/milestones.
- No requirement for DNSH to all investments as some may be transitioning from a permanently harmful threshold, some indicators permanently harmful.

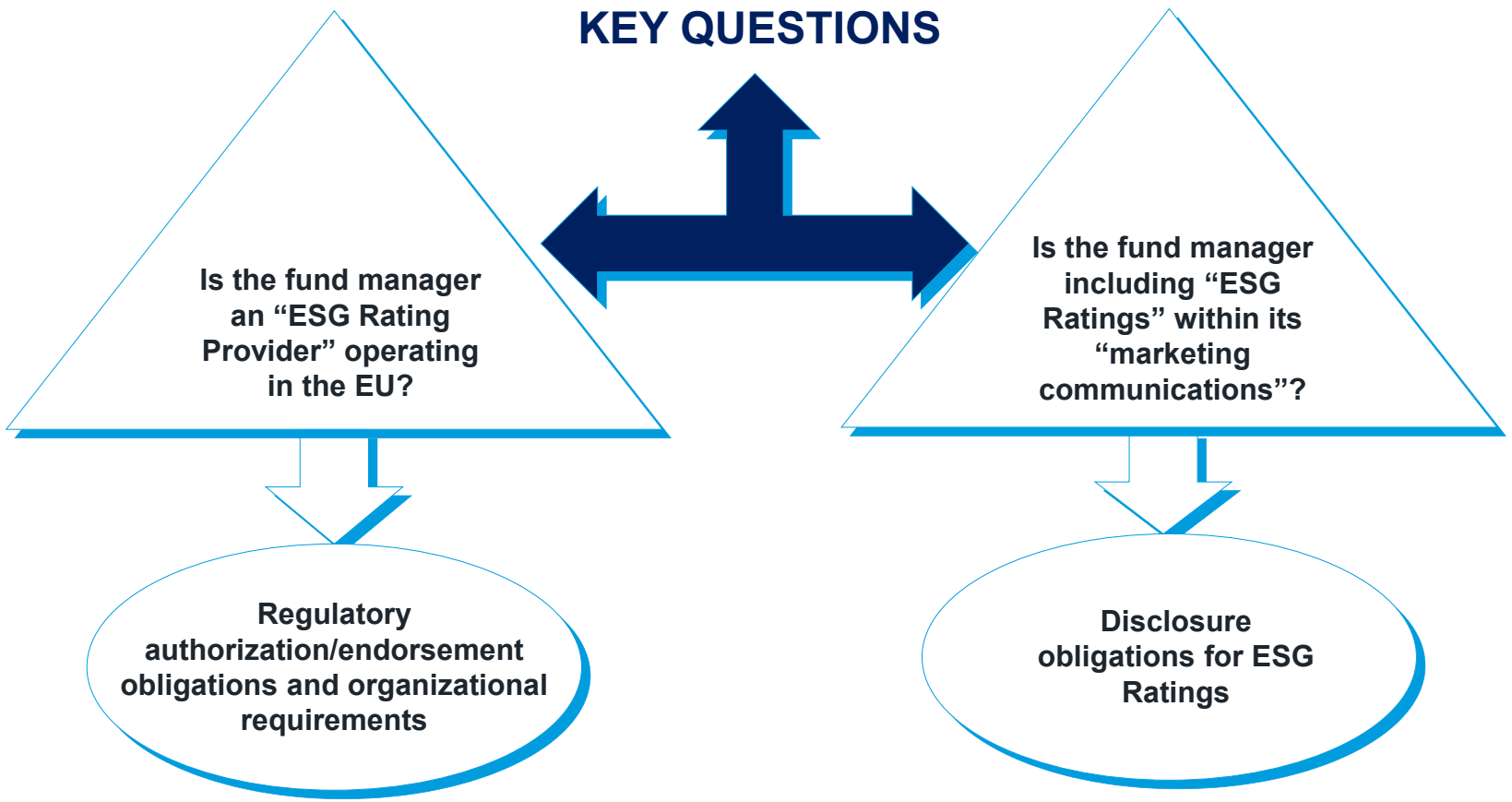
Other concepts:

- Funds not categorised either to disclose sustainability features or have a disclaimer
- Also consider a sustainability indicator to be present.
- Sustainability risks disclosures to be retained.
- Differentiate between "consider" PAIs and "information on" PAIs – and potentially some PAIs to be disclosed for all funds.

