MAPLES GROUP

IRELAND AS A CENTRE FOR GREEN FINANCE

A Guide to Sustainable Investment Funds

2ND EDITION

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A Guide to Sustainable Investment Funds

Foreword

We are delighted to present the 2nd Edition of our Guide to Sustainable Investment Funds during Climate Finance Week Ireland 2020.

Notwithstanding the impact of the COVID-19 pandemic, we have seen significant developments in Irish and international markets for sustainable investment since the publication of last year's Guide.

The year opened on the back of the presentation of the European Commission's Green Deal in December 2019. This hugely ambitious project set out a growth strategy aiming to make Europe the first climate neutral continent by 2050.

As part of the Green Deal, a European Green Deal Investment Plan (the "Plan") was presented in January 2020 seeking to mobilise at least €1 trillion of sustainable investments over the next decade. The Plan envisages a framework to facilitate the public and private funding needed for a transition to a climate-neutral, green, competitive and inclusive European economy.

Irish investment funds and their managers will play a significant part in this transition.

To further build on this momentum, the European Commission launched a consultation for a renewed sustainable finance strategy which closed in July 2020. We await the results and are confident it will create further opportunities for funds, managers and investors in this space.

Turning to the domestic market, 2020 was another strong year for Ireland in the ESG and wider sustainable investment markets.

A General Election resulted in the Green Party joining a new Coalition Government in a move which will further move sustainability to the core of Irish politics and policy.

The October 2020 Budget saw a number of fiscal measures introduced to transition the economy towards a sustainable future. We also saw a number of initiatives in the public and private sector which stemmed from the Ireland for Finance Strategy 2025. This plan includes sustainable finance as one of three priorities across all of its strategic pillars[1].

Finally, notwithstanding the impact of the COVID-19 pandemic on international and domestic markets, both assets under management and the number of funds domiciled in Ireland reached record numbers at the end of August 2020.

Against this extremely positive backdrop, the Maples Group look forward to continuing to support Sustainable Nation and SIF Ireland.

Our Funds & Investment Management Group has again been ranked as the largest in Ireland and our partners and leading lawyers have been recognised as market leaders and innovators for green funds and sustainable finance projects.

We are proud to have worked on the authorisation of some significant ESG products during the year and to advise some of the world's leading managers, institutions, financial services firms and their advisers on the EU's Sustainable Action Plan.

We continue to be of the view that, with strong support from the Irish Government, the Central

Bank of Ireland and local industry, Ireland will build on its highly successful funds and investment management sector and become a global centre of excellence for sustainable investment funds.

We further believe that the global recovery from COVID-19 presents further opportunities for sustainable and responsible investment.

We hope that this revised Guide will provide managers with information on how to raise private capital in Ireland in order to fund the challenges posed by climate change and to further promote ESG aims.

Peter Stapleton

Head of Funds & Investment Management
Maples Group

Stephen Nolan

Chief Executive Officer
Sustainable Nation

[1] https://assets.gov.ie/24482/278893738e764db79c43eada83c030e3.pdf

SUSTAINABLE FINANCE IN THE CONTEXT OF FUNDS AND INVESTMENT MANAGEMENT

There are many terms used to describe global trends in green finance, sustainable finance, responsible investment, impact investing and the many facets of ESG labelling.

This Guide addresses many of these concepts but its focus is on sustainable investment fund strategies and the activity of their managers taking ESG factors into account.

The European Commission's ("EC") Action Plan: Financing Sustainable Growth ("Action Plan") sets out the EU Strategy to integrate ESG considerations into its financial policy framework and mobilise finance for sustainable growth. In particular, we shall concentrate on the existing legal, regulatory and tax regimes in Ireland while taking account of some notable changes introduced on foot of the Action Plan, such as the EU Sustainable Financial Disclosure Regulation EU/2019/2088 (the "Disclosure Regulation")[2] and the "Taxonomy Regulation"[3].

[2] Regulation (EU) 2019/2088 of the European Parliament and the European Council of 27 November 2019 on sustainability related disclosures in the financial services sector. Online at: https://eur-lex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:32019R2088&-from=EN.

[3] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

“

The European Green Deal is the first priority for a very important reason, it is a reflection of how serious and how big the challenges are when it comes to climate change, environmental degradation and social cohesion.

MARTIN SPOLC
HEAD OF SUSTAINABLE FINANCE UNIT, EUROPEAN COMMISSION
(16 JUNE 2020)

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THE CLIMATE EMERGENCY AND DEMAND FOR PRIVATE CAPITAL

"While public funding will be vital for the green transition, it cannot pay the massive investment bill alone. We also have to tap private capital, and greatly scale up green investment so that it can help address the climate emergency.

Valdis Dombrovskis, Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union, stated at the launch of the International Platform on Sustainable Finance ("IPSF") on 18 October 2019.

