Making financial services work

Asset management and investment funds

Legal and regulatory developments

Covering the period
1 April to 30 June 2023

KEY DATES	
2023	
1 January 2023	**SFDR Level II financial report disclosure template became effective and should be incorporated in annual reports published after this date for funds subject to SFDR Article eight or Article nine (in accordance with financial report rules in Chapter V of the SFDR Level II).**
30 June 2023	**Financial market participants that comply with the entity-level principal adverse impacts rules to address the disclosure requirements set out in SFDR Level II by this date.**
1 July 2023	**End of transitional period for in-scope investment firms to ensure compliance with the Central Bank's new client asset regulations.**
30 September 2023	**Deadline for fund management companies to put a plan in place to address any gaps in their arrangements as against the Central Bank's expectations on fund fees and costs.**
3 October 2023	**ESMA Guidelines on certain aspects of the MiFID II suitability requirements apply**
Q4 2023 (TBC)	**Outsourcing Register filing via the ONR (reference date 31 December 2022) for in-scope fund management companies (exact timing remains to be confirmed by the Central Bank).**
1 December 2023	**Operational resilience action plans taking account of the Central Bank's operational resilience guidance to be in place.**
29 December 2023	**Effective date for compliance with the common conduct standards and changes to the fitness and probity regime pursuant to the Individual Accountability Framework.**
2024	
10 January 2024	**Application date of the revised ELTIF Regulation.**
24 May 2024	**In-scope funds investing over 50% of their portfolio in directly or indirectly held Irish property assets ("Property Funds") to take action to ensure their liquidity timeframes comply with the Central Bank's guidance on redemption terms for Property Funds.**

This is a condensed version of our Asset Management and Investment Funds Legal and Regulatory Report setting out key developments during the quarter.

QUARTER HIGHLIGHTS

In this quarter's edition of the legal and regulatory report, we include a number of key outputs from **ESMA**, including its updates to Q&As on the application of the AIFMD and the UCITS Directive (outlined at sections **1.2** and **2.2** of the report) and its final report following the completion of its common supervisory action outlining its supervisory expectations on asset valuation rules (**4.6(e)**).

The **Central Bank** in a welcome development updated its AIFMD Q&A to increase the investment limits for QIAIFs seeking exposure to digital assets (**1.3**). It has also published its template data return to facilitate its active monitoring of the progress made by funds with Irish property asset exposure to implement its published leverage limits (**3.3**).

The **European Commission** published its Retail Investment Strategy (**4.2(c)**) which sees further legislative measures being proposed on costs and charges and enhancements to the PRIIPs key information document. The Commission has also initiated a review of the UCITS Eligible Assets Directive that will, among other things, take stock of market practices and other intervening developments (**4.2(a)**). A number of now published legislative proposals namely to accelerate data access in finance (**4.4(f)**); and to simplify cross-border taxation procedures for investment (**4.4(g)**) complete the Commission's Capital Markets Union Action Plan 2020.

Work also continues across the regulatory bodies towards the implementation of the Individual Accountability Framework (**3.4** and **3.6(a)**), MiCA (**4.2**), the ELTIF (**4.6(a)**) and DORA (**4.6(f)** and **4.6(g)**).

In June, the **Department of Finance** published a wide-ranging review of the funds sector Funds Sector 2030 (**4.31(c)**).

A number of **sustainability-related updates** were released during the quarter with the Commission publishing in June a further sustainable finance package (**4.13(a)**) alongside the draft sustainability reporting standards under the Corporate Sustainability Reporting Directive (**4.13(c)**). The **European Supervisory Authorities ("ESAs")** issued a consultation on proposed amendments to the SFDR Delegated Regulation (**4.13(d)**) and are expected to finalise their final advice containing revisions to regulatory technical standards for consideration by the Commission by the end of October 2023.

Finally, as supervisory progress on mitigating **greenwashing risks** gather apace fund management companies should consider the contents of the ESAs interim reports (**4.13(d)**) highlighting supervisory concerns and their recommendations in order to mitigate against the risks of financial participants engaging in greenwashing.

1. AIFMD DEVELOPMENTS

1.1 ESMA Q&A on AIFMD update (May 2023)

On 26 May 2023, ESMA published an updated version of its Q&A on the application of the AIFMD containing a new section XVII 'Marketing' on whether non-European Union ("**EU**") AIFMs are allowed to carry out pre-marketing activities pursuant to the pre-marketing requirements of Article 30a of AIFMD.

The new Q&A states that Article 30a of the AIFMD does not cover pre-marketing activities by non-EU AIFMs. Therefore, non-EU AIFMs should not be allowed to carry out pre-marketing activities pursuant to the AIFMD.

However, national laws, regulations and administrative provisions may allow non-EU AIFMs to carry-out pre-marketing activities at national level in the relevant EU member state. Where this is the case, non-EU AIFMs do not benefit from a passport allowing them to carry out these activities in other EU member states. The Q&A re-states that national laws, regulations and administrative provisions should not in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs.

1.2 ESMA Q&A on AIFMD update (June 2023)

On 14 June 2023, ESMA published an updated version of its Q&A on the application of AIFMD, which contains new Q&As relating to 'Conditions for pre-marketing', 'De-notification of marketing arrangements', 'Notifications of AIFMs' and 'Calculation of leverage-real estate assets'.

On the conditions for pre-marketing:

Where an investment strategy is developed by a third party (e.g. the fund initiator), any pre-marketing conducted by that third party on behalf of an authorised AIFM is subject to the obligations and conditions of Article 30a AIFMD, including appropriate authorisation of that third party. Additionally, registered AIFMs are not subject to the obligation to notify pre-marketing pursuant to Article 30a(1) AIFMD unless the registered AIFM is required otherwise under national rules. The Q&A notes that registered AIFMs do not have the EU-wide AIFM passport to exert cross border asset management activities.

On de-notification of marketing arrangements:

In cases where there are no investors in a host member state in an EU AIF, AIFMs wishing to de-notify the arrangements previously made for marketing the shares of the EU AIFs have to comply with the obligations set out in Article 32a(1) of the AIFMD. These conditions include making sure that there are no investors uninformed about the AIFM's market exit, that all marketing is publicly terminated and any marketing arrangements with the third parties are terminated or modified to prevent any further marketing of the de-notified AIF.

Scope of activities passported by AIFMs:

Where intending to provide activities and services cross-border the AIFM may not passport only the other functions that an AIFM may additionally perform in the course of the collective management of an AIF (which are referred to in point (2) of Annex I to the AIFMD) without also passporting its investment management functions. Importantly, the Q&A clarifies that these other functions such as administration or marketing services are ancillary to the activities referred to in Annex I, point 1 and cannot be exercised independently from those investment management functions.