ESG Ratings Regulation

EU ESG Ratings Regulation – Key Questions

- **Purpose:** ensure investors and other stakeholders have access to reliable and comparable ESG rating objectives (what they assess) and methodologies (how they assess).
- Potential capture of fund managers.
- ESMA to draft further requirements.
- Coming into force 2025/2026.



Is the fund manager an “ESG Rating Provider” operating in the EU?

Breakdown of key terms

- “**ESG Rating Provider**” – any legal person whose occupation includes the issuance and (a) publication; **or** (b) the distribution by subscription of ESG ratings on a professional basis.

- “**ESG Rating**” – an opinion, a score or combination of both relating to a rated item’s profile or characteristics in relation to environmental, social and human rights or governance factors or exposure to risks of the same, based on both an established methodology and a defined ranking system of rating categories.

- “**Operating in the EU**” – triggered where the non-EU ESG Ratings Provider “issues and distributes” ESG ratings through subscription or other contractual relationships. - Lower bar for EU-based ESG Ratings Providers and may be in scope where entities “issue and publish” their ESG Rating.

- **Authorization or endorsement** – if found to be an ESG Rating provider then need to be authorized by ESMA if EU entity or endorsed by ESMA if non-EU and follow organizational requirements.

ESG opinion:
an ESG assessment that is based on a rules-based methodology and defined ranking system of rating categories, involving directly a rating analyst in the rating process or systems process

ESG score:
ESG measure derived from data, using a rule-based methodology, and based only on a pre-established statistical or algorithmic system or model, without any additional substantial analytical input from an analyst

Is the fund manager an “ESG Rating Provider” operating in the EU?

useful exemptions

a) **private ESG ratings which are not intended for public disclosure or for distribution;**

b) ESG ratings issued by regulated financial undertakings that are used exclusively for internal purposes or for providing in-house or intra-group financial services or products;

c) **ESG ratings issued by a regulated financial undertaking in the EU, that are incorporated in a product or a service where that product or service is already regulated under EU law (e.g., under SFDR, AIFMD, MiFID, CRD IV, etc.) and are disclosed to third parties;**

d) the publication or distribution of data on ESG and human rights factors;

e) products and services which incorporate an “element of” an “ESG Rating” (e.g., MiFID investment research);

f) **mandatory disclosures pursuant to Articles 6, 8, 9, 10, 11 and 13 of the EU SFDR and Articles 5, 6 and 8 of the EU Taxonomy; and**

g) ESG ratings which are developed exclusively for accreditation or certification processes which do not target investment and financial analysis or decision-making.

E.g., contractual agreement via side letter to provide an “ESG Rating”.

E.g., “ESG Rating” is disclosed in fund’s marketing materials related to a regulated product or service to prospective investors.

Manager describes an internal proprietary ESG rating system, e.g. in marketing materials, and provides example of a rated investment held by another fund.

E.g., “ESG Rating” is described in product-level periodic reporting for an Article 8 fund, pursuant to Article 11 SFDR reporting requirements.

Is the fund manager including “ESG Ratings” within its “marketing communications”?

What are “marketing communications”?

- Undefined in the ESG Ratings Regulation
- Proposed approach to refer to ESMA’s Marketing Guidelines on the cross-border distribution of funds, which excludes legal and regulatory documents / information of a fund, such as a prospectus, Article 23 disclosure, KID/KIID, periodic reports under AIFMD.

What if we do have ESG Ratings in our marketing communications?