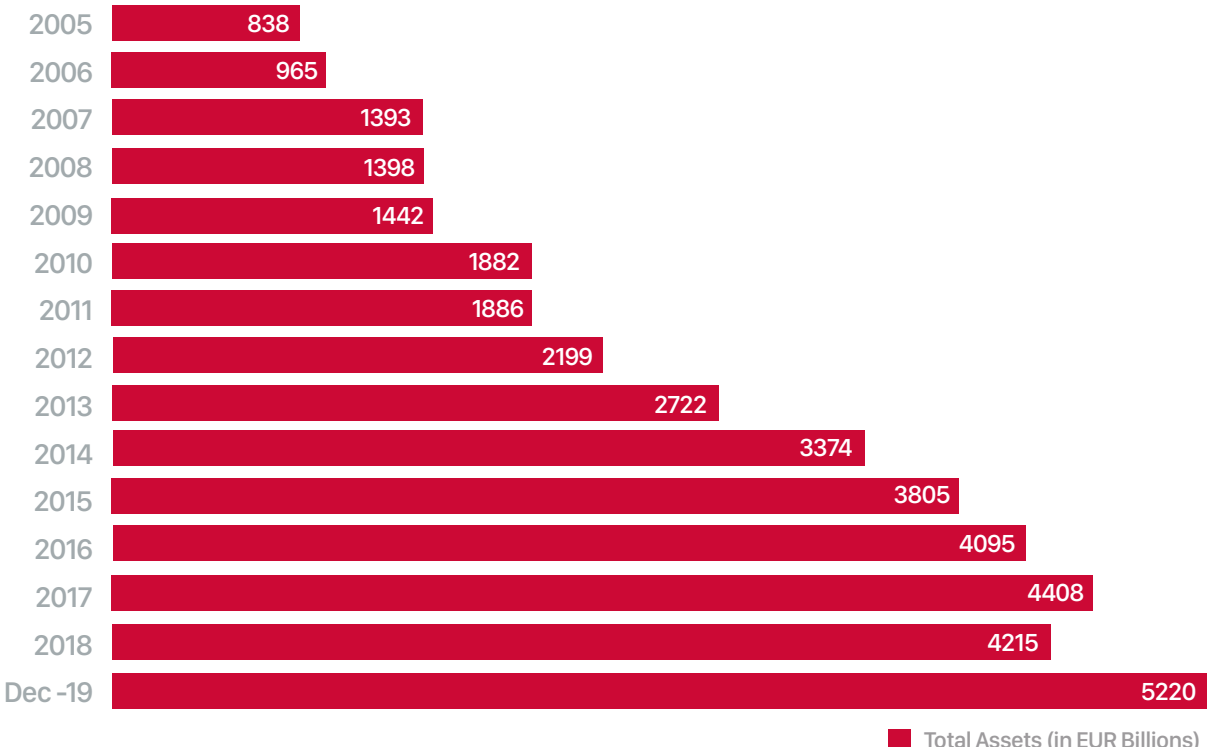
It is conservatively estimated that in order to reach the targets set by the Paris Agreement in 2015, trillions of euro will need to be invested in sustainable infrastructure over the next decades For the EU alone, additional financing in the range of €175 and €290 billion per year is estimated.

THE IRISH INVESTMENT FUND SECTOR

Ireland is internationally recognised as one of the world's leading investment fund and management company domiciles.

Assets under management in Irish domiciled funds reached an all-time high of €3 trillion in 2019. This figure is augmented by over €2 trillion of assets in non-Irish funds, bringing the total value of funds administered out of Ireland to €5.2 trillion.

Total Assets Under Administration in Ireland



Source: The Central Bank of Ireland and Irish Funds

These figures evidence the attractiveness of Ireland as a much needed source of private capital to finance sustainable infrastructure and investment.

IRELAND AS A CENTRE OF EXCELLENCE

There are a range of factors that make Ireland a compelling prospect for sustainable investment funds and their managers.

A National Focus on Sustainable Finance

- The **Fossil Fuel Divestment Act 2018** resulted in Ireland becoming one of the first countries in the world to withdraw public money from investment in fossil fuels.
- A growing green bond sector (Ireland issued its first sovereign green bond for €3 billion which was heavily oversubscribed) and listing of a number of private green bonds on the Irish Stock Exchange.
- The Irish Government's **Ireland for Finance** strategy puts sustainable finance at the heart of a five-year plan which will run until 2025.
- The Green Party joining a Coalition Government in 2020 and a number of fiscal measures aimed at promoting a sustainable agenda in our national budget released in October 2020.
- Ireland plays a leading role internationally for thought leadership and is the European base for the United Nations' Financial Centres for Sustainability ("FC4S") initiative.

Key Investment Fund Metrics[4]

- Ireland employs over 16,000 direct full-time employees in the funds sector.
- Over 950 managers from 50+ countries have assets administered in Ireland.
- 17 of the top 20 global asset managers have Irish domiciled funds.
- Ireland is the largest hedge fund administration centre in the world servicing over 40% of global hedge fund assets.
- Ireland is home to many of the world's leading legal, regulatory, tax, consultancy, depositary, listing and related financial service providers.
- Ireland is one of the world's largest Undertakings for Collective Investment in Transferable Securities ("UCITS") and Alternative Investment Fund ("AIF") domiciles and the largest ETF domicile in the EU.

[4] Statistics from Irish Funds and the Central Bank of Ireland.

Legal and Regulatory Framework

- EU Member State, Eurozone, OECD and FATF Member Country.
- Common law system.
- The CBI is a globally recognised regulator of funds and investment managers and is often at the forefront of regulatory thought leadership in this area. The CBI has established a dedicated team to lead on sustainable finance and ESG policy.

Tax

- Ireland's funds tax regime is stable, transparent and fully compliant with OECD guidelines and EU law.
- Legislation-based system which does not rely on rulings.
- One of the first adopters of FATCA and the OECD's Common Reporting Standard ("CRS") regime.

Location

- Favourable time zone for US and EU headquartered firms.
- Infrastructure including: human resources, residential and commercial property availability, and flights and access.
- Leading global centre for technology and financial services.

REGULATORY REGIME

This section examines the main categories for regulated investment funds in Ireland.

UCITS

UCITS are open-ended collective investment schemes established and authorised pursuant to EU law.

Ireland was one of the first EU jurisdictions to implement the UCITS Directive[4] into its domestic laws and the first Irish UCITS were established in 1989. Over the past 30 years, the UCITS product has become increasingly popular as a liquid, transparent, diversified and robustly regulated investment fund with Ireland at the forefront of UCITS product development.

For these reasons and many others it is extremely popular with managers launching ESG funds.

Key Features of a UCITS	
Liquidity	A UCITS must be able to offer redemptions at least twice a month. A 10% fund level gate is permitted. Redemption proceeds must be received within 14 calendar days/10 business days of the redemption deadline.
Asset Eligibility	At least 90% of assets must be in liquid (UCITS eligible) instruments such as listed equities, fixed income, money market instruments, regulated funds and derivatives on eligible assets or financial indices. No direct short-selling is permitted. Direct exposure to restricted asset classes including real estate and commodities is not permitted.
Asset Diversification	Generally no single asset can represent more than 10% of the fund's assets; holdings of more than 5% cannot in aggregate exceed 40% of the fund's assets. This is known as the "5/10/40" rule. There are certain exceptions for government issued securities and for index tracking funds.

[4] Council Directive 2009/65/EC (UCITS Directive).

Borrowing and Leverage Limits	Temporary borrowing is limited to 10% and not permitted for investment purposes. A general leverage limit of 100% is applied, although use of Value-at-Risk ("VaR") to measure global exposure for more complex strategies gives appropriate flexibility for strategies producing notionally higher levels of leverage.
Distribution	May be sold across the European Economic Area ("EEA") on the basis of the UCITS marketing passport and received special recognition in non-EEA centres owing to regulatory status. As a result, a UCITS has global distribution capability.
Service Providers	Irish based, regulated depositaries, administrators and auditors provide independence in key support and oversight functions.
Investor Requirements	No minimum subscription or investment level is applied under UCITS regulation (although funds may fix levels themselves); no investor eligibility criteria is applied.
Structuring	UCITS can operate as a standalone fund or as an umbrella fund, with multiple sub-funds with segregation of liability at sub-fund level.
Governance	Detailed operating rules are applied covering, for example, valuations, board oversight and monitoring, set out in greater detail in CBI guidance.
ESG Considerations	As part of the Action Plan the EC has begun introducing compulsory requirements in the areas of disclosure, classification of investments and benchmarking in a staggered fashion (please see below "The EU Commission's Sustainable Action Plan"). In the interim, UCITS managers have focused on constructing portfolios of ESG compliant transferable securities and other UCITS eligible assets and branding their strategies accordingly.

- For further information on UCITS please see our UCITS – A Guide for Asset Managers.

ALTERNATIVE INVESTMENT FUNDS

Ireland was an early adopter of the Alternative Investment Fund Managers Directive ("AIFMD")[5] , and implemented it into domestic law in 2013 along with detailed regulatory guidance, including the CBI's **AIF Rulebook**.

AIFMD focuses on the regulation of alternative investment fund managers ("AIFMs") and, subject to limited exceptions, is indirectly applied to the alternative investment funds ("AIFs") they manage, including all non-UCITS funds. EU AIFMs are required to implement operating, operational, transparency, leverage, private equity and marketing requirements. Non-EU AIFMs may avail of exemptions from these requirements depending on where the AIFs they manage are located and whether or not they market to EEA investors.

Ireland has two main categories of regulated AIFs: (a) Qualifying investor alternative investment funds (QIAIFs); and (b) Retail investor alternative investment funds (RIAIFs).

	QIAIF	RIAIF
Regulatory Regime	Regulated by the CBI pursuant to AIF Rulebook and related domestic laws, rules and guidance.	Regulated by the CBI pursuant to AIF Rulebook and related domestic laws, rules and guidance.
Available Structures	QIAIFs can be structured as single funds or as umbrella funds with segregated sub-funds. They can also be established as part of global master-feeders, co-investment or joint-venture structures.	RIAIFs can be structured as single funds or as umbrella funds with segregated sub-funds. They can also be established as part of global master-feeders, co-investment or joint-venture structures but have greater diversification and underlying fund eligibility restrictions in comparison to QIAIFs.

[5] Council Directive 2011/61/EU.

	QIAIF	RIAIF
Share Capital/ Units	QIAIFs can issue multiple classes of shares/units with differing features and characteristics (e.g. fees, currency denomination etc.). QIAIFs may in limited circumstances allocate assets to share classes.	RIAIFs can issue multiple classes of shares/units with differing features and characteristics (e.g. fees, currency denomination etc.).
Eligible Investors	Qualifying investors including "professional investors" under AIFMD and other categories of sophisticated investors permitted by the CBI.	Retail investors.
Minimum Initial Investment	€100,000 or foreign currency equivalent (subject to certain exemptions for investments by the AIFM or connected persons).	None.
Permitted Strategies	All major alternative investment fund strategies used by hedge funds, private equity, real estate funds, credit funds, funds of funds, managed accounts, master-feeders and hybrid structures are permitted.	The liquidity, investment and borrowing restrictions make the RIAIF best suited to liquid alternative strategies.
Investment and Borrowing Restrictions	The CBI does not impose any material investment or borrowing restrictions on QIAIFs. However, there are some sector specific restrictions in the areas of loan origination, master-feeder funds and significant holdings.	The CBI imposes investment, borrowing and asset eligibility requirements for all RIAIFs. In general RIAIFs are subject to less investment and eligible asset restrictions than UCITS.
Liquidity	At least quarterly if open-ended. Unrestricted for QIAIFs structured as limited liquidity or closed-ended.	At least monthly.
Timeline	Where the fast track process is availed of, the CBI will approve new QIAIFs within 24 hours of receiving a completed application pack. Post-authorisation matters (e.g. addition of new sub-funds, new share classes, documentation updates) also fall within this fast-track regime.	The CBI reviews RIAIF applications and typically it will take 6-10 weeks to obtain approval for a RIAIF.

	QIAIF	RIAIF
Distribution	May be registered for sale to MiFID II Directive 2014/65/EU (MiFID) professional investors in any EU member state under AIFMD passport regime. Can be sold in major non-EEA jurisdictions subject to compliance with local securities laws.	May be registered for sale to professional investors in any EU member state under AIFMD passport regime. In addition, a RIAIF may be marketed to retail investors within the EU, although this is on an EU member state by EU member state basis, rather than via a marketing passport, and subject to local conditions in each EU member state.
ESG Considerations	Owing to the flexibility on investment restrictions, borrowing and related features as well as the speed-to-market, the QIAIF is among the most popular regulatory categories for ESG funds. AIFMs have taken full advantage of the flexibility provided by QIAIFs to invest in sustainable asset classes as varied as land-based salmon farms, wind and solar power plants. As part of the Action Plan the EC has begun introducing compulsory requirements in the areas of disclosure, classification of investments and benchmarking in a staggered fashion (please see below "The EU Commission's Sustainable Action Plan").	RIAIFs are ideally suited to liquid alternative ESG strategies which seek greater flexibility than UCITS, e.g. borrowing. As part of the Action Plan the EC has begun introducing compulsory requirements in the areas of disclosure, classification of investments and benchmarking in a staggered fashion (please see below "The EU Commission's Sustainable Action Plan").

LEGAL STRUCTURES

The following legal structures are the main categories available for regulated ESG funds in Ireland:

Legal Structure	UCITS	AIF	Overview
ICAVs	Yes	Yes	Ireland's flagship corporate fund vehicle created by bespoke investment fund legislation (Irish Collective Asset-management Vehicles ("ICAV") Act 2015, **No. 2 of 2015**) and suitable for use across a wide range of strategies including mutual funds, liquid alternatives, hedge funds, fund of funds and other open-ended, limited liquidity or closed-ended structures. For further details see our "**ICAV – A Guide for Asset Managers**".
Investment Companies (PLCs)	Yes	Yes	Investment company established under Part 24 of Ireland's Companies Act 2014 **No. 2 of 2014**. The Act allows for the establishment of fixed and variable capital Public Limited Companies ("PLCs").
Unit Trusts	Yes	Yes	Leading common law unit trust structure. The structure is established by way of a contractual trust deed between a manager and trustee. Used globally, but has historically been most popular for Asian based investors and managers, including in Japan.

Legal Structure	UCITS	AIF	Overview
Common Contractual Funds (CCFs)	Yes	Yes	A regulated asset pooling and tax transparent structure which enables institutional investors to pool assets into a single fund vehicle. A CCF is an unincorporated body established under a deed and investors are "co-owners" of underlying assets which are held pro-rata with their investment.
Investment Limited Partnerships	No	Yes	Ireland's flagship common-law, regulated partnership structure. It adapts key investment fund requirements for use in partnerships. It is established by an Irish general partner and one or more limited partners who have limited liability. Particularly popular for private equity, real estate, infrastructure and real asset strategies. A Government Bill proposing significant reform has been published in 2020. For further details please see our website page "**The Investment Limited Partnership**".

In addition to these main categories of regulated fund vehicles, Ireland offers a limited partnership regime and also a comprehensive trading company and SPV regime.

We have published a comprehensive guide showing how these main legal structures are being used by managers in Ireland and related trends. For further details please see our "**Irish Funds, Product and Distribution Trends 2013-2018**".

They have great strength in handling country registrations and all aspects of maintaining all regulatory filings...

Commercially minded, aware of new developments and very proactive...

They are outstanding on international aspects...

CHAMBERS EUROPE

Highly knowledgeable, proactive and, above all, pragmatic...

...regarded by some as being 'the best in Dublin'...

Exceptional technical knowledge...

LEGAL 500

Partners and associates are technically excellent and can be relied on for practical and sound business advice...

The team at Maples is outstanding...

Maples is one of the key law firms in Ireland. They're very commercial, responsive and solutions-orientated...

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IRISH MANAGEMENT COMPANY OPTIONS

In addition to a Tier 1 funds framework, Ireland offers a very attractive regime for the establishment of fund management companies and fully operational investment firms.

These entities may be established under core funds legislation of UCITS and AIFMD referred to previously, and also under MiFID and related laws and guidance. Further, owing to increasing overlap and harmonisation at EU level between the UCITS Directive, AIFMD and MiFID it is possible to establish a wide variety of "hybrid entities" depending on the requirements of the manager and the ESG products they want to cover. These stem from single management companies under one regulatory category to dual-authorised "Super ManCos" with MiFID top-up permissions.

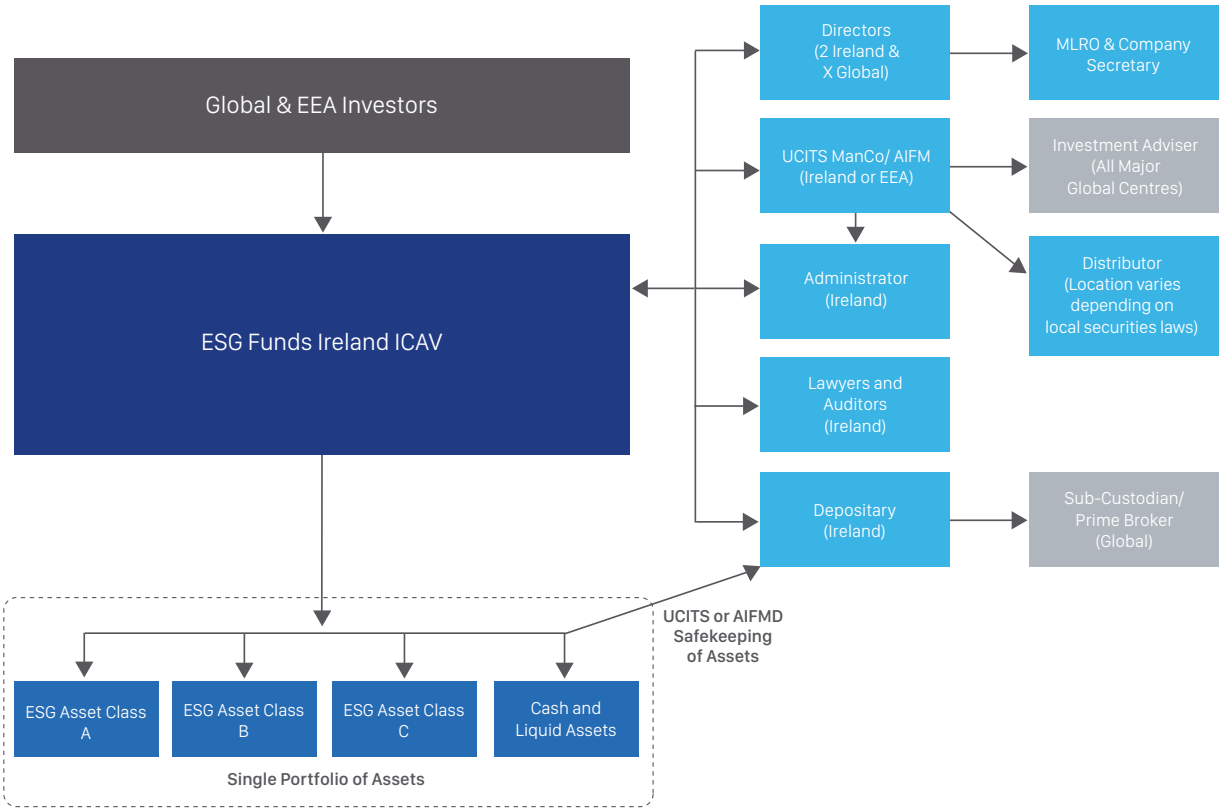
In 20 October 2020, the Central Bank of Ireland ("CBI") published the findings of its themed inspection of Irish fund management company ("FMC") governance, management and effectiveness.

We welcome the publication and associated guidance which provide further clarity to Irish FMCs on best-in-class governance, management and organisation principles.

Indeed, the inspection found that, when applied correctly, the current CP86 regime provides a framework of robust governance, management and oversight arrangements. The findings also revealed areas for improvement in the key areas which are detailed in our client update **CP86 2.0: Welcome Clarity on Corporate Governance Issues.**

TYPICAL STRUCTURE FOR AN IRISH ESG FUND

Please see below for a sample structure for an Irish ESG fund.



THE EU COMMISSION'S SUSTAINABLE ACTION PLAN

The EU is strongly supporting the transition to a low-carbon, more resource-efficient and sustainable economy. It has been at the forefront of efforts to build a financial system that supports sustainable growth.

Following the Paris Agreement in 2015, the EU Commission developed its Action Plan with input of leading experts and technical know-how. The Action Plan aims to promote sustainable finance worldwide and many hope that:

(a) EU measures will, in time, be considered as a global template considering the comparatively advanced stage versus the US and other major economic centres; and

(b) Elements of the Action Plan, in particular the taxonomy and green labels (discussed below), can develop beyond the EU and become a global standard.

Main Objectives of the Action Plan	• Create an environment to raise the estimated €175 and €290 billion per year of private capital needed to finance a sustainable infrastructure and related investment. A significant percentage of this will come from investment funds. • Foster transparency and "long-termism" in financial and economic activities. • Manage financial risks from climate change, resource depletion and environmental degradation. • Factor ESG objectives into the above measures.
Strategic Pillars of the Action Plan	• Establish long-term orientated corporate governance. • Create consistent standards and labels for "green" financial products, including a new EU "Green Bond" framework. • Mandate better disclosure on the integration of ESG factors into investment decisions and advice taken by investors, asset managers and financial advisors (the impact on UCITS, AIFMD and MiFID will be a key element for investment funds). • Introduce requirements to incorporate sustainability into financial advice. • Create a unified system for the classification (a "taxonomy") of sustainable economic activities. • Incorporate climate change and ESG factors into prudential requirements for banks and insurance companies. This will indirectly impact on investment funds as these entities are major sources of finance and large investment. • Create low-carbon and positive-carbon impact benchmarks. • Integrate sustainability in credit ratings and market research. • Foster better integration of sustainability and non-financial disclosures in public reporting by late companies.

Main Legislative Steps

As part of the Action Plan, several significant steps have been taken to put ESG at the top of the list when firms, funds and service providers are making strategic decisions about their futures. Aspects of these steps are relevant to all firms, not just those who have a clear ESG or sustainable focus.

The laws and regulations which will have the greatest impact are summarised below.

Disclosure Regulation Overview

The Disclosure Regulation lays down harmonised rules on transparency for financial market participants and financial advisers with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts and the provision of sustainability related information with respect to certain financial products.

Financial products falling within scope of the Disclosure Regulation (including UCITS, AIFs and segregated accounts) marketed in the EU which promotes, among other things, environmental or social characteristics or has sustainable investment as its objective will have to comply with more granular requirements than other types of financial products, the main objective being to mitigate "greenwashing" and ensure that the "green" or "ESG" labelling is not just a marketing exercise but is actually reflected in investment decision-making.

The Disclosure Regulation also seeks to avoid divergent measures across EU member states and to ensure end-investors are offered standard and comparable information, in order to make an informed decision.

Disclosure Regulation – Key Features

The Disclosure Regulation introduces a number of transparency requirements based on the type of financial products that are being marketed:

- Disclosure of integration of sustainability risks in the investment-decision process and remuneration policies, both at the level of the investment manager, and (where applicable) the financial product. For the financial product level disclosure, there is an option to "comply or explain" where sustainability risks are not relevant for the financial product in question.
- Disclosure of principal adverse impacts where the assessment leads to the conclusion that those risks are relevant, such as the risks arising from underlying investee companies. The extent to which those sustainability risks might impact the performance of the financial product should be disclosed either in qualitative or quantitative terms. Where the sustainability risk assessment leads to the conclusion that there are no sustainability risks deemed to be relevant to the financial product, the reasons should also be explained. This is a "comply or explain" disclosure which becomes mandatory for firms with more than 500 employees.
- Disclosure of information relating to financial products that are marketed with, among other characteristics, environmental or social characteristics or that are marketed as having sustainable investment as their objective.
- Disclosures have to be made on firms' websites; through investor pre-contractual disclosures (e.g. in a prospectus) and through periodic reporting to investors (e.g. in the annual financial statements).

Sustainability Related Concepts

The Disclosure Regulation includes a number of sustainability-related concepts:

Sustainable Investment

- A "sustainable investment" means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective.
- Such social objectives include, an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities. Such investments must also comply with the do not significantly harm any of above objectives principle ("DNSH") and that the investee companies follow good governance practices, in particular, with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

Sustainability Risk

- The Disclosure Regulation defines "sustainability risk" as an ESG "event or condition that, if it occurs, could cause an actual or potential material negative impact on the value of the investment". The definition refers to the notion of an actual or potential "material impact" on the financial performance of an investment product. It will be down to the investment manager to assess those risks which will have a material impact on the value of the investment.

Principle Adverse Impact

- The concept of "principal adverse impact" is intended to capture the impact of investment decisions and advice that result in negative effects on sustainability factors, for example, the negative effect of an underlying investee company on sustainability factors. As such, the concept of "sustainability risk" applies to the value of the financial product whereas the assessment of a "principal adverse impact" applies to the underlying investee company. Secondary legislation will clarify how investment managers are expected to measure the principal adverse impacts of their investment decisions. Some indications are provided in the Regulatory Technical Standards ("RTS") below.
- Sustainability Factors
  As regards "sustainability factors", these refer to environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
- Financial products can promote "sustainable characteristics" or a "sustainable objective", which are concepts that are not defined in the Disclosure Regulation.

Taxonomy Regulation Overview

The Taxonomy Regulation was officially adopted in June 2020. It sets out an EU-wide classification system or "taxonomy", which will provide a common method to identify those economic activities which are considered environmentally sustainable.

Taxonomy Regulation - Key Features

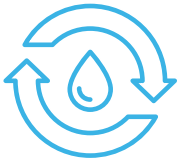
The Taxonomy Regulation requires financial markets participants, including investment managers, to make certain disclosures, primarily focusing on disclosing the level of alignment with activities that are considered as sustainable by the Taxonomy Regulation.

Pursuant to the Taxonomy Regulation and recommendations from the EC's technical expert group (the "TEG"), the investment managers of financial products with sustainable characteristics or objectives will need to:

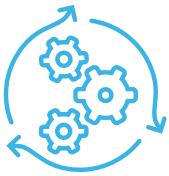
- Disclose how and to what extent they have used the Taxonomy in determining the sustainability of the underlying investments;
- Disclose to what environmental objective(s) the investments contribute. An "environmental objective" is an economic activity defined in the Taxonomy Regulation that contributes to:

CLIMATE CHANGE MITIGATION

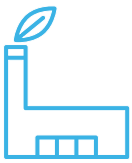
CLIMATE CHANGE ADAPTATION



SUSTAINABLE USE AND PROTECTION OF WATER AND MARINE RESOURCES



TRANSITION TO A CIRCULAR ECONOMY, WASTE PRODUCTION AND RECYCLING



POLLUTION PREVENTION AND CONTROL

PROTECTION OF HEALTHY ECOSYSTEM

Take into account whether the investment is an "environmentally sustainable activity", i.e. an activity which should: (i) contribute substantially to one of the above objectives; (ii) not significantly harm any of the above objectives and (iii) be carried out in compliance with international standards such as the Guidelines for Multinational Enterprises and UN Guiding Principles on Business and Human Rights;

Disclose the proportion of underlying investments that are taxonomy aligned, expressed as a percentage of the investment, financial product or portfolio. An investment manager which does not market its financial product as "green" might also decide to perform this calculation on a voluntary basis and is required to include the following disclaimer: "the investments underlying this financial product do not take into account the EU criteria for environmentally sustainable investments" in accordance with the requirements of the Taxonomy Regulation.

For general disclosures (i.e. not seeking specific accreditation or labelling), there is no "correct" percentage or threshold of taxonomy aligned securities in a financial product, but investors may wish to explain elements of their strategy or approach in the narrative, especially where the percentage is low. The TEG has recommended some examples in their March 2020 report, including:

- Financial products investing in companies whose ESG performance is low but improving over time may wish to describe the methods used to identify and engage companies and the expected time frame for that improvement;
- Where financial products use a different methodology for determining environmental performance, then best practice will be to explain the strategy, its environmental objectives and main points of variance from the Taxonomy Regulation;
- Investment managers may also wish to explain how they consider metrics, such as taxonomy aligned capital expenditure ("capex"), when evaluating the sustainability of underling investments and their trajectory towards the criteria;
- Investment managers who appoint delegate fund managers may wish to disclose details of how they use the Taxonomy when engaging with these external managers.

The TEG recommends that investment managers complete calculations separately for each of the environmental objectives for which substantial contribution technical screening criteria have been developed. As noted overleaf this means differing timetables for climate change mitigation and adaptation versus the remaining four objectives.

The Taxonomy Regulation notes that investment managers will need further guidance and detail to implement these environmental measures and make the requisite disclosures. To this end, European Supervisory Authorities ("ESAs") and European policymakers are currently drafting secondary legislation to further define the various activities that can be considered environmentally sustainable in light of the EU Green Taxonomy.

Draft criteria for activities that contribute to climate change mitigation and climate change adaptation on the EC website[6] provide a sense of the direction of travel. As regards climate change mitigation, criteria have been drafted for eight sectors (agriculture, forestry, manufacturing, energy production, water management[7], transport, information and communication and construction and real estate activities). For climate change adaptation, criteria have been drafted for six sectors (agriculture, forestry and fishing[8], energy production, water management, information and communication, financial and insurance activities and professional, scientific and technical activities).

Secondary legislation associated with the Taxonomy Regulation is expected to be published prior to the end of 2020. It will firstly cover the objectives of "climate change mitigation" and "climate change adaptation" . The focus will then shift to the other environmental objectives set out in the Regulation with guidance scheduled for the end of 31 December 2021.

The Taxonomy Regulation also applies to large issuing companies on public markets[9]. It is therefore expected that these companies will disclose the percentage of their activities that match the Taxonomy Regulation as part of their non-financial reporting.

[6] https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190618-sustainable-finance-teg-report-taxonomy_en.pdf
[7] Specifically electricity, gas and air conditioning supply.
[8] Under the Taxonomy Regulation, the TEG has developed technical screening criteria for agriculture and forestry, but not fishing.
[9] Companies in scope of the non-financial reporting directive (2014/95/EU) ("NFRD").

Delegated Regulation

As part of the Action Plan, the EC published a draft delegated regulation ("Delegation Regulation") to amend the MiFID II Organisational Requirements Regulation (EU/2017/565) ("MiFID 2 Delegated Regulation"). The Delegated Regulation is designed to ensure that firms providing financial advice and portfolio management consider client sustainability preferences in the selection of financial products offered. This means that firms should carry out a mandatory assessment of ESG preferences of their clients in a questionnaire addressed to them and then take these ESG preferences into consideration in the selection process of the financial products that are offered to these clients.

As the Disclosure Regulation has now been published, the EC shall make formal steps to amend the MiFID 2 Delegated Regulation.

Delegated Acts

On 8 April 2020, the EC published the draft delegated acts ("Delegated Acts"). The Delegated Acts set out minimum standards for the two new benchmarks introduced under Regulation 2019/2089, minimum explanations to be provided for all benchmarks on how ESG considerations are included in both the relevant benchmark and its methodology. Once these Delegated Acts are approved by the EC, they will be subject to review by the European Parliament and the Council and will only enter into force after being published in the EU's Official Journal.

Benchmark Regulations

Key Features

Numerous low-carbon and sustainable investment benchmarks were introduced by Regulation 2016/1011, however, they were used on a sporadic basis by investors and managers and do not have a uniform methodology or set of rules.

Therefore, Regulation 2019/2089 introduced two new benchmarks:

- A low carbon benchmark based on a standard "decarbonising" benchmark; and
- The positive-carbon benchmark covering a portfolio of investment assets which needs to demonstrate measurable carbon reduction to be aligned with the Paris Climate Agreement global warming limits.

Benchmark administrators will now need to disclose whether their benchmarks pursue ESG objectives.

Regulatory Technical Standards

On 23 April 2020, the Joint Committee of the ESAs published a consultation paper on proposed Regulatory Technical Standards ("RTS") (level 2 regulations) on content, methodologies and presentation of disclosures under the Disclosure Regulation. The RTS aim to ensure that financial market participants and financial advisers give the necessary information on the adverse impacts of investment decisions and financial advice to help end-investors make informed investment decisions.

The draft RTS relate to several disclosure obligations under the Disclosure Regulation. The proposals include the following:

- Product compliance with the principle of "do not significantly harm" in the draft Taxonomy Regulation;
- Entity-level website disclosure of the principal adverse impacts of investment decisions on sustainability factors; and
- Disclosure of the sustainability characteristics or objectives of financial products in an entity's pre-contractual and periodic documentation and on their website.

ESMA Advice

Impact on Managers Authorised under UCITS or AIFMs	Senior management to be responsible for the integration of sustainability risks and integration into their products. Managers to consider sustainability risks in the context of overall governance and controls. Managers to have necessary resources (including employees) and expertise for the effective integration of sustainability risks. Managers must consider conflicts arising in the context of the integration of sustainability risks (including “greenwashing” or misrepresentation of investment strategies). Managers to develop engagement strategies/exercise of voting rights to seek to reduce the principal adverse impact of investee companies on sustainability factors. Risk management policies must reference sustainability risks.
Impact on MiFID Firms	There is a considerable degree of overlap in the recommendations including: Where ESG considerations are relevant they should be taken into account in compliance with MiFID organisational requirements. The risk management policy of a MiFID firm should take account of sustainability risk. Key management figures and internal audit of a MiFID firm should consider aspects related to sustainability risks in their respective duties. Identification of conflicts should extend to those that arise from the distribution of sustainable investments. When making target market assessment for particular products, consideration should be given to clients’ ESG preferences.

CONTACTS

Dublin

Peter Stapleton
Head of Funds & Investment Management
+353 1 619 2024
peter.stapleton@maples.com

Caitriona Carty
Partner
+353 1 619 2157
caitriona.carty@maples.com

Stephen Carty
Partner
+353 1 619 2023
stephen.carty@maples.com

Ian Conlon
Partner
+353 1 619 2714
ian.conlon@maples.com

Ronan Cremin
Partner
+353 1 619 2756
ronan.cremin@maples.com

John Gallagher
Partner
+353 1 619 2073
john.gallagher@maples.com

Philip Keegan
Partner
+353 1 619 2122
philip.keegan@maples.com

Deirdre McIlvenna
Partner
+353 1 619 2064
deirdre.mcilvenna@maples.com

Aaron Mulcahy
Partner
+353 1 619 2104
aaron.mulcahy@maples.com

Eimear O'Dwyer
Partner
+353 1 619 2065
eimear.o'dwyer@maples.com

Niamh O'Shea
Partner
+353 1 619 2722
niamh.o'shea@maples.com

Emma Conaty
Head of Global Registration Services
+353 1 619 2708
emma.conaty@maples.com

London

Adam Donoghue
Partner
+44 20 7466 1711
adam.donoghue@maples.com

Fearghal De Feu
Partner
+44 20 7466 1714
fearghal.defeu@maples.com

Cayman

Pádraig Brosnan
Partner
+1 345 814 5441
padraig.brosnan@maples.com

Hong Kong

Michelle Lloyd
Partner
+852 3690 7504
michelle.lloyd@maples.com

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