On calculation of leverage – real estate assets:

Under Article 6(3) of Delegated Regulation (EU) 231/2013, an AIFM must include the exposure contained in financial or legal structures involving third parties controlled by the AIF when calculating the leverage of such AIF, where these structures are specifically set up to directly or indirectly increase the exposure at the level of the AIF. This requires when calculating the leverage of an AIF whose core investment policy is to invest in real estate directly or indirectly, an AIFM shall include the exposure contained in financial or legal structures involving third parties controlled by that AIF (as referred to in

Article 6(1) and (3) of the Delegated Regulation). The exemption referred to in the second sentence of Article 6(3) relating to non-listed companies or issuers should not apply to AIFs, which acquire real estate assets indirectly through non-listed companies, as such non-listed companies are being utilised by the AIF with the purpose of implementing the AIF's investment policy, which is the acquisition of real estate assets.

1.3 47th Edition of the AIFMD Q&A.

On 4 April 2023, the Central Bank of Ireland (the "**Central Bank**") published the 47th edition of its AIFMD Q&A. The latest Q&A revises ID1145, which considers if a RIAIF or a QIAIF can invest either directly or indirectly in crypto-assets. The revised Q&A does not change the Central Bank's position precluding a RIAIF from gaining exposure to digital assets. The Central Bank is increasing limits for indirect exposure to digital assets, depending on the liquidity provided by the QIAIF as follows:

(a) where a QIAIF is open-ended it can gain exposure to digital assets of up to 20% of net asset value ("**NAV**"); or

(b) where a QIAIF is closed-ended or has limited liquidity it can it can gain exposure to digital assets of up to 50% of NAV.

Direct investment in digital assets is not permitted until such time as it is demonstrated to the Central Bank that a depositary can meet its obligations under AIFMD to provide custody or safe-keeping services to digital assets.

Where a QIAIF proposes to invest indirectly in digital assets the following requirements apply:

(a) the AIFM must have an effective risk management policy to address all risks relevant to investment in digital assets. This must address, at a minimum, risk relating to liquidity, credit, market, custody, operational, exchange risk, money laundering, legal, reputational and cyber risk;

(b) the AIFM must carry out appropriate stress testing on the proposed investment in digital assets. The stress testing should be extreme yet plausible, reflecting asset price volatility of digital assets including the potential entire loss of value in the investment;

(c) the AIFM must have an effective liquidity management policy in place which includes a sufficient suite of tools to enable the AIFM to manage liquidity events arising in the QIAIF;

(d) the prospectus of the QIAIF must contain clear disclosure in relation to the nature of the proposed investment in digital assets and must contain a clear articulation of the risks associated with that investment;

(e) the QIAIF should assess the overall construction of its portfolio to ensure that there is an alignment between the redemption profile, the level of investment in digital assets and the likelihood of illiquidity (both in normal and stressed conditions) in the types of digital assets invested in. In this regard,

    (i) where a QIAIF proposes to invest up to 20% of its NAV in digital assets, the QIAIF may be structured as having open-ended liquidity provided that the portfolio as a whole is determined by the AIFM to be suitable for an investment fund providing open-ended liquidity; and

    (ii) where a QIAIF proposes to invest up to 50% of its NAV in digital assets, the QIAIF must have either limited liquidity or be closed-ended.

In light of the above, the Central Bank has updated the pre-submission process for QIAIFs proposing to invest indirectly in digital assets in excess of the thresholds outlined in ID1145 or to make any direct investment in digital assets.

Our recent advisory outlines the key changes to the digital asset regime introduced by the Central Bank.

2. UCITS DEVELOPMENTS

2.1 39th Edition of the Central Bank UCITS Q&A

On 4 April 2023, in tandem with the update to its AIFMD Q&A, the Central Bank published the latest 39th Edition of the UCITS Q&A.

This updated Q&A amends Q&A ID 1100 to reflect a change in terminology usage only. It reaffirms the Central Bank's current position precluding a UCITS from gaining exposure to digital assets.

2.2 ESMA updated UCITS Q&A (June 2023)

On 14 June 2023, in tandem with its updated version of the AIFMD Q&A (as outlined at section 1.2 of this report), ESMA published an updated version of its Q&A on the application of the UCITS Directive, addressing the management of AIFs and pension schemes by UCITS management companies, the de-notification of marketing arrangements for UCITS and scope of activities passported by UCITS management companies.

Scope of activities passported by UCITS management companies

The updated Q&A confirms (similar to the AIFMD Q&A at 1.2 above) that the UCITS passporting regime is linked to the management of UCITS by UCITS management companies on a cross-border basis. The provisions of the UCITS Directive governing the management of collective investment schemes by UCITS Management Companies and the cross-border management of UCITS cannot be interpreted otherwise than referring to investment management foremost, whereas auxiliary services remain as such auxiliary and cannot be solely passported in a host EU Member State without also passporting investment management functions.

On the management of AIFs and pension schemes by UCITS management companies:

Pursuant to Article 6(2) of the UCITS Directive, management companies can manage other collective investment vehicles, for which the management company is subject to prudential supervision. AIFMs registered in accordance with Article 3(3) AIFMD should be considered as prudentially supervised within the meaning of Article 6(2) of the UCITS Directive.

Accordingly, UCITS management companies are allowed to manage AIFs as a registered AIFM under Article 3 of AIFMD. Additionally, UCITS management companies are allowed to manage pension schemes under Directive (EU) 2016/2341 (the IORP Directive). Article 6(3), point (a), of the UCITS Directive provides the possibility for member states to authorise UCITS management companies to provide, in addition to the management of UCITS, the management of pension funds' portfolios, in accordance with mandates given by investors on a discretionary, client-by-client basis, where such portfolios include one or more of the instruments listed in section C of Annex I to MiFID.

Therefore, member states can authorise UCITS management companies, in addition to the management of UCITS, to manage investment portfolios of pension funds only on a mandate basis, acting as service providers and not as investment managers of the pension funds.

On de-notification of marketing arrangements for UCITS

The updated Q&A states that where UCITS wish to de-notify the arrangements previously made for marketing shares the obligations set out in Article 93a (1) of the UCITS Directive apply where there are no investors in a host member state.

3. CENTRAL BANK UPDATES

3.1 Financial Stability Review 2023

On 7 June 2023, the Central Bank published its first Financial Stability Review of 2023. This report outlines the key risks facing the financial system and the Central Bank's assessment of the resilience of the economy and financial system to adverse shocks.

The review discusses measures the Central Bank has taken during 2022 to address perceived vulnerabilities in Irish Property Funds and liability driven investment ("**LDI**") funds. The Review indicates that liquidity mismatches, leverage and interconnectedness are key potential sources of vulnerability in non-bank financial intermediaries ("**NBFI**") which could be amplified by significant price movements and further progress is needed at a global level to strengthen the resilience of the NBFI sector.

As part of the Governor's address which accompanied the publication of the Review his remarks highlighted that given the vulnerabilities in the NBFI sector in Ireland, and building on the announcement of macroprudential measures for Irish Property Funds last year, the Central Bank is continuing to work with international partners to develop and operationalise a macroprudential framework for the sector. To advance global discussion and progress in this area, Governor Makhlouf said the Central Bank will publish a discussion paper in July 2023 outlining an approach to macroprudential policy for funds and that it will seek stakeholder feedback in the months ahead.