- Detailed additional disclosures must be provided on the website – with a link to those disclosures in the marketing communications

Indicative table of materials:

Flipbooks or slide decks or similar investor-facing materials	Marketing material (unless communication issued in the context of pre-marketing)
SFDR pre-contractual disclosures	Legal/regulatory document (not a marketing material)
SFDR website disclosures	Legal/regulatory document (not a marketing material)
Prospectus	Legal/regulatory document (not a marketing material)
PPM	Possibly a legal/regulatory document (not a marketing material) depending on how a firm treats a PPM for the purposes of ESMA’s Marketing Guidelines under the CBDF
SFDR periodic disclosures	Legal/regulatory document (not a marketing material) even if provided to prospective investors
Voluntary ESG reports (or similar voluntary materials) which are sent to existing investors in a fully closed closed-ended fund	Not a marketing material

Key EU ESG Ratings Regulation Takeaways

1. Establish whether EU entities issue and publish ESG Ratings and apply exemptions.

2. Establish whether non-EU entities “operating in the Union” issue and distribute ESG Ratings and apply exemptions.

3. Assess whether any marketing materials that are not legal/regulatory documents have ESG Ratings included in them and consider next steps with regards to meeting disclosure requirements.

Please note that the regulation is still making its way through the formal process to come into force and will not be effective until 2025/2026 at the earliest. Nevertheless with public website disclosure requirements, it is recommended to plan ahead.

Further Discussion Points

Further sustainable finance regulation discussion points

CSRD

- Scoping exercises completed/underway – not always a neat mapping between financial/sustainability reporting
- Material topics listed
- Remember core objective of this being a disclosure effort, not a compliance exercise
- EFRAG guidance – under constant update
- Training for portfolio companies
- Selecting service providers – consultancy, legal and assurance
- Timing: CSRD is in force and the application is rollout in staged manner depending on company size

UK SDR

- Very limited private markets take up – AEW UK Impact Fund (PAIF) has announced will use label
- UK funds only (with one exception)
- UK firms required to make entity level disclosures capturing approach to managing sustainability risks and opportunities in relation to UK and overseas funds managed from the UK (in 2025 onwards)
- Retail focus
- Ongoing movement across regulatory landscape – "wait and see" for SFDR first, with SDR being voluntary
- Timing: SDR is in force, application to overseas retail funds expected in future

U.S. ESG

- Range of competing pressures remain, consider review/refresh on the following, as relevant:
  - U.S. Public Company Climate Change Disclosures
  - California Climate Reporting Legislation
  - SEC ESG investigation sand enforcement
  - ERISA ESG requirements
  - ESG proposed reporting requirements for investment advisers
  - U.S. human capital disclosure rules
  - Anti-boycott rules

Addendum 1 – FCA Anti-Greenwashing Rule

FCA Anti-Greenwashing Rule

- **In force 31 May 2024**
- **Applies to all FCA authorized firms**
- **Extension of existing clear, fair and not misleading requirements**
  - Communications with a client (potential or actual, retail or professional) in the United Kingdom in relation to a product or service
  - Communications or approvals of financial promotions to a person in the United Kingdom
  - Where the communication/financial promotion infers or refers to the sustainability characteristics of a product or service
  - Inclusive of firm-level information which does not relate to a specific product or service which may still be in scope if considered part of 'representative picture' of a product or service

The FCA Rule

A firm must ensure that any reference to the sustainability characteristics of a product or service is:

- ***consistent with the sustainability characteristics of that product or service; and***
- ***fair, clear and not misleading***

Three pillars of the FCA Anti-Greenwashing Rule

1. Correct and capable of being substantiated

- Factually correct
- RobU.S.t and credible evidence
- Substantiated at the time of making the statement and on an ongoing basis
- If specific evidence is referenced, consider making that evidence available
- Avoid overstating

2. Clear and presented in a way that can be understood

- Transparent and straightforward
- Technical terms explained
- useful to intended audience
- Images and colour to be consistent with claims
- Avoid general, broad statements
- Avoid misleading impressions through misuse of images and colours

3. Complete

- Representative of the product/service
- Prominently state conditions, caveats and limitations of data/metrics
- Present in a balanced way – include negative sustainability impacts
- Cover full life cycle – specify what applies, when
- Avoid cherry-picking

See FCA Guidance for further information and good practice examples: FG24/3: Finalised non-handbook guidance on the Anti-Greenwashing Rule (fca.org.uk)

Indicative steps plan to meet FCA anti-greenwashing expectations

Assess universe of in-scope materials

- **Territorial scope:**
  - From the UK firm or manager more broadly that could be considered to include UK service/product?
  - To a UK recipient or potentially to a UK recipient?
- **Broad scope:** 'references to sustainability characteristics could be present in (but are not limited to) communications that include statements, assertions, strategies, targets, policies, information, and images relating to a product or service'

Review/update in-scope materials

- **Definitions / concept bank:** develop or refresh manger's house view on terminology to drive consistency
- **Changes to materials:** if amendments are required, consider approval required internally, externally with investors and if triggers a material change for regulatory purposes
- **Disclaimers**: ensure appropriate disclaimers are in place on materials

Processes and policy update

- **Approvals of sustainability material**: consider any required updates for approval process of materials with sustainability element
- **Periodic review:** consider review process e.g. scheduled periodic review of live materials in compliance monitoring and internal audit
- **Further due diligence:** Consider any additional diligence required e.g. on data providers/portfolio companies

Governance, oversight, skills

- **Training:** consider training from board to PMs to risk and compliance – do they understand the house approach to sustainability terminology and its use cases?
- **Board/committee materials:** are they fit for purpose with appropriate descriptions of sustainability-related terms to understand what they are approving?

Addendum 2 – Proskauer & ESG

Examples of Proskauer ESG services

1. ***Drafting/review support across fund documentation, marketing materials, websites and side letters***
   - Ensuring a consistent approach is taken, with regards to house view and as well as regulatory requirements such as SFDR and limiting liability risk, where possible

2. ***Regulatory and litigation risk training***
   - What are the legal litigation actions that might arise? What are the likely practical considerations if a litigation claim is made?
   - What are the common themes of SEC ESG-related regulatory investigation and enforcement actions? What are the relevant European and UK regulators' approach?

3. ***Definitions/concepts review***
   - Testing your sustainability house definitions bank

4. ***Board sustainable finance regulation training***
   - Support with providing sustainable finance regulation 101 training to the board – can be inclusive of litigation/regulatory risk

5. ***Greenwashing dos and don'ts guide***
   - Practical anti-greenwashing advice, split between "entity level, governance organizational", "fund ESG strategy, objectives and characteristics" and "KPIs, metrics and progress reporting"

6. ***Disclaimers drafting***
   - Limiting liability appropriately with regard to broader regulatory responsibilities

7. ***ESMA Guidelines on fund names scoping Review***
   - Establish list of funds in scope of new requirements.

8. ***ESMA Guidelines - drafting/review support across fund documentation, marketing materials and websites***
   - Reviewing fund names and drafting relevant disclosures and exclusions to ensure a consistent approach in line with ESMA Guidelines.

9. ***Assistance with any material change notifications***
   - Support with notifications to EU regulators and communication to investors for any fund name/asset allocation/thresholds.

10. ***Scoping Review – ESG Ratings Provider***
    - Assessment of requirements of "ESG Ratings Provider" and any applicable exemptions.

11. ***Scoping Review – marketing materials for ESG Ratings Regulation***
    - Assessment of whether "ESG Rating" is provided in "marketing materials".

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Appendix 3 – AIFMD 2.0 – Further information

Background / Timeline

- On 26 March 2024, the final legislative text for targeted amendments to Directive 2011/61/EU (the "**AIFMD**") and (to a certain extent) the UCITS Directive – known informally as "**AIFMD II**" – was published in the Official Journal of the European Union, with an adoption date of **15 April 2024**.

- AIFMD II seeks to address (i) perceived shortfalls in the AIFMD; and (ii) new risks that have emerged, following the significant growth of the funds industry (including specific risks arising from direct lending activities).

Date	Summary
February 2024	European Parliament and European Council approved the final legislative text.
15 April 2024	AIFMD II was adopted in the Official Journal of the European Union (the "**Adoption Date**").
16 April 2026	Following a 2-year implementation period, AIFMD II will come into force.
16 April 2029	End of the grandfathering period for loan origination funds which were established prior to the Adoption Date. During this period, pre-existing AIFs (i.e. AIFs constituted prior to the Adoption Date) will not be required to comply with the leverage limits, diversification rules and the closed-ended requirement. However, any pre-existing AIFs which are already in breach of the leverage and/or diversification rules as at the Adoption Date must not increase their leverage or lending to the relevant borrower during this period. In addition, certain requirements (e.g. lending to certain parties, risk retention and the prohibition on "originate to distribute" strategies) will not apply to pre-existing loans as at the time of the Adoption Date.

Applicability

Entity	Summary
Sub-threshold EU AIFMs	AIFMD II changes not applicable.
Full-scope EU AIFMs	General requirements set out on slides 5 to 9 are applicable.
Non-EU AIFMs	If AIFs are marketed in the EU under the national private placement regimes ("**NPPRs**") (i) the disclosure and reporting; and (ii) the marketing and distribution requirements, set out slides 7 and 8 are applicable.
Full-scope EU AIFMs that carry out loan origination activity	Additional requirements set out on slides 10 to 14 are applicable (as well as the requirements set out on slides 5 to 9).
Full-scope EU AIFMs that manage "loan-originating AIFs"	Additional requirements set out on slides 15 to 17 are applicable (as well as the requirements set out on slides 5 to 14).

- **Note:** In implementing AIFMD II, certain Member States may extend additional obligations (i.e. "goldplating") to EU AIFMs as well as non-EU AIFMs. It is still to be seen whether this occurs and should continue to be monitored.
- The subsequent slides set out the key considerations arising from AIFMD II for credit fund managers.
- The changes introduced by AIFMD II do not constitute a major overhaul of the existing regime, but credit fund managers (in particular) are expected to be impacted by the new pan-European regime for "loan-originating AIFs" as set out on slides 15 to 17.

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Requirements Applicable to Full-scope EU AIFMs

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General requirements applicable to all EU full-scope AIFMs

Broader permitted activities for AIFMs – Articles 6(4) to 6(5)

- Currently, EU AIFMs can only perform the AIF management and ancillary activities set out in the AIFMD, as well as certain "top up" MiFID activities and UCITS management activities. AIFMD II introduces the following additional "top up" permissions that an AIFM will be able to provide:

  (i) benchmark administration (although EU AIFMs will not be able to administer benchmarks used in the AIFs they manage); and

  (ii) credit servicing.

- AIFMD II also includes the following in Annex I as permitted ancillary activities for EU AIFMs:

  (i) originating loans on behalf of an AIF;

  (ii) servicing securitisation special purpose entities;

- **Will there be a cross-border lending passport? Too early to tell.** The inclusion of the above ancillary activities appears to allow for "originating loans on behalf of an AIF" to be carried out on a cross-border basis across the EU – in effect, establishing a loan origination "passport". However, this is not explicitly stated in AIFMD II, so the current market view is that the ability to lending into specific EU Member States should be assessed on a country-by-country basis. This should be monitored as guidance / market practice develops.

General requirements (cont.)

Delegation – Articles 20, 24(2)(d) and 7

- AIFMD II expands the concept of "delegation" to beyond jU.S.t portfolio and risk management. The "top up" MiFID activities and additional ancillary activities set out on the previous slide are now also included, as well as the existing ancillary activities set out in Annex I (which include administration and marketing).

- AIFMs will be required to provide additional information in relation to their delegation arrangements, as part of their applications for authorisation / ongoing Annex IV reporting.

Disclosure and reporting – Articles 23 and 24

- The Article 23 pre-contractual disclosures have been expanded (to include, for example, a description of the conditions under which the AIFM may use liquidity risk management tools).

- Certain additional reporting requirements have also been introduced (including, for example, the total amount of leverage employed, further information on delegation etc.).

General requirements (cont.)

Marketing and distribution – Articles 20(6a) and 42(1)

- Marketing carried out by distributors acting on their own behalf under the Markets in Financial Instruments Directive 2014/65/EU ("**MiFID II**") or the Insurance Distribution Directive 2016/97/EU ("**IDD**"), even where a distribution agreement is in place with an AIFM, is not considered to be "delegation" under AIFMD II.

- This should be distinguished from arrangements where a distributor acts on behalf of the AIFM (e.g. as a sub-distributor), which would be subject to the delegation requirements under AIFMD II.

- In addition, non-EU AIFMs marketing their funds in the EU under NPPRs must not be established in "high-risk" jurisdictions under the Fourth Anti-Money Laundering Directive 2015/849/EU (e.g. the UAE is currently on this list) or jurisdictions that do not comply with certain EU / OECD tax standards.

- **Note:** Marketing by non-EU entities is not generally considered to fall under MiFID II or the IDD. As such, it seems that such entities would necessarily be treated as "delegates", even if acting on their own behalf. This should continue to be monitored as guidance / market practice develops.

General requirements (cont.)

Authorisation and substance requirements – Article 8(1)(c)

- Under AIFMD II, an EU AIFM seeking authorisation will need to conduct its business with at least two full-time people in the EU (either employed full-time by the AIFM or who are executive members of its governing body).
- EU AIFMs will also need to provide more information as part of their authorisation applications regarding the individuals conducting the business of the AIFM.

Depositary appointments – Article 21(5a)

- AIFMD II allows for Member State regulators to permit AIFMs to appoint depositaries in a different Member State to the home Member State of the AIF, subject to certain conditions.

Liquidity management in open-ended AIFs – Article 16(2b)

- The current liquidity management provisions have been broadened such that there will be new liquidity management rules for open-ended funds. In particular, EU AIFMs that manage open-ended AIFs are required to select at least two liquidity management tools from a specified list set out in a new Annex V of AIFMD II and comply with certain additional requirements.
- **Note:** Article 47(4) of AIFMD II contains a provision which allows for the extension of these liquidity management requirements to non-EU AIFMs. This should continue to be monitored.

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Requirements Applicable to Loan Origination Activity by Full-scope EU AIFMs

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Definition of Loan Origination – Article 4(ar)

- "Loan origination" is defined as:

  (i) granting a loan either directly where the AIF is the original lender; or

  (ii) indirectly originating a loan through a special-purpose vehicle or another party (where the manager structures the loan or sets out its characteristics before gaining exposure to it).

- There is no definition of "loan" in AIFMD II.

- **Note:** The expected market approach is that preferred equity and/or bonds and notes issued by a portfolio company to an AIF should not be caught. This should continue to be monitored as guidance / market practice develops.

- It is also unclear how tranched loans will be viewed – the expectation is that they would be viewed as a single loan, but this should continue to be monitored as it is relevant to the risk retention requirements (set out on the next slide).

Risk retention – Article 15(4i)

- The AIF will have to retain an economic interest of 5% of the notional value of the loans granted and sold to a third party. This is until maturity of the loan or for at least eight years (where the term of the loan is beyond eight years).
- This requirement is subject to certain carve-outs, such as:

  (i) where the AIF is being wound down and selling assets to allow investors to redeem interests as part of the AIF's liquidation;

  (ii) where such disposal is necessary to comply with EU sanctions rules;

  (iii) where necessary for the AIFM to implement the AIF's investment strategy "in the best interests of the AIF's investors"; or

  (iv) where there is a sale of assets as a result of a deterioration in the risk associated with the loan and the purchaser is informed of that deterioration when acquiring the loan.

- **Note:** The exact scope and parameters of when these carve outs will apply is subject to regulatory guidance that is yet to be published.
- It is currently unclear whether tranched loans would be required to be retained on a per-tranche basis or grouped together as a single "loan" (e.g. 5% of the value of the loan, but held through a holding of the loan's most junior tranche only).
- These points should continue to be monitored as guidance / market practice develops.

Diversification – Articles 15(4a) to (4d)

- AIFMs must ensure that a loan originated to any single borrower by an AIF it manages does not exceed 20% of the capital of the AIF where the borrower is itself an AIF, a UCITs or a financial undertaking (e.g. credit institutions, investment firm, insurance undertakings or mixed financial holding companies).
- This rule applies from the date specified in the fund's constitutional documents or prospectus, and it cannot be later than 24 months from the date of first closing.
- This requirement is subject to certain carve-outs and will:
  - (i) cease to apply once the AIFM starts to sell assets of the AIF in order to redeem units or shares as part of its liquidation; and
  - (ii) can be temporarily suspended where the capital of the AIF is increased or reduced (although this limited in time to the period that is "strictly necessary, taking due account of the interests of the investors in the AIF", and, in any case, shall last no longer than 12 months.
- **Note:** The exact scope and parameters of when these carve outs will apply is subject to regulatory guidance that is yet to be published.
- This should continue to be monitored as guidance / market practice develops.

Other relevant requirements

Lending restrictions – Articles 15(4e) and (4g)

- An AIF may not lend money to its AIFM, its staff, the depositary or members of the AIFM's group (save for certain exceptions).
- **Note:** Article 15(4g) of AIFMD II contains a provision which allows Member States to prohibit loan origination to consumers (i.e. natural persons acting outside their trade, business or profession). It is still to be seen whether this occurs and this should continue to be monitored.

Prohibition on AIFs which "originate-to-distribute" – Article 15(4h)

- EU AIFMs are prohibited from managing AIFs that originate loans with an "originate-to-distribute strategy" (i.e. where their sole purpose is to sell those loans to third parties).

Policies and procedures – Article 15(3)(d)

- AIFMs are required to *"implement effective policies and procedures and processes for the granting of credit"*. Where an AIFM manages AIFs which carry out loan origination, they must implement effective policies, procedures and processes to assess credit risk.
- These policies and procedures must be reviewed on an annual basis.

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Requirements Applicable to “Loan-Originating AIFs” managed by Full-scope EU AIFMs

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Definition of “Loan-Originating AIF” – Article 4(at)

- A “Loan-originating AIF” is defined as an AIF whose:

  (i) investment strategy is mainly to originate loans; and

  (ii) whose originated loans have a notional value that represents at least 50% of its net asset value.

Leverage limits / General closed-ended requirement

Leverage limits – Article 15(4b)

- The leverage of a loan-originating AIF cannot exceed:

  (i) 175% where that AIF is open-ended; or

  (ii) 300% where the AIF is closed-ended.

- These limits do not apply to lending activities solely consisting of shareholder loans as long as the notional value of those loans does not exceed in aggregate 150% of that AIF's capital.

- Leverage for these purposes is calculated according to the "commitment method" and reflects the definition in the original text of AIFMD (which can be interpreted quite broadly). Under this method, financial derivatives instruments may not need to be taken into account where they do not provide incremental exposure or leverage, however this is subject to a case-by-case analysis.

General closed-ended requirement (subject to certain exceptions) – Article 16(2a)

- AIFMs must ensure that loan-originating AIFs are closed-ended unless the AIFM can demonstrate that the AIF's liquidity risk management system is "compatible with its investment strategy and redemption policy".

- This requirement is subject to the parameters of the EuVECA Regulation ((EU) No 345/2013), EU.S.EF Regulation ((EU) 2019/115) and ELTIF Regulation ((EU) 2015/760) (as applicable).

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Breakfast Briefing

Navigating European and U.S. Regulatory Trends and Developments

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