SLAUGHTER AND MAY/

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ASSET MANAGEMENT - HOT TOPICS

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Welcome to the Winter/Spring 2024 edition of the Asset Management Hot Topics. Many developments covered in this edition relate to the shape of UK's post-Brexit financial services framework as the UK seeks to increase its international competitiveness in the sector while at the same time ensuring high standards of investor protection and market integrity. An overarching theme is the tension (whether actual or perceived) between these policy objectives and the resulting sense in which legal and regulatory developments in the asset management sector appear to move in different directions. Whether UK legislators and regulators succeed in walking this tightrope will only become more apparent with time. The use of technology, including AI, to drive innovation in the industry, the growth of private capital and sustainability issues all continue to feature heavily on the regulatory agenda.

1 Future of the UK regulatory framework

Following the announcement of the "Edinburgh Reforms", a package of reforms to financial services regulation which sets out the government's vision for the shape of the post-Brexit UK financial services regulatory framework, which will dictate its regulatory agenda for some years to come, and with the Financial Services and Markets Act 2023 having finally received Royal Assent at the end of June 2023, the UK has reached a significant milestone in implementing its post-Brexit regulatory framework. The Act paves the way for a significant revamp of the existing regulatory model by granting more responsibility to UK's regulators to make the framework for the revocation and restatement of all retained EU law ("**REUL**") relating to financial services.

The FSMA 2023 revokes most REUL relating to financial services, including secondary legislation that amended REUL as part of the "on-shoring" process following Brexit (which are in any event, no longer relevant, as they were passed to correct deficiencies in any on-shored REUL). Regulations have since been made to revoke the Money Market Funds Regulations and certain provisions of the Sustainable Investment Regulation. In relation to the asset management sector, further revocations of note that took effect on 1 January 2024 include the ELTIF Regulation and the PRIIPs Regulation

New secondary objective for regulators

Under FSMA 2023, the FCA and PRA were also given a new secondary objective of facilitating the international competitiveness of the UK economy (including, in particular, the financial services sector), and its medium to long-term growth, subject to aligning with relevant international standards. How this translates into their supervisory approach as it relates to the asset management industry will be interesting - as the FCA noted, this remains a "secondary" objective; in other words, it is not intended to be advanced on its own but does and will shape how the FCA advances its primary objectives - that is, consumer protection, market integrity and effective competition in the interests of consumers.

Unsurprisingly, the FCA takes the view that there is no inherent tension between the objectives, noting that "*when markets are efficiently and proportionately regulated and firms are able to compete and innovate in a safe, trusted and stable environment, it benefits consumers and investors, and it ensures the UK economy, including financial services, sustains its international competitiveness*" and stating in its latest Business Plan that [it] "*fully embrace[s] this secondary objective as already significantly in line with [its] approach*".

Nonetheless, there is scope for the regulators to streamline the UK asset management regime especially in relation wholesale markets and professional funds. Calls have already been made by industry groups to consider the scope of the AIFMD regime or to apply the IFPR regime in a more proportionate manner to smaller firms that only cater to professional investors. The FCA's strategy seems two-fold: to prioritize regulation in relation to retail products that seeks good consumer outcomes while liberalising or streamlining requirements for wholesale markets and funds. Nonetheless, the regulatory boundaries can be difficult to draw and regulation designed for the retail market may nonetheless impact "professional" funds.

> *// [We] fully embrace this secondary objective as already significantly in line with [our] approach //*
>
> FCA Business Plan 2023/24

Overseas funds

Consistent with the government's general desire to improve the UK's international competitiveness and to demonstrate UK as an open hub for financial services, the government has recently announced its decision to treat the European Economic Area as "equivalent" under the UK Overseas Funds regime (OFR) paving the way for European asset managers to market their funds in the UK on a permanent basis. It was also decided that EEA funds will not be required to comply with any additional UK requirements as part of this equivalence determination at this time. Secondary legislation will be required to implement this decision but temporary arrangements (under which EEA funds can continue to be marketed in the UK on the same basis pre-Brexit) which were due to expire at the end of 2025 will also be extended until the end of 2026, to ensure funds are able to smoothly transition to the OFR.

The UK has been consistent in taking a fairly open approach (even in the absence of a reciprocal move by the EU) to allowing EEA funds access to the UK market as being conducive to maintenance of the UK as one of the most significant centres for asset management. The FCA is itself consulting on the establishment of the future framework for the recognition of overseas funds, if the government decides to make any equivalence determinations under the OFR in respect of any jurisdiction.

Another recent development which the government is keen to trumpet is the recently signed Berne Financial Services Agreement between the UK and Switzerland. The Agreement provides an institutional framework for cooperation and development of the financial services relationship between the two countries based on an "*outcomes-based mutual recognition of domestic laws and regulation*". With respect to the asset management sector, the Agreement ensures the relatively open access for the marketing of professional funds and delegation of portfolio management services between the two countries remains in place.

2 Updating the UK asset management regulatory regime

With discussion turning to the detail of how the Government and regulators should shape the UK post-Brexit regulatory framework for asset management, the FCA published in February 2023 its Discussion Paper (DP 23/2) on updating and improving the UK regime for asset management (see our client briefing). The paper covered a wide range of topics relating to the regulatory regime for asset management as it seeks industry input on how best to create a framework that continues to be "*coherent, agile and internationally respected*". The topics include the structure of the asset management regulatory regime as a whole, improvements to the current regime (focussing on improving existing conduct and product rules), technology and innovation in the industry and improving investor engagement. While no detailed recommendations were made, the paper seeks to facilitate an open discussion with stakeholders as the FCA considers what changes to make and prioritise when reviewing the regime.

Views on the discussion paper have been mixed, with many in the industry highlighting the fact that wider (and more holistic) reform would be required to make the UK a more attractive centre for the asset management sector in the future. In other words, broader policy changes are needed with respect to the tax, company and partnership law and other regimes - which are not necessarily within the FCA's remit to

change. One question was whether given the "piecemeal" nature of the regulatory framework governing asset management (derived largely from EU legislation – as set out in UK UCITS, UK AIFM and UK MiFID), there was appetite for consolidating the rules into a simplified rulebook. While noting the theoretical advantages of doing so, the practical reality is that with most asset managers having already operationalized and implemented the various regimes, such a major overhaul of the rulebook is more likely to result in significant operational risk and cost to the asset management sector without yielding any clear benefits to end-investors, competitiveness of the UK sector, or reduction in cost of compliance.

Industry respondents have noted that there was no great need for divergence, especially with regard to the retail UCITS regime – which has grown to become an internationally recognised "brand" – where alignment with the EU regime is in fact welcomed. Similarly, in relation to the AIFMD regime, respondents thought that there was no need for significant changes to be made, with many considering the advantage of being closely aligned to EU AIFMD being of more overall benefit than divergence even if there are aspects of the regime that have been challenging to implement. Given that the asset management industry has mostly adapted to the regime, the view is that any major change now would be of limited benefit. Others have commented on the lack of discussion on rules relating to distribution and observations have been made that it is often at the point of distribution where regulatory failings with respect to end investors (often in relation to the sale of the investment product to retail investors) have been identified.

In its response, the Investment Association, expressed the view that the FCA should instead be prioritising areas which would make most impact on the competitiveness of the industry while maintaining high levels of investor protection and in particular, focus on responding and promptly embracing the use of technology to enable innovation in the asset management sector, for example, by driving digitalisation and tokenisation of the fund delivery chain (see Technological developments and AI innovation below).

Following feedback, the FCA has since confirmed its priorities for updating the asset management regime: making the UK AIFMD regime more proportionate, updating the retail funds regime – in particular, in relation to retail non-UCITS funds which are regulated like AIFs (where in principle only retail rules should apply) - and supporting technological innovation. The first two items are on the list for consultation during 2024.

Targeted changes

While the Discussion Paper revealed the lack of appetite for wholesale change of the asset management regime, there are some specific rules where UK's ability to diverge from the EU and drive its own agenda has been broadly welcome. Focus should therefore be on targeted incremental changes to particular rules and the proportionate application of existing rules.

PRIIPs Regulation

One regulation which is immediately in the government's crosshairs is the much-derided PRIIPs Regulation. The Regulation, meant to provide a standardised disclosure framework across EU to allow retail investors to make informed decisions, was seen as unnecessarily prescriptive and often resulted in misleading disclosures when applied to a wide range of products given its "one size fits fall" approach. Having previously made some targeted changes to the regime, the FCA has since published a Discussion Paper, consulting on a wholesale overhaul of the regime, to be replaced by the creation of a new retail disclosure regime. The FCA intends for the new regime to apply to PRIIPs, non-PRIIP packaged products, UCITS, and NURS. In contrast to the prescriptive approach in the PRIIPs Regulation, the FCA is proposing a principles-based regime with a primary focus on ensuring that retail investors receive the necessary information to make informed decisions, and not to impose comparability between all types of in-scope products. This approach is consistent with that taken by the FCA in developing new regulations such as the Sustainability Disclosure Requirements and the Consumer Duty.

Investment research review – MiFID II

Another area where calls have been made for reform is the investment research regime, resulting in a proposed overhaul of the regime being included as part of the Edinburgh reforms. It is widely accepted that, with asset managers often opting to pay for research out of their own resources following the unbundling of research services under MiFID II, the availability of high quality external research particularly for smaller-cap companies and access of asset managers to that research - vital to their ability to identify investment opportunities and inform investment decisions – has declined.

On 10 July 2023, HM Treasury published a report setting out the outcome of the UK Investment Research Review (led by Rachel Kent). The report makes a series of recommendations for the government, the FCA and the

industry to improve the UK market for investment research, which the government and the FCA have committed to accepting. These include creating a central "Research Platform" to cover smaller cap companies which lack coverage as well as permitting additional optionality regarding payment for research in order to: (a) permit asset managers to pay for research on a bundled basis; and (b) ensure that UK asset managers remain able to procure research from elsewhere in the world, especially the US.

3 Technological developments and AI innovation

Fund tokenisation

Technological-driven solutions have also been seen as a significant aspect of UK's attempt to ensure the competitiveness of its asset management industry. Indeed, a large part of the FCA's discussion paper on updating the UK asset management regime was focused on the use of technology in improving the UK's asset management regime.

One solution that has been heavily promoted in the asset management industry is fund tokenisation which generally refers to representing or turning an investor's share or unit in a fund into a digital token which are then generally traded and recorded on a distributed ledger (DLT) rather than a traditional system of records. Its proponents, including many within the industry, have extolled its advantages primarily around efficiency and speed - for example, in simplifying books and records and therefore reconciliations and in aligning settlement profiles of underlying assets with settlement of fund units, as well as in *"[enabling] greater liquidity, the creation of more bespoke portfolios and significantly enhanced risk management"*.

The industry-led Technology Working Group to the government convened Asset Management Taskforce has produced an interim report in November 2023, which sets out a blueprint for implementing the tokenisation of funds in the UK. The report concludes that there are no regulatory issues with implementing a baseline "Stage One" model for fund tokenisation - this envisages a scenario where the only changes relative to a typical UK investment fund operating today are in the deployment of DLT in the registry and transaction functions. A private, permissioned chain would act as the master record for the fund unit register. In other words, this would involve a UK authorised fund with transactions settled in the usual manner "off-chain" and the only change being the replacement of the traditional register with a DLT register.

The FCA itself has been keen to emphasize its commitment to innovation, including in this area. To this end, it has worked with the Technology Working Group on its assessment of the FCA rulebook for the Group's baseline approach to tokenisation and announced its participation in collaborative initiatives with international regulators, including Asian and the Swiss regulatory authorities. Another helpful development fostered by the FCA is the launch of a permanent Digital Sandbox to allow firms to trial the use of new technology in financial services. The platform serves as a testing environment for firms at the early stage of product development by enabling experimentation through proof of concepts but also enables parties such as regulators observe in-flight testing at a technical level.

With many in the industry advocating for it and the FCA acting as a supportive regulator, it would not be difficult to expect rapid progress in the near future as various firms work towards offering tokenised versions of their products.

AI innovation

Artificial Intelligence (AI) and its use and impact on various sectors featured in many headlines over 2023. Unsurprisingly, its use and effect on financial services have also been heavily discussed. The use cases for AI in the asset management industry are potentially many, from streamlining internal processes to analysing large data volumes to help investment decisions in portfolio management, trading and portfolio risk management. While firms consider AI advances in order to gain competitive advantage, regulators are also increasingly alive to the considerable issues that may arise and the implications of AI on the prudential and conduct supervision of financial firms, including asset managers.

The UK supervisory authorities (the Bank of England, PRA and FCA) published Discussion paper DP5/22 in October 2022 and summarised responses to the paper in its October 2023 Feedback statement FS2/23. The statement does not provide any policy proposals but does give a useful gauge on what stakeholders think would be most useful in relation to regulation in this area. It should be noted that the supervisory authorities are clear that they are not technology regulators - but they do have to consider how the use of AI poses risks to the financial services. In their responses, most respondents expressed preference for a "technology-neutral, outcomes-based and principles-based approach" to the regulation of AI in financial services. This seems sensible in light of the rapid developments in technology which would be make it

more difficult for a tightly prescriptive regulatory framework to adapt to.

The focus of the regulators, as indicated, for example, in the speech made by FCA CEO Nikhil Rathi on the FCA's emerging regulatory approach to AI and Big Tech in July 2023, is on governance, oversight and consumer outcomes particularly where data sharing and behavioural biases may arise where AI is more heavily involved in making financial decisions. Other concerns include issues of market integrity resulting from the AI manipulation of information as amplified through social media channels which may lead to trading volatility or promotion of fraudulent investment schemes. There is no doubt that this will prove a complex area to regulate, involving and requiring the interaction between data regulation and various other regulatory regimes governing areas from operational resilience and risk management, firm governance (such as the SMCR) to consumer protection (such as the Consumer Duty).

4 Consumer Duty - bedding down implementation

The Consumer Duty came into force on 31 July 2023 for new and existing products and services that are open to sale or renewal and will apply to closed products and services from 31 July 2024. It is clear that despite the rule changes brought in following the Retail Distribution Review more than a decade ago and requirements aimed at improving product governance under MiFID II, there are still concerns surrounding the relationship between product manufacturers and the consumers of those products.

The Duty represents a further development in addressing these concerns. As the FCA has stated, the Consumer Duty represents a significant shift in their expectations of regulated firms. It introduces a more outcomes-focused approach to consumer protection and sets higher expectations for the standard of care that firms give customers.

The FCA has laid down its store in expecting the Duty to be "top priority" for financial services firms, including asset managers, and for good outcomes for customers to be "*at the heart of firms' strategies and business objectives.*"

Broadly, the Duty applies in relation to a firm's "retail market business" and requires firms to deliver good outcomes for actual and prospective retail customers. The scope of the Duty is wide - it is sufficient that firms have responsibility for determining or "materially influencing" retail customer outcomes even if they do not have a direct relationship with the customer. The FCA's most recent letter to asset managers (both authorised fund managers and alternative asset managers), custodians and fund service providers on the implementation of the Consumer Duty demonstrates the far-reaching impact to the sector, including to firms which may not have thought of themselves or the products and services they offer as necessarily within scope, given their lack of immediate nexus to retail customers.

A number of points made by the FCA illustrates this:

- Many alternative investment firms have customers who are categorised as high net-worth or sophisticated customers. These are still retail customers and the four customer outcomes, the Principle and cross-cutting rules may apply.

- Firms working with investors who elect to be treated as professional clients (to which the Duty does not apply) still need to consider the Duty with respect to the process used to classify the clients.

- Some asset management firms, even if they do not have a direct relationship with the customer, may be in a retail distribution chain and potentially in scope of the Duty.

The latter point is particularly significant as asset managers (as product manufacturers) cannot simply rely on compliance by distributors and push all responsibility to them. The onus is on them to have good lines of communication and processes in place with distributors and investment platforms given the need to have knowledge of the interaction between distributors and end investors in order for them to properly comply with the Duty.

The potentially far-reaching scope of the Duty is the source of much challenge and discussion. Some commentators have made the point that it is disproportionately onerous to require firms to consider whether products or services that are intended exclusively for institutional or professional investors fall within scope. There has been some helpful FCA guidance in this respect: a portfolio manager whose role is limited to managing assets under a mandate determined by a professional client that is entirely independent of the manager is excluded (although the portfolio manager could be said to be operating in the distribution chain that ultimately has an end-retail customer). This reflects the rule which applies the Duty to "indirect" retail customers *"only to the extent that the person is responsible in the course of that retail*

market business for determining or materially influencing retail customer outcomes".

With many firms having spent considerable resources in implementing the Duty, the layering of the overarching requirement on top of other existing requirements has raised concerns about the resulting complex and increasingly costly bureaucracy. The overlap between the Duty – which is intended to operate on the basis of a principles and outcomes-based approach - and existing prescriptive rules relating to product design and governance has also resulted in some regulatory confusion. This has been tacitly acknowledged in the FCA letter which notes certain COLL and PROD rules have similar objectives to the outcome rules set out in PRIN 2A which provide the more detailed expectations for a firm's conduct. The letter does seek to remind firms of the FCA's approach in addressing this overlap. For example, the Assessment of Value rules in COLL have similar objectives to the Price and Value Outcome in PRIN 2A.4. Authorised fund managers which are subject to the COLL rules should continue to comply with the relevant Assessment of Value rules in COLL and are not subject to the price and value rules in PRIN. Similarly, where PROD 3 applies in relation to any financial products or services, the rules of PRIN 2A.3 (which are broadly equivalent) do not apply in respect of that product or service. Nonetheless, the FCA warns that the Duty as a whole is broader than PROD so satisfying the PROD rules is "unlikely to meet all aspects of the Duty".

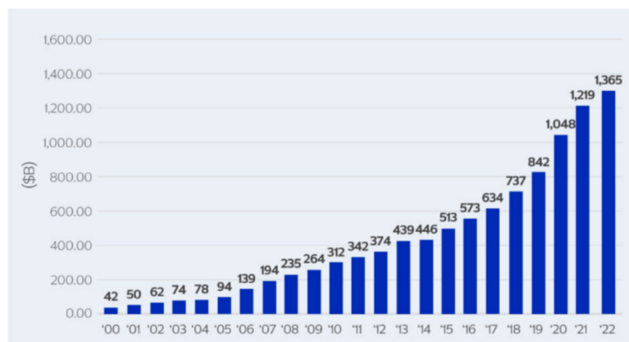
With the Duty applying to closed products and services from 31 July 2024, firms will need to make preparations and ensure, on an ongoing basis, that they can are and can demonstrate that they are delivering good consumer outcomes. For more on the implications of the Consumer Duty for the asset and wealth management sector, please listen to our podcast series on Consumer Duty.

5 Private capital - continuing 'retailisation'

Private capital (broadly encompassing private credit, private equity, infrastructure and real estate) continues to grow as an asset class. Both the EU and UK are keen to mobilise long term capital from retail investors (although, in this context, this means primarily high net worth individuals rather than the mass retail market) to help fund investment (particularly in infrastructure) but again, tension exists in regulators having to ensure that they continue to meet their investor protection objectives.

Growth of private credit

Private Credit Assets Under Management



Source: Preqin, 31 December 2022

Arguably, the "hottest" trend in private capital has been private credit, with some recent estimates putting overall assets under management in this asset class at US$1.5 trillion, of which some US$500 billion remains available to be lent. Alternative asset managers such as Ares Capital and Oaktree are long established in the private credit arena, but more "traditional" private equity sponsors such as Blackstone and Apollo have rapidly expanded their private credit offerings and now manage some of the largest credit funds.

Many more "mainstream" asset managers such as M&G and Amundi are also seeking to expand their exposure to this asset class. While access to such funds remain limited for the mass retail market, many are now targeting high net-worth individuals. Both Apollo and Blackstone have launched funds focused on private credit targeting wealthy private investors, including Blackstone's European Private Credit Fund which was the first open-ended credit fund that provides senior secured debt to European companies. Even traditional lenders are joining the bandwagon as more recently, Société Generalé announced a joint venture with Brookfield to establish an up to EUR10 billion credit fund targeting renewable energy and transport companies as well as the finance sector, and the private equity sponsor, Centrebridge announced a US$10 billion credit fund in partnership with Wells Fargo. Even if the pace of growth slows, 2024 looks to see the continual growth of private credit as an alternative to mainstream bank-lending given the regulatory headwinds such as higher capital requirements that lending banks face.

Fund structures – new launches and developments

In the UK, the introduction of the Long-term Asset Fund (LTAF) structure - a category of authorised open-ended

fund specifically designed to invest in long-term, illiquid assets - was widely seen as a welcome addition to the UK fund range. Although launches of LTAF products initially started slowly, momentum has swung more recently following the launch of the first LTAF by Schroders in March 2023 – with the likes of Aviva Investors and Blackrock also announcing the launches of their respective LTAFs (the former to invest in real estate and the latter in a mix of private market asset classes, including infrastructure and private credit) and other firms contemplating moves to follow suit. Given current restrictions in place limiting LTAF access to certain categories of individual investors, as well as Defined Benefit (DB) and qualifying Defined Contribution (DC) schemes, the LTAFs launched so far have only targeted UK DC investors. However, following consultation, the FCA has sought to broaden access by re-categorising units in a LTAF from a Non-Mass Market Investment to a Restricted Mass Market Investment (RMMI), thereby allowing distribution to be extended to mass market retail investors, as well as self-select DC pension schemes and Self-Invested Personal Pensions.

The EU has also been reforming the European Long Term Investment Fund (or ELTIF) following much criticism of the restrictive regulatory framework governing it which has severely impacted uptake. Recent reforms aiming to improve usability have been promising - ESMA published its draft implementing rules (Regulatory Technical Standards) on ELTIF reform for consultation in May 2023 and its final report in December 2023, which allow an ELTIF to provide for the possibility of redemptions during the life of the fund provided certain conditions (such as appropriate liquidity management) are met. The possibility of designing an ELTIF as an "evergreen" fund which permit regular redemptions by investors which can also be passported across the EU could make it a much more attractive vehicle.

Following feedback, certain initial proposals have been refined – for example, the proposal for a fixed minimum lock up period before any redemptions are permitted, which may cause issues for vehicles that are continually fundraising, has not been taken forward. Instead, the manager of an ELTIF is allowed to select its own minimum period although it is required to justify this to regulators based on criteria set out in the standards. However, some of the rules on the proportion of liquid assets that must be held to meet redemption requests still look overly restrictive and a 12-month minimum notice periods for redemptions (subject to certain exemptions) remains. The proposals remain subject to endorsement by the Commission and subsequent scrutiny by the European Parliament and Council but asset managers may want to take another look at the revised ELTIF as a vehicle for private capital when the reforms are finalised.

Industry participants have noted that while these structures are helpful in order to facilitate the growth of the retail market, many challenges remain on the operational side as investor reporting ands product distribution relating to private funds are not designed to accommodate large inflows of retail capital. A move towards fuller "retailisation" would require firms to navigate their way through significant operational and regulatory hurdles, as discussed below.

Increasing regulatory scrutiny

The push to broaden access to private capital also means increased regulatory scrutiny by various regulators. While wanting to facilitate investment into such asset classes by retail investors, regulators are also mindful of their (potentially conflicting) responsibilities to ensure investor protection. At the same time as proposing reforms to the ELTIF regulation, the European Commission also recently announced a retail investment package comprising an amending Directive (the Retail Investment Directive) amending various regulations relating to both retail (UCITS) funds and alternative funds (AIFMD) and an amending Regulation, which revises the PRIIPs Regulation. The proposed Retail Investment Directive covers a broad range of topics including client categorisation, marketing and product governance rules, with the focus being squarely on investor protection. Much discussion has centred on the ban on inducements, and while the Commission is not proposing a full ban on non-independent advice, it is extending the ban to certain types of retail execution-only distribution. The Directive also introduces new value assessment and pricing process for manufacturers, distributors and managers. Significantly, some of the provisions will still apply even in a wholly institutional context.

In the US, the SEC has recently adopted its long-trailed package of amendments to the Investment Advisers Act 1940 aimed at increasing transparency and strengthen investor protection. Although not a direct result of private funds becoming more widely accessible to retail investors, the SEC has justified its proposals by citing how private funds and their advisers "*play an increasingly important role in the lives of everyday Americans*" and how "*numerous investors have indirect exposure to private funds through private pension plans, endowments, feeder funds established by banks and other financial institutions, foundations, and certain other retirement plans.*". While some of the initial proposals have been pared back, the final

package of rules will still have a very significant impact on the management and operation of private funds by investment advisers and constitutes what an industry body has called "the most extensive regulatory intervention in the global private capital funds industry". These include measures to restrict the charging of certain fees and expenses to the fund and to prohibit the provision of preferential terms to investors regarding redemptions from the fund and the sharing of certain information (subject to certain limited exceptions). Staggered transition periods are in place for implementation of these rules and importantly, for non-US (including UK) firms, the SEC has made concessions in limiting the extra-territorial effect of these rules, clarifying that the restricted activities rule and the preferential treatment rule do not apply to offshore registered or unregistered advisers with respect to their offshore funds (regardless of whether those funds have U.S. investors).

The proposals have proven very contentious with the industry, with many arguing that the rules stifle innovation, restrict (legitimate but) riskier investment strategies that have previously produced outsized returns and sharply increase costs. In their defence, the private fund industry has argued that their investors represent the most sophisticated investors in the world, particularly those representing sovereign wealth funds, pension funds, professionally managed university endowments and charitable foundations - and the narrative that regulation is required to protect unsavvy individuals who are the ultimate beneficiaries is a false one as in reality, their interests are represented by highly sophisticated advisers who negotiate on their behalf. A number of industry bodies have since filed suit against the SEC challenging the rules on grounds of regulatory overreach.

In the UK, the plethora of regulatory developments including the introduction of the Consumer Duty weigh against the desire to widen access to retail investors. Firms are likely to exercise much caution before offering higher-risk products that allow access to private asset classes. The FCA is also increasingly concerned about private market valuations as high inflation rates continue to persist and is expected to carry out a review of the disciplines and governance around private market valuation soon - although the scope of that review has yet to be published. Particular concerns of the FCA are likely to be around conflicts of interest and the extent of the influence or input that the manager has on the valuation process. There is little doubt that regulators and policymakers have a tough balancing act as they seek to give private capital easier access to individual investors while protecting investors from what they may view as unacceptable risks.

6 The evolving sustainability landscape

As has been the norm in the recent past, the volume of legal and regulatory developments relating to ESG and sustainability matters continue apace albeit pushback in some quarters, particularly in the US, against the so-called "ESG agenda" has also resulted in some legal and regulatory measures in the opposite direction - indeed some have introduced measures aimed at limiting or restricting asset managers' ability to take into account ESG factors.

With some research suggesting that financial objectives remain paramount particularly for retail investors, the narrative of continual growth for 'sustainable' funds seen in previous years has dampened in the midst of an environment where many concerned with high inflation and costs-of-living. Transition costs have also become more evident as various economies consider and implement more concrete policies to meet net zero targets, giving rise to some opposition to certain of these policies. For asset managers, delivery of ESG/sustainability objectives in this environment is complex and made more challenging given different views and preferences among investors, even those who, in principle, are supportive of the sustainability agenda. The role of investment managers and market-driven solutions in driving societal change in areas that are normally within the remit of politics or government policy is also the subject of much debate.

Nonetheless, this remains an area that asset managers cannot afford to ignore. As noted in the IA's annual survey for 2022/23: *"Firms are of the view that the Sustainable and Responsible Investment (SRI) agenda will remain a defining one for the industry, particularly with respect to the urgency of tackling climate change."*

Sustainability reporting

One of the most significant milestones in corporate sustainability reporting was achieved when the ISSB finally published its first two sustainability standards (IFRS S1 and S2) in June 2023. The Standards are expected to form the global baseline for sustainability-related reporting. S1 relates to general requirements for sustainability-related disclosures and S2 sets out specific climate-related disclosure requirements. Much work remains to be done, not least as the Standards still require widespread formal adoption by a critical mass of national governments. Further, the specific standards issued to date relate to only one - albeit a very significant one - aspect of sustainability matters, that is, climate-related disclosures. Nonetheless initial

indications are promising with IOSCO having announced its endorsement of the Standards and over 40 jurisdictions having initially supported the establishment of the ISSB in the first instance. The UK government has been quick to reiterate its commitment to endorse the standards and is aiming to make an endorsement decision by July 2024. In August 2023, the Department of Business and Trade (DBT) announced the government's intention to base the UK Sustainability Disclosure Standards on the ISSB standards, markedly noting that divergence from the standards will occur only "*if absolutely necessary for UK specific matters*."

The FCA also intends to consult on disclosure rules referencing the ISSB Standards for listed companies in the first half of 2024, with a view to applying them in financial years commencing on 1 January 2025. For asset managers, any standardisation of sustainability reporting by corporates can only be welcome both for capital allocation purposes as they seek data to inform their investment decisions and for their own reporting purposes. Many, and especially large listed asset managers, would of course also have to report in their own right as they are expected to be entities within scope of the new legal and regulatory requirements.

EU developments in sustainability reporting

The EU has gone down a parallel path in pursuing its ambitious green agenda. The EU Corporate Sustainability Reporting Directive (CSRD) was finalised and came into force on 1 January 2023, requiring companies within scope to report in accordance with the European Sustainability Reporting Standards (ESRS), which were adopted by the Commission on 31 July 2023. While much has been made on the inter-operability of ESRS and the ISSB Standards, the ESRS remains a more ambitious regime encompassing 'double materiality' and covering the full range of environmental, social, and governance issues, including climate change, biodiversity and human rights. Significantly. CSRD applies to non-EU undertakings which are listed on an EU regulated market or which satisfy certain thresholds in relation to the size of their EU activities and presence.

More specific to asset managers, the EU continues to refine the SFDR regime. The overall regime has been in force for over two years now, while the detailed requirements set out in Regulatory Technical Standards (RTS) governing the format and content of the disclosures required under both SFDR and the EU Taxonomy Regulation took effect on 1 January 2023. Application of SFDR remains challenging. Uncertainty over many of the concepts introduced by the regime continues to dog many firms as they seek to comply with its requirements – amply illustrated by the widely reported decision(s) by many asset managers to re-classify their sustainable funds, resulting in the downgrading of many funds initially classified as "Article 9" funds to "Article 8" funds due to a lack of clarity on what constitutes an Article 8 (products that "promote environmental or social characteristics") or Article 9 (products that have "sustainable investment" as their objective) fund. Since the introduction of SFDR, questions ranging from the definition of "sustainable investments" to the meaning of "promotion of environmental or social characteristics" to whether an Article 9 fund can only invest in sustainable investments as defined under the Regulation (following a Commission statement that suggests that Article 9 funds should invest all of their assets in sustainable investments) have been raised.

That said, the Commission had always maintained that the SFDR is a disclosure regime, not a labelling regime – in other words, it functions to by promoting transparency, not by setting standards. Nevertheless, the disclosure requirements and compliance regime differ markedly depending on the classification of a fund, and, given that the regime depends on self-classification of relevant funds by asset managers, the uncertainty surrounding the definition of, and criteria for, the different categories of funds is clearly unhelpful. ESMA has since issued guidelines clarifying some of the questions raised, but much uncertainty remains and a recent survey indicates that, for commercial and regulatory reasons, many asset managers have not re-upgraded the classifications for their funds despite the updated interpretative guidance from ESMA. The requirement to report against principal adverse impacts (PAI) indicators adds further complexity to SFDR and is often cited as one of the most challenging elements of the regime.

Beyond reporting obligations

Corporate Sustainability Due Diligence Directive

A significant regulatory development relating to sustainability which many financial institutions have been closely following is the EU's Corporate Sustainability Due Diligence Directive (CS3D). The Directive establishes a framework on sustainable corporate governance which introduces obligations on in-scope companies to carry out due diligence in relation to their "value chains", requiring them to identify, assess, prevent, mitigate, and remedy adverse human rights and environmental impacts in relation to *their own operations, those of their subsidiaries and their business partners*. This is not just a disclosure obligation but requires organisations to

address the potential adverse impacts of their activities on environmental and social issues.

For financial institutions, including asset managers, much of the debate has centred around the extent of their "value chain". Following extended discussion, provisional agreement was reached in December 2023 which confirmed that the financial sector would be within scope with regard to their "upstream activities" (i.e. broadly their business partners), but would receive a partial and temporary exclusion in relation to their "downstream activities" (which would cover their lending and financing activities - in effect, imposing obligations on them with respect to their clients). While this probably serves as a (temporary but) welcome relief for the financial services sector, asset managers would still be subject to the due diligence requirements in respect of their upstream activities. Firms should also still be prepared to receive requests for information from their clients or suppliers who are within scope of the Directive and who may be under obligation to carry out the mandated due diligence.

Transition plans

As various companies and organisations set net zero targets or seek to align their business with the objectives of the Paris agreement, transition plans are increasingly seen as an integral part of business strategy giving credence to how such organisations intend to achieve their net zero targets. Both IFRS S2 and ESRS will require entities to adopt and publish transition plans if they have them and CS3D will also subject in-scope entities to transition plan requirements. In October 2023, the Transition Plan Taskforce (TPT) published the TPT Disclosure Framework intended to set out a "gold standard" and best practice framework for the disclosure of transition plans (on which we advised).

The TPT has also published seven deep-dive sectoral guidance which was open for consultation until the end of December 2023. That includes guidance for asset managers and separately, asset owners. For asset managers, reduction of emissions is less in relation to their own operations, but their role in facilitating and financing emissions. The focus of the TPT sector guidance for asset managers reflects this with much emphasis placed on the disclosure of firms' plans to reduce financed emissions associated with its investment activities. However, transition plans pose some unique challenges to asset managers as a large part of their role lies with their assessment of investee companies' own plans and the impact of those plans on their capital allocation and investment decisions.

Investment product labelling

The FCA's delayed policy statement (PS23/16) to its consultation on Sustainability Disclosure Requirements and investment labels (CP22/20) was finally published at the end of November 2023 (for further details, see our client briefing). In light of the significant number of responses it received, the hope was that the delay had given the FCA more time to properly calibrate the proposed regime in a way that "*protects consumers but also recognises and takes account of any practical challenges that firms may have*". While many in the sector are supportive of a clear labelling system and disclosure regime for sustainable investment products (that would be particularly useful to retail investors) which would combat greenwashing and build consumer confidence in the nascent market, industry participants have also raised concerns that the proposed criteria for a product to qualify for a label is too strict and prescriptive. Concerns were also raised that the proposed product naming and marketing rules are too restrictive and will unduly prohibit the use of "common" terms which are otherwise used in a legitimate manner across investment strategies.

Much attention has already been given to the general anti-greenwashing rule which imposes an express obligation applicable to *all* FCA-authorised firms to ensure that sustainability-related claims made about their financial products or services are fair, clear and not misleading and consistent with the sustainability profile of the product or service. This rule remains although firms will be given until 31 May 2024 before the rule comes into force rather than immediately as originally proposed. The FCA has also published for consultation more detailed draft guidance (GC23/3) setting out its expectations for this rule.

The FCA may be lauded for its ambition to ensure that the labelling regime is used only for products with clear and substantiated sustainability objectives and characteristics and which are intended to achieve positive outcomes. In rowing back in a number of areas in response to the feedback received, the hope is that the proposals are at least more workable but the overall package remains challenging to implement.

With the market often applying the SFDR regime as a *de facto* labelling regime, the European Commission has also recently published a targeted consultation reviewing the functioning of SFDR. The consultations focus on the functioning of SFDR under its current requirements, but also considers whether SFDR framework should be recast to create a product labelling system (to amend or replace the de facto labelling regime that has arisen). In particular, the

Commission cites greenwashing risk and Member State divergence as potential reasons to replace the current Article 6, 8 and 9 framework with a voluntary fund labelling regime, and asks whether an approach to product categorisation similar to that currently being developed by the FCA might be appropriate in an EU context.

In the US, the SEC has introduced fund naming rules which, although of broader application, would require registered funds with names that suggest a focus on ESG investments to invest at least 80% of the value of their portfolio assets in investments with those characteristics. However, the SEC has reconsidered its approach to temporary departures and retained the current requirements that a fund invest in accordance with this 80% policy "under normal circumstances". In a change from the initial proposed amendments, the final rules require that a fund review its investments least quarterly, to determine whether they continue to be consistent with its 80% rule. Any departure would be required to be remedied as soon as reasonably practicable and in any case, within 90 days - a change from the initially proposed 30-day timeframe.

All these issues illustrate the complexity of the issues involved as regulators seek to build a robust and credible regime in terms of ensuring the proper labelling of products as "sustainable" but without stifling innovation and flexibility in managers' investment strategies.

ESG data and ratings providers - Code of conduct

As many have noted, the growth of demand for ESG or sustainability products and also regulatory requirements relating to sustainability reporting has led to an increasing reliance on third party ESG data and ratings providers, especially given the well-documented issues relating to data gaps. In its November 2021 report "Environmental, Social and Governance (ESG) Ratings and Data Product Providers", IOSCO recommended that regulators focus more attention on such providers and encouraged the development or following of voluntary industry standards or Codes of Conduct. IOSCO also set out recommendations for ESG ratings and data products providers to improve practices across several key areas that raise concerns: transparency, governance, systems and controls, and management of conflicts of interest.

In response, the FCA appointed the International Capital Market Association and the International Regulatory Strategy Group to convene an industry working group (on which we are represented) to develop a voluntary code of conduct for these providers. The working group published for consultation a draft Code in July 2023 and finalised the Code in December 2023. Based on the IOSCO recommendations, the Code sets out six Principles, each underpinned by a series of actions, which provide a practical guide to the application and interpretation of the Principle. Bringing the data and ratings providers within the regulatory perimeter remains on the cards and HMT is also consulting on whether the FCA's regulatory perimeter should be extended to include such providers.

Ultimately, increased transparency in key areas relevant to the products offered by ESG data and ratings providers engendered by these measures should improve the ability of asset managers (and other financial institutions) to better understand and utilise ESG ratings and data products and contribute to enhancing trust in these products.

Contacts

If you would like to discuss any of the issues highlighted in this publication or any other legal or regulatory matter, please do contact us or speak to your usual Slaughter and May contact.

Jonathan Marks

Partner

T +44 (0)20 7090 3056

E jonathan.marks@slaughterandmay.com

Robin Ogle

Partner

T +44 (0)20 7090 3118

E robin.ogle@slaughterandmay.com

Jan Putnis

Partner

T +44 (0)20 7090 3211

E jan.putnise@slaughterandmay.com

Paul Dickson

Partner

T +44 (0)20 7090 3424

E paul.dickson@slaughterandmay.com

Caroline Phillips

Partner

T +44 (0)20 7090 3884

E caroline.phillips@slaughterandmay.com

Sabine Dittrich

Head of EU Financial Regulation

T +44 (0)20 7090 3706

E sabine.dittrich@slaughterandmay.com

Nick Bonsall

Partner

T +44 (0)20 7090 4276

E nick.bonsall@slaughterandmay.com

Nicholas Pacheco

Partner

T +44 (0)20 7090 3143

E nicholas.pacheco@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

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For further information, please speak to your usual Slaughter and May contact.

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