The intention is that the work programme on non-bank finance and macroprudential policy will be covered in more detail in the discussion paper.

3.2 AIFM marketing guidance update

On 11 May 2023, the Central Bank revised its summary of marketing guidance in respect of AIFs.

The key changes made in the revised guidance are the replacement of Central Bank approval in respect of national private placement filings by a requirement for such alternative investment fund managers to notify the Central Bank pursuant to 35, 37 and 43 of the EU AIFM Regulations 2013.

3.3 Irish property assets data return (*This is a further update to section 3.3 of the report covering the fourth quarter of 2022)*

On 24 May 2023, the Central Bank published its template data return entitled 'Information on Property Funds' and the associated Guidance Note.

All AIFs that are authorised by the Central Bank and that invest 50% or more of their portfolio directly or indirectly in Irish property assets (i.e. which meet the criteria for being in-scope of the Central Bank's macroprudential policy framework for Irish property funds) are required to complete the return on an annual basis.

The purpose of the data return is to enable the Central Bank's assessment of the implementation by Property Funds of the 60% leverage limit (total debt to total assets) (the "**Leverage Limit**").

The Central Bank will be actively monitoring and following up to ensure appropriate progress is being made to implement the Leverage Limit and expects that deleveraging should be significantly progressed by the end of year three.

Clients with Irish property asset exposures should send any queries on the return or the guidance notes directly to the firm's supervisory team.

3.4 Consultation Paper on the Central Bank's administrative sanctions procedure (*This is a further update to section 3.6 of the report covering the first quarter of 2023)*

On 22 June 2023, the Central Bank launched a 12 week consultation on enhancements to the Administrative Sanctions Procedure ("**ASP**") Consultation Paper 154 entitled *'Consolidated Guidelines in respect of the Central Bank's ASP (CP154)*'.

The Central Bank (Individual Accountability Framework) Act 2023 was signed into law on 9 March 2023 and introduces a number of important changes to the ASP, which underpins and supports the Individual Accountability Framework ("**IAF**"). The IAF includes four key elements:

1. The Senior Executive Accountability Regime;
2. Conduct Standards;
3. Enhancements to the current Fitness & Probity Regime; and
4. Enhancements to the Administrative Sanctions Procedure.

The Central Bank recently completed a separate consultation entitled "*Enhanced governance, performance and accountability in financial services- Regulation and Guidance under the Central Bank (Individual Accountability Framework) Act 2023 (CP153)*" on how to implement the first three elements of the IAF. The Central Bank is currently reviewing the comments received and intends to publish these comments and a Feedback Statement on the Central Bank's website in due course.

The IAF builds on the Central Bank's existing enforcement powers, and enhances the Central Bank's ability to hold both firms and individuals to account. The purpose of CP154 is to seek views on the revised procedures in the ASP following the introduction of changes under the IAF Act and to provide guidance in an open and clear manner as to how the Central Bank proposes to operate these revised procedures.

The IAF Act proposes changes to how the ASP will apply, subject to transitional arrangements, and in particular proposes changes to the enforcement of any obligations under the ASP, whether those matters are related to existing obligations under financial services legislation, new obligations introduced as part of the IAF or otherwise become subject to the ASP.

While the overall structure of the enforcement process remains the same, various procedural amendments to the ASP have also been made to incorporate additional safeguards to further fortify the existing process and in recognition of the expanded population of individuals coming within the scope of the ASP under the IAF Act.

The Central Bank has reviewed the ASP with a view to updating its associated processes and procedures to reflect these changes and clarify its approach to them in addition to certain policy changes based on its experience of utilising the ASP. Accordingly, the Central Bank has prepared draft composite guidelines which consolidate the existing published ASP Outline 2018, Inquiry Guidelines 2014 and ASP Sanctions Guidance 2019.

The consultation will remain open for 12 weeks until 14 September 2023. The Central Bank has expressed a desire to hear from a wide range of interested parties ranging from firms, to staff, representative bodies, industry consultancies, service providers, financial services customers, shareholders, investors, civil societies and any other members of the public. Following this period, the Central Bank will review all feedback received on CP 154 and prepare a Feedback Statement for publication online.

3.5 Annual report 2022 & annual performance statement 2022- 2023 (*This is a further update to sections 3.2 & 3.3 of the report covering the first quarter of 2023)*

On 24 May 2023, the Central Bank published its Annual Report 2022 & Annual Performance Statement 2022- 2023, which reiterated its key priorities for 2023. The Central Bank's key regulation and supervisory priorities of interest to the funds industry remain consistent with those outlined by it in Q1 in its cross-sectoral 'Dear CEO' Letter.

The report shows that the investment fund sector continued to grow in scale and complexity in 2022 with a significant volume of fund (744) and fund service provider (23) authorisations. On application for authorisation, the Central Bank intends to prioritise early engagement with firms, enabling them to engage at the preliminary or speculative phase to gain information and guidance about the authorisation process and with the Central Bank's authorisation standards in line with international norms.

Above all, the report emphasises the Central Bank remains committed to stakeholder engagement and building genuine two-way dialogue on its priorities in the year ahead.

3.6 Central Bank speeches during the period

(a) *IAF – what it means for directors*

On 1 June 2023, Gerry Cross delivered a speech on the IAF and what it means for directors.

On the Conduct Standards

The draft IAF Guidance (published as part of CP153) sets out the Central Bank's expectations in relation to the Conduct Standards and some non-exhaustive examples of the steps it may be reasonable in the circumstances for an individual to take to ensure they are met. The concept of reasonable steps is at the heart of the Conduct Standards, with the expectation that an individual subject to the Conduct Standards shall take reasonable steps to achieve compliance.

*On the Conduct Standards vs the fitness and probity ("**F&P**") regime*

The F&P regime and the IAF can be thought of as two aspects of one overall framework of sound governance and accountability – with the F&P regime being about suitability of individuals and the IAF about their clear responsibilities and ongoing conduct. While the F&P standards are relevant to assessing individuals prior to their appointment (and on an ongoing basis while performing the controlled function), the Conduct Standards only apply once the individual is in the role.

On the annual F&P certification

The IAF introduces a number of improvements to the F&P regime including that firms and holding companies will need to certify annually the ongoing compliance with standards of fitness and probity of individuals carrying out CF roles. The Central Bank do not propose to require firms to submit details regarding such certification, though this information should be available on request. As part of the existing annual PCF return, firms will required to confirm the completion of the certification process.

(b) *Building resilience in markets* (*This is a further update to sections 3.8(a) of the report covering the first quarter of 2023)*

On 16 May 2023, Deputy Governor, Vasileios Madouros delivered remarks entitled "*Building resilience in Markets" which* focused on the resilience of markets and in particular the role of NBFI.

His remarks noted a missing ingredient in the regulatory framework for NBFI is in developing macro-prudential regulation for non-banks, including investment funds. The efforts to strengthen resilience of the sector are being led by the policy recommendations of the Financial Stability Board ("**FSB**") – these policy questions are being approached globally in a holistic way. That work covers dimensions related to the observed spikes in demand for liquidity, especially by non-banks, for example where they needed to sell assets to meet investor redemptions (such as money market funds or open-ended funds) or unwind leveraged positions (such as LDI funds).

Resilience of NBFI is at the forefront of the Central Bank's thinking, given the size of the sector, especially asset management, based in Ireland. He focused his consideration of the Central Bank's approach to NBFI on the investment fund sector, partly because this is a sector where it has particular expertise in regulation and supervision, but also because it has grown significantly in systemic importance at a global level in recent years. Mr Madouros outlined how the tenets of the required regulatory approach should be centred in four areas:

- Focus on cohorts of the non-bank sector;
    - Avoiding a 'one-size-fits-all' approach across the sector - individually rational actions by individual funds can – collectively – lead to disruptions in core markets.

- An example was seen in the recent LDI crisis in the UK, where a single LDI fund that had taken on substantial leverage through repos or derivatives could perhaps sell assets in the face of market volatility, without materially affecting market outcomes. But, in aggregate, across all LDI funds with similar vulnerabilities, the impact of correlated actions can – and did – lead to a destabilisation of markets.

- Aim to limit vulnerabilities before shocks hit;
  - The Central Bank has identified key sources of financial vulnerabilities in the funds sector – (i) leverage and (ii) liquidity transformation.
  - The underlying focus of a macroprudential perspective would be to identify and mitigate those vulnerabilities ex ante – these being particularly pronounced when funds are key participants in core markets.

- Framework reflecting the evolving risk environment;
  - By way of example, a gradually growing importance of the fund sector in a given core market would be a structural factor that implies that a disruption in that form of financing could have a greater impact on the functioning of that market in times of stress.

- Call for actions to be co-ordinated at a global level.
  - The actions by one jurisdiction can have a direct impact on financing conditions of another jurisdiction. So developing policies to strengthen resilience of non-banks at a global level – as per the agenda of the FSB and IOSCO – is optimal.
  - Further steps need to be taken to strengthen the resilience of segments of the non-bank financial system, including by developing a macroprudential lens in the regulation of non-banks.

(c) *Preventing financial crime in a rapidly changing environment: A regulator's view*

On 25 May 2023, the Director of Enforcement and Anti-Money Laundering, Seána Cunningham, delivered a speech entitled "*Preventing Financial Crime in a Rapidly Changing Environment: A Regulator's View*". In her speech Ms. Cunningham discussed the current geo-political and economic context and set out key ways to counter the extant challenges.

Her remarks included the following recommendations for firms to keep pace with this rapid change in risks arising from financial crime:

- Ensuring a thorough understanding of the money-laundering ("**ML**")/terrorist financing ("**TF**") risks to which the business is exposed is key to the development of an effective AML/CFT risk management framework. A key regulatory requirement is that ML/TF risks specific to a business should be captured in a firm's business-wide ML/TF risk assessment. It is from this business wide risk assessment that all AML/CFT policies and procedures will be developed and it is therefore critical that firms have a strong understanding and articulation of the ML/TF risks to which they are exposed from the outset and that this is kept live and under review, as risks and/or business activities will change. It is also key that firms have the right people in place and the new PCF 52 (Head of AML/CFT) role in the Irish regulatory regime emphasises this.

- The scale and pace of the new sanctions against Russia has brought into sharp focus the challenges of the wider European and national financial sanctions framework. Understanding the sanctions regime and the risks associated with not complying with the regulations is critically important. This is particularly the case for any activity with an exposure to those sanctioned entities or individuals.

(d) *Governor's blog* **-** *Crypto and the consumer* (*This is a further update to section 1.1 of the report covering the month of April 2023)*

On 5 May 2023, the Central Bank Governor's latest blog post *'Crypto and how we can protect the consumer'* notes that the Central Bank remains cautious on the benefits and risks of crypto, notwithstanding that Ireland's exposure to the sector is currently low.

The Central Bank differentiates between 'backed crypto' and 'unbacked crypto'. It is open towards the potential of 'backed crypto' – such as Electronic Money Tokens (EMTs) and Asset Reference Tokens (ARTs) under the Markets in Crypto Assets Regulation (EU) 2023/1114 ("**MiCA**") – where appropriate reserves and controls are in place. However, consumers should know these are not risk free. 'Unbacked crypto' (including poorly or unreliably-backed crypto) is a very different proposition with the Governor noting descriptions of unbacked crypto as "investment" is an abuse of the word ("Ponzi schemes" might be more accurate).

In general, the Central Bank remains concerned at the potential for consumer harm and, in particular, discourages the marketing of crypto to the public. The lack of regulation is a significant gap and in its absence consumer/investor protection, aggressive and misleading advertising, contagion risk, inappropriate use of client assets and insufficient quality of reserves among some crypto remain key risks.

(e) *The evolving crypto landscape - towards the implementation of MiCA*

On 30 May 2023, Director of Financial Regulation, Policy & Risk, Gerry Cross delivered remarks entitled "*The evolving crypto landscape - towards the implementation of MiCA*" wherein he welcomed the publication of the consultation paper by IOSCO with detailed recommendations on regulating cryptoassets (as outlined at section 4.2(b) of this report).

Mr Cross stressed the distinction between the situation of unbacked crypto marketed to retail customers and the same product made available to non-retail, professional investors. The Central Bank's approach is that the latter group of investors, subject to the appropriate marketing and disclosure rules by product providers, are better able to look out for themselves. On this basis, the Central Bank recently updated its guidance on investments in digital assets to allow greater flexibility for professional only investment funds or QIAIFs to invest in these assets albeit indirectly.

Backed crypto offerings, are a potentially very different animal. Where a crypto product purports to be backed by meaningful assets, then where this is reliably and effectively done, there is the potential for meaningful purposes and uses to be developed. In this context, amongst the features that will be particularly important from a regulatory perspective are a high quality governance, effective "backing" of the crypto offering so that the purported value aligns with the realisable value, and high quality transparency and communication with investors, in particular, retail investors so that they know clearly and understand fully what risks they are exposed to. He noted that at this stage the Central Bank have not seen a working model of tokenisation for investment funds - nonetheless the potential benefits are interesting.

He also referred to MiCA's forthcoming regulation of crypto asset service providers ("**CASPs**"). CASPs are firms that provide crypto asset services to third parties on a professional basis. This will include, for example, trading platforms; exchanges; custody providers; execution firms; and advice providers. This aspect also includes unbacked assets.

MiCA will impose important consumer protection measures on CASPs, with governance obligations, minimum capital requirements, and transparency requirements. MiCA will also provide for prohibitions on insider dealing, market manipulation and the unlawful disclosure of inside information. CASPs will need to maintain segregated accounting practices to properly keep customer funds separate and suitably protected from incidents such as insolvency. In addition, CASPs will be required to maintain a suitable insurance that will cover its exposures in case of a partial or total technical failure. The Central Bank is engaged with the Department of Finance who will consult on the exercise of its discretions under MiCA in due course.

His comments concluded the Central Bank are committed to implementing the regulatory, supervisory and approvals approaches which allow the unlocking – for the benefit of consumers, businesses and the wider economy – the potential of blockchain and other technological innovation.

3.7 Thematic assessment on effective conduct-focused culture in the wholesale market

On 15 June 2023, the Central Bank published a thematic report entitled "*Embedding an effective conduct-focused culture in wholesale market – The Role of the Board and senior management in fostering positive conduct and behaviour*". The scope of the assessment of conduct risk management frameworks addressed a number of firms engaged in MiFID activities, including investment firms, broker-dealers and fund service providers.

The report notes that culture is consistently seen as a driving factor in cases of misconduct and conduct risk governance failures in the financial services industry and having an effective conduct-focused culture plays a critical role in minimising opportunities for these risks crystallising. The term effective conduct-focused culture describes a culture that is underpinned by an effective conduct risk management framework which seeks to mitigate the market conduct risks enabling senior management to foster positive conduct and behaviour which ultimately culminates in a culture that has the best interests of investors and the wider securities market at heart.

The assessment recognises the importance of a conduct-focused culture with some good practices recorded. Section 3 of the report sets out a number of key findings and observations falling within the following themes:

- *On leadership and decision-making* - Boards and senior management should "set the tone from the top". This involves making positive efforts to communicate the desired culture to the rest of the organisation. The Central Bank expects independent non-executive directors to bring an independent viewpoint to the deliberations of the Board, challenge the culture that prevails and to critically evaluate the strategic direction of the firm and the emerging risks to its business mode.

- *On governance structures* – Boards and senior management are expected to take "active ownership of the governance of market conduct risk" which includes ensuring the firm has effective frameworks in place for the identification and management of market conduct risk.

- *On the identification, assessment and monitoring of conduct risk & culture* - Firms are expected to ensure that responsibilities for managing and mitigating market conduct risk are consistently articulated in the role profiles and objectives for senior management. The report notes that deficiencies in the practices of the assessed firms were observed with regard to management information ("**MI**"). Accordingly, boards and senior management should be "proactive and ensure they are provided with appropriate, timely MI and reporting" to allow for appropriate challenge and oversight of market conduct risk.

- *On fostering a speak-up culture* - Boards and senior management should consider how they can enable an inclusive "speak-up" culture that fosters and promotes an environment where staff can raise concerns. Firms are expected by the Central Bank to have clear disclosure policies and mechanisms for raising concerns in operation - and firms are reminded that they are required to comply with the Protected Disclosures (Amendment) Act 2022. The report noted that improvements are required in the depth, quality and local relevance of firms' protected disclosure policies, the supporting management communications and the reinforcement of an environment that promotes psychological safety amongst staff. In particular, firms relying on group protected disclosures policies run the risks of not complying with all local legal obligations in this regard.

- *On hybrid-working arrangements* - Firms should proactively consider any mitigation measures or steps to take to ensure defined values and expected behaviours are being adhered to in a hybrid-working environment. As highlighted in the Central Bank's Securities Markets Risk Outlook Report 2023, such firms with a hybrid-working model are expected to conduct regular governance reviews and ensure that there are policies and procedures, controls and a monitoring regime in place sufficient to meet their regulatory obligations.

The Central Bank expects firms to be "guided in all their activities by a commitment of a culture of high standards for conduct and market integrity".

3.8 Investment fund statistics Q1 2023

On 30 May 2023, the Central Bank published its Investment Fund Statistics for Q1 2023, which show large inflows into Irish resident funds ("**IFs**") as the total net asset values of IFs continued to increase reaching €3,738bn in Q1 2023. Both large inflows (€7bn) and positive revaluations (€76bn) were the main drivers of this increase.

4. OTHER LEGAL AND REGULATORY DEVELOPMENTS

4.1 Beneficial Ownership Register

On 16 June 2023, the EU (Anti-Money Laundering: Beneficial Ownership of Corporate Entities) (Amendment) Regulations 2023 (S.I. 308/2023) were signed into law by the Minister for Finance.

S.I. 308/2023 amends Regulation 25(3) of (S.I. 110 of 2019) the Anti-Money Laundering: Beneficial Ownership of Corporate Entities Regulations 2019, such that access to both registers of beneficial ownership information (namely the Register of Beneficial Ownership of Companies and the Central Register of Beneficial Ownership of Irish Collective Asset-management Vehicles, Credit Unions and Unit Trusts operated by the Central Bank) can be provided to members of the public who have - and can demonstrate through the making of a submission - a "legitimate interest". A legitimate interest can must be demonstrated in accordance with the European Court of Justice ("**ECJ**") ruling which struck down unrestricted public access for beneficial ownership registries in the EU.

In summary, the S.I. prescribes that the requester will have to justify access, to the relevant registrar, by demonstrating that the requester is engaged in the prevention, detection or investigation of money laundering and/or terrorist financing offences. In addition, the person must demonstrate that the entity which is the subject of the access request is connected with persons convicted (whether in the State or elsewhere) of an offence consisting of money laundering or terrorist financing, or that the entity holds assets in a high-risk third country.

4.2 Crypto Regulation

(a) *European Banking Authority ("**EBA**") consultation on changes to the AML/CTF risk factor guidelines to include CASPs*

On 31 May 2023, the EBA published a consultation paper on proposed changes to its guidelines on customer due diligence and the factors credit and financial institutions should consider when assessing ML and TF risk associated with business relationships and occasional transactions under Articles 17 and 18(4) of the Fourth Money Laundering Directive (EU) 2015/849.

The EBA is proposing to extend the scope of the guidelines to CASPs. It explains that CASPs are exposed to ML and TF risks and that developments such as the use of innovative technologies, instant transfers of crypto assets across the world and services that contain privacy-enhancing features can increase these risks.

The consultation closes on 31 August 2023.

(b) *IOSCO consultation on crypto and digital assets*

On 23 May 2023, IOSCO published its consultation report with policy recommendations for crypto and digital asset ("**CDA**") markets.

The recommendations cover six key areas, consistent with the IOSCO Objectives and Principles for Securities Regulation and relevant supporting IOSCO standards, recommendations, and good practices:

- conflicts of interest;
- market manipulation, insider trading and fraud;
- cross-border risks and regulatory cooperation;
- custody and client asset protection;
- operational and technological risk; and
- retail access, suitability and distribution.

The consultation proposes 18 policy recommendations, which support greater consistency with respect to regulatory frameworks and oversight in its member jurisdictions, to address concerns related to market integrity and investor protection arising from crypto-asset activities. The report demonstrates IOSCO's efforts to put global guardrails in place to respond to widespread concerns regarding market integrity and investor protection within crypto-asset markets.

The deadline for responses to the consultation is 31 July 2023. IOSCO aims to finalise the CDA recommendations in early-Q4 2023.

(c) *European Systemic Risk Board ("**ESRB**") report on cryptos and decentralised finance*

On 25 May 2023, the ESRB published a report outlining the systemic implications of crypto markets and proposing policy options to address the risks stemming from crypto-assets and decentralised finance ("**DeFi**").

To better understand developments in crypto-assets and their potential financial stability implications, the ESRB proposed two main policy options as follows.

1) the EU's capacity to monitor potential contagion channels should be improved. This applies both to channels between the crypto sector and traditional finance, and to channels within the crypto sector. To this end, it is key to promote standardised reporting and disclosure requirements for:

    - traditional financial sector institutions such as banks that are exposed to cryptos;
    - investment funds with crypto exposures; and
    - entities such as stablecoin issuers or e-wallet service providers in the crypto sector; and

2) policy options to address risks arising from crypto conglomerates, crypto-based leverage, novel operational challenges, DeFi and crypto staking and lending.

(d) *EU Parliament adoption of MICA and TFR (This is a further update to section 4.3 of the quarterly report covering the fourth quarter of 2022)*

On 20 April 2023, the European Parliament issued a press release announcing the adoption by passing its final vote of **MiCA** and the regulation on information accompanying transfers of funds and certain crypto-assets ("**TFR**"). MiCA is the EU's main legislative proposal to oversee the crypto industry in member countries and is a significant development for the crypto industry in the EU.

MiCA will prohibit persons within the EU from providing crypto-asset services, unless they are authorised as a CASP Crypto-asset services includes the activities of provision of advice and the provision of portfolio management on crypto-assets as well as the custody, administration and reception and transmission of orders of crypto-assets on behalf of third parties. Undertakings seeking to be authorised as a CASP are required to be 'established' in the EU and MiCA will subject all CASPs to conduct, prudential and governance requirements, as well as specific outsourcing, conflict of interest and asset safeguarding rules.

MiCA will also allow AIFMs and UCITS management companies with the MiFID II Directive (2014/65/EU) ("**MiFID II**") top-ups to apply for a 'MiCA top-up' to provide crypto-asset services equivalent to the permissions for portfolio management, investment advice and reception and transmission of order (as relevant) for which they are authorised under the AIFMD or UCITS regimes (Article 53a).

The TFR builds on the definitions established under MiCA. It requires CASPs, as obliged entities under the current AML regime, to collect, verify and submit certain information about the originator (i.e. a person that holds a crypto-asset account or address) and the beneficiary (i.e. a person that is the intended recipient of the transfer of crypto-assets) of crypto-asset transfers (the "travel rule").

On 9 June 2023, Regulation (EU) 2023/1114 (MiCA) and Regulation (EU) 2023/1113 (recast TFR) were published in the Official Journal of the EU (the "**OJ**") and entered into force on 29 June 2023. The provisions regarding the regulation of stablecoins under MiCA will apply from July 2024. The remainder of the provisions under MiCA together with the TFR will apply from 30 December 2024 (18 months following their entry into force).

A recent advisory from the Walkers regulatory team summarises the key points to note on the adoption of MiCA and TFR.

(e) *Commissioner speech on crypto assets*

On 19 April 2023, Commissioner McGuinness delivered remarks at the European Parliament plenary joint debate on crypto assets where she welcomed the European Parliament's vote to approve comprehensive EU rules on MiCA and TFR. She noted the measures are a world first and her support for international regulatory discussions in this area. Ms McGuinness emphasised that the new rules are being applied progressively, giving stakeholders time to adapt and also allowing time to adopt the secondary legislation for the implementation of the rules.

(f) *IAIS report on cyber insurance coverage and cyber resilience in the insurance sector*

On 21 April 2023, the International Association of Insurance Supervisors ("**IAIS**") published a report analysing the risks and trends associated with cyber insurance coverage, cyber resilience in the insurance sector, and the impact these risks may have on financial stability.

The IAIS report finds that:

- global cyber insurance premiums have continued to grow despite tighter terms and conditions and stricter risk selection;
- supervisors are actively developing and implementing macroprudential supervision frameworks for cyber risks; and
- cyber underwriting activities of insurers in the sample are not assessed to pose a threat to financial stability due to the currently limited volumes of affirmative cyber insurance underwriting. However, significant data gaps remain in gauging the systemic risk posed by non-affirmative coverage.

4.3 Department of Finance

(a) *Speech to Irish Funds*

On 8 May 2023, the Minister for Finance, Michael McGrath, delivered remarks to Irish Funds which touched on:

- the impact on the Irish economy of:
  - the war in Ukraine;
  - the pandemic;
  - the fallout from Brexit;
  - inflation; and
  - monetary policy;
- the Department of Finance's review of the Funds sector; and
- the Irish government's engagement on aspects related to the CMU package.

(b) *Department of Finance 'Funds Sector 2030' review – Terms of Reference*

On 6 April 2023, the Minister for Finance published the terms of reference for the Department of Finance to conduct a review of Ireland's funds sector and produce a report '*Funds Sector 2030: A Framework for Open, Resilient & Developing Markets*'.

The Department of Finance will conduct and produce a report 'Funds Sector 2030: A Framework for Open, Resilient & Developing Markets. The review will include:

(a) an examination of the taxation regime for funds, life assurance policies and other related investment products, with the goal of simplification and harmonisation where possible, and to do so with a net revenue-raising or neutral mandate;

(b) an examination of the regimes for real estate investment trusts ("**REITs**") the Irish real estate funds ("**IREFs**") and their role in the property sector, including how they support housing policy objectives; and

(c) the use and scope of the Section 110 regime, both in the context of the property sector and more generally so as to ensure that the regime is fit for purpose and meeting agreed policy objectives; and

(d) relevant peer comparisons (most notably from other EU jurisdictions).

The Department is engaging with stakeholders including by means of the public consultation (outlined at (c) below) and will present a draft report to the Minister of Finance by Q2 of 2024

(c) *Funds Sector 2030 review: A framework for open, resilient & developing markets*

On 22 June 2023 the Department of Finance published a public consultation paper, entitled "Funds Sector 2030: A Framework for Open, Resilient & Developing Markets". The consultation forms a wide-ranging review of the funds sector to consider investment funds products, the taxation of funds and life assurance policies announced in last September's Budget 2023 speech, under the broad and interlinked themes of "Open Markets, Resilient Markets and Developing Markets".

Key objectives of the review include developing a framework within which Ireland can maintain its leading position in fund management and fund servicing and ensuring that the sector continues to support economic activity both at the regional and national level in Ireland.

The paper outlines the review with respect to the asset management and funds servicing sector as a whole, including summaries of specialist fund categorisations, such as in particular the ELTIF, two products types which are particularly prominent in Ireland namely Exchange Traded Funds (ETF) and MMFs and legal structures such as the Investment Limited Partnership (ILP).

The paper is split into the following sections:

Section 2: Investment funds and asset management landscape
Section 3: The regulatory and supervisory framework
Section 4: Assessing the impact of the funds sector
Section 5: Taxation of investment products
Section 6: The role of the REIT and IREF regimes in the Irish property market
Section 7: The role of the Section 110 Regime

The consultation includes 48 questions of which about half deal specifically with tax aspects. Annex 1 to the paper contains a consolidated list of the questions posed as part of the consultation. A number of areas of potential focus of the review which will be of interest to investment funds and FMCs are as follows:

Key elements of the funds and asset management sector

The summary in the paper outlines the sector under the subheadings of fund categories, fund products and asset classes and notes the importance of responding to investor demand for ESG investments in SFDR Article 8 & 9 funds.

A number of key questions posed demonstrate the review is designed to be both holistic and extensive, representing a significant opportunity to fully unlock the potential of the asset management and fund servicing industry in Ireland.

- What are the key opportunities for the sector in the medium- to long-term and how can they be delivered?
- How will technological change and innovation influence the sector's future development?
- How best can Ireland position itself in the future as a location of choice for EU and international firms?
- How can Ireland best support the growth and development of the market for ESG products and the transition to carbon neutrality?
- What elements of EU policy, including Capital Markets Union ("**CMU**") policy, are most relevant to the growth and development of the funds and asset management sector in Ireland and why?
- How does the funds framework in Ireland compare to those other jurisdictions?
- Are there any updates or changes needed to the current legislation governing the legal structures used to establish investment funds?

The role of NBFI

The summary on the role of NBFI notes the Irish NBFI sector grew from €1.24 trillion at the end of 2010 to €3.9 trillion at the end of 2021. It further notes that in response to concerns that the NBFI sector could become a source of systemic risk given the overall scale and interconnectedness of the sector (in its widest meaning), there has been growing commentary around mitigating potential financial stability risks with macro-prudential policy in the non-bank financing sector, which includes parts of the funds sector.

The question posed in the paper suggest a focus of the review will be on delivering opportunities for funds providing credit intermediation:

- For the NBFI sector, those investment funds providing credit intermediation, what are the key opportunities for the sector in the medium- to long-term and how can they be delivered?

Section 110 companies

The summary of the use and scope of the Section 110 regime in the consultation paper is a fairly measured and neutral overview of the Section 110 regime and acknowledges that as a result of various Finance Act amendments including the 2016 real estate / distressed property debt amendments, Section 110 has become a very complex regime with significant anti-avoidance measures. Two broad questions are asked:

- What policy objectives should section 110 be supporting?
- What changes are needed, if any, to ensure the section 110 regime meets those policy objectives?

The Section 110 summary may indicate a focus of the review is specific to Irish real estate exposure and is relatively narrow in the context of Section 110 companies:

*"Like IREFs and REITs, concerns about the role of section 110 companies in the Irish property market were highlighted in responses to the [Commission on Taxation & Welfare ("**COTW**")] public consultation. As a consequence, the COTW recommended that the Government undertake a wide review of section 110 tax regimes, to include their role in facilitating institutional investment in the Irish property market. This recommendation will be considered within the context the current Review."*

Next steps

Responses to the public consultation are sought by 15 September 2023 allowing all stakeholders to submit their views on how Ireland can maintain its leading position in asset management and fund servicing, how the sector can support economic activity both at the regional and national level and how to ensure the sector is financially resilient, future-proofed and continue to meet international best-practice.

According to the Department's press release accompanying the consultation the responses to the public consultation will form the basis for a series of targeted engagements by the Department's multi-disciplinary review team with respondents as well as national and international stakeholders in Q3, Q4 of 2023 and into Q1 of 2024. The review team expects to present its draft report to the Minister by summer 2024.

Walkers will be involved in framing responses to the consultation across our Tax and Asset Management & Investment Funds practice groups as part of our membership of industry bodies.

4.4 European Commission (the "**Commission**")

(a) *Request for ESMA advice on the review of the Eligible Assets Directive.*

On 16 June 2023, the Commission issued a formal request to ESMA for technical advice on the review of the Eligible Assets Directive 2007/16/EC (the "**EAD**"). The Commission intends to carry out a review of the EAD that will, among other things, take stock of market practices to ensure that the eligibility rules are implemented in a uniform manner in all member states. The review will also take into account market and regulatory developments that have occurred since the EAD was adopted.

The Commission mandates ESMA to carry out an assessment of the implementation of the EAD, to analyse whether any divergences have arisen in this area and to provide the Commission with a set of recommendations on how the EAD should be revised to keep it in line with market developments.

The Commission's requests to ESMA include for it to:

- propose clarifications on the key definitions and the criteria against which the eligibility of an asset is assessed. It should analyse whether and to what extent cross-references to other EU legal frameworks could improve legal clarity and, where appropriate, consistency between these frameworks;
- assess the risks and benefits of UCITS gaining exposures to asset classes that are not directly investable for UCITS;
- gather data on the manner and the extent to which UCITS have gained direct and indirect exposures to certain asset categories that may give rise to divergent interpretations or risk for retail investors (such as structured or leveraged loans, catastrophe bonds, emission allowances, commodities, crypto-assets, unlisted equities and other relevant asset classes); and
- make a preliminary assessment of the impacts of the proposed regulatory adjustments, if any, taking into account the characteristics of the underlying market.

The Commission requests ESMA to deliver its technical advice by 31 October 2024.

(b) *UK-EU memorandum of understanding ("**MoU**") on regulatory co-operation in financial services*

On 27 June 2023, the Commission published a press release confirming that the European Commissioner for Financial Services, Financial Stability and CMU and the UK's Chancellor of the Exchequer, have signed a MoU on UK-EU regulatory co-operation in financial services. The MoU is intended to help establish a constructivre, mutually beneficial relationship in financial services between the UK and the EU. The press release notes that the signing of the MoU this allows the UK and the EU to move forward in a spirit of partnership, based on trust, co-operation and delivering benefits for people on both sides.

The MoU establishes an ongoing forum, the Joint UK-EU Financial Regulatory Forum, for the UK and the EU to discuss voluntary regulatory co-operation on financial services issues. The first meeting of the forum is expected to take place in autumn 2023.

(c) *Adoption of the Commission's Retail Investment Strategy* ("**RIS**") (*This is a further update to section 4.3(a) of the report covering the first quarter of 2023)*

On 24 May 2023, the Commission adopted and published its retail investment strategy, a key tenet of its Capital Markets Union Action Plan 2020 (the "**CMU Action Plan**"). One of the core objectives of the CMU Action Plan is to develop retail investment and make the EU a more appealing location for individuals to save and invest long-term, allowing individual investors to benefit from adequate protection, bias-free advice, fair treatment and cost-efficient markets with transparent and understandable product information.

The RIS consists of two "mutually reinforcing" legislative proposals:

- an Omnibus Directive amending a number of existing directives in the financial services sector, namely, the UCITS Directive (2009/65/EC), Alternative Investment Fund Managers Directive (2011/61/EU) ("**AIFMD**"), MiFID II, the Solvency II Directive (2009/138/EC), and the Insurance Distribution Directive ((EU) 2016/97) as regards the Union retail investor protection rules (COM(2023) 279 final); and

- a proposed Regulation amending Regulation (EU) 1286/2014 (the "**PRIIPs Regulation**") as regards the modernisation of the key information document (KID) (COM(2023) 278 final).

It is envisaged that the RIS proposals will deepen the involvement of retail investors in capital markets, partly by using tougher protections to build up trust in investing and support the EU's long-term competitiveness. While the aims of the RIS are undoubtedly both ambitious and wide-ranging spanning multiple sectors and harmonising investor treatment across a number of investment products, some notable proposals in the RIS package of legislative measures have the potential to impact on UCITS management companies and alternative investment fund managers ("**FMCs**") namely:

- that costs and charges must be justified under new quantitative cost benchmarks introduced as part of "value for money" assessments, and so be aligned with the expected returns of the fund of share class; and

- enhancements to the PRIIPs key information document ("**KID**") to make it more suited to the evolving needs of investors and to increase legal clarity.

Value for Money in Fund Costs

Following the Central Bank's own findings and expectations arising from its review of the costs and fees charged to UCITS as part of the European Securities and Markets Authority's ("**ESMA**") Common Supervisory Action on costs and fees (the "**CSA**") and secondly ESMA's Opinion earlier this month seeking clarifications to the legislative provisions relating to undue costs (outlined at section 4.6(b) of this report), the details of the Commission's value for money proposals have been keenly awaited by the funds industry.

Under the proposals contained in the Omnibus Directive, FMCs will need to meet new standards applicable to UCITS and also to AIFs that are marketed to retail investors demonstrating that they deliver value for money for those investors. The pricing processes maintained by FMCs will be strengthened by the introduction on a legislative basis in both the UCITS Directive and AIFMD of value for money obligations. The rules will clarify by way of regulatory technical standards ("**RTS**") those costs deemed eligible costs and ensure that the relevant conditions are met in the pricing process. ESMA had recommended that the Commission should clarify the eligibility of fund costs in light of the list of costs and expenses contained in the existing PRIIPs Regulation RTS.

ESMA is mandated to develop, make publicly available, and regularly refine cost and performance benchmarks for UCITS and AIFs (which market to retail investors) which present similar levels of performance, risk, strategy, objectives, or other common characteristics. To facilitate the development of these benchmarks, it is proposed that an obligation be imposed on FMCs to report the costs borne by investors and the performance of the relevant investment product to national competent authorities ("**NCAs**") who would in turn provide the data to ESMA.

Under the proposed Omnibus Directive, FMCs will be required to conduct a pricing process assessment annually to include a comparison with the relevant benchmark on costs and performance published by ESMA. In the event of deviation and where justification and proportionality of costs and charges cannot be demonstrated, or if the UCITS/AIF or its share classes do not comply with other criteria set out by the FMC in the pricing process, that UCITS/AIF or its share class would be prevented from being marketed to retail investors by the FMC. Additionally if in the course of the assessment the FMC determines that undue costs have been charged, including where costs have been miscalculated to the detriment of investors compensation will be required to be paid to affected investors.

Targeted Changes to the PRIIPs KID

Following recommendations made by the European Supervisory Authorities for significant changes to make the KID more consumer friendly and a broad review of the PRIIPs framework, the RIS includes a number of concrete proposals to improve and standardise the information provided to retail investors under the PRIIPs Regulation. These include:

- the introduction of a summary dashboard, to make key information on the costs and risks of investment products highly visible at the top of the document;
- more flexibility to display information from KIDs in a digital and user-friendly way, notably by allowing the use of layering, i.e. the possibility to click on the titles of different sections of the KID and expand the text of the sections of interest, which complements the fixed document, such as in PDF format, that exists today. The package also specifies conditions for more interactive features;
- a new sustainability section in the KID to make information on sustainability-related characteristics of investment products more visible, comparable and understandable for retail investors. This section will build entirely on existing sustainability disclosures, avoiding any new reporting burdens; and
- clarifications to provide greater legal clarity on the exclusion of specific products (e.g. corporate bonds) that were not originally intended to be captured by the PRIIPs Regulation.

Other aspects of the RIS including proposals on enhanced product governance assessment and suitability rules and the tightening of the conditions under which inducements are permitted under MiFID II have attracted significant focus in the debate.

Next Steps

The next step is for the European Parliament and the Council of the EU to scrutinise the legislative proposals in the time remaining in the mandate of the current Commission. The proposed Omnibus Directive states that member states will have twelve months to transpose it from the entry into force date and shall apply the Directive's provisions from the date 18 months after the entry into force date.

The proposed Regulation states that it should apply from the date 18 months after the entry into force date in order to provide sufficient time for RTS under the new legislation to be developed.

As a reminder, FMCs managing both UCITS and AIFs are expected to steps by the end of Q3 2023 to conduct a gap analysis against the Central Bank’s expectations in its recent industry letter on costs and fees.

Related resource materials, including the Commissioner's announcement on the adoption of the RIS, FAQs, a factsheet and an impact assessment report are available on the Commission's RIS webpage.

(d) *Delegated Act relating to the Commission's list of high risk third countries for AML purposes*

On 17 May 2023, the Commission published a draft delegated act which proposes including the South Africa and Nigeria on the Commission's list of high risk third countries. Cambodia and Morocco are to be de-listed. This list sets out the countries which present strategic deficiencies in their AML/CFT regimes that are considered to pose significant threats to the financial system of the EU.

Article 18a of Directive (EU) 2015/849 obliges member states to require obliged entities to apply enhanced customer due diligence measures when establishing business relationships or carrying out transactions involving high-risk third countries identified by the Commission. Accordingly, the consequences of a specific country being included on this list is that enhanced customer due diligence will apply in respect of entities domiciled in a jurisdiction included on the list.

The update of the list of high-risk third-country jurisdictions takes the legal form of a delegated regulation, which will enter into force after scrutiny and non-objection of the European Parliament and the Council over a period of one month (which can be prolonged for an additional month).

On 26 June 2023, the amending Delegated Regulation (EU) 2023/1219 was published in the OJ and will enter into force on 16 July 2023.

(e) *Commissioner's statement on CMU*

On 1 May 2023, the Commission published a statement by Commissioner McGuinness where she renews the EU's commitment to work to achieve integration and a deepening of the CMU. The statement noted the Commission will be presenting 3 additional legislative proposals in the coming weeks namely:

- the RIS which is aimed at fostering trust and investment by retail investors in capital markets,
- to accelerate data access in finance; and
- to simplify cross-border taxation procedures for investment.

These additional legislative proposals will complete the Commission's CMU Action Plan.

(f) *Legislative proposals on financial data access and payments package*

On 28 June 2023, the Commission published legislative proposals for a Directive and two Regulations which includes financial access to data. The Commission states in its press release that the package is to "ensure the EU's financial sector is fit for purpose and capable of adapting to the ongoing digital transformation, and the risks and opportunities it presents – in particular for consumers".

The proposed measures would amend and modernise the current payments services directive, and introduce a new Regulation for a framework for financial data access.

The proposed Regulation on a framework for financial data access would amend the EU Regulation 2022/2554 on digital operational resilience for the financial sector ("**DORA**") including requirements relating to strengthened protection of customers' personal data in line with the General Data Protection Regulation (EU) 2016/679) ("**GDPR**").

The initiative also fits into the EU's broader data strategy and builds on the key principles for data access and processing set out in initiatives such as the Data Governance Act, the Digital Markets Act and the proposal for a Regulation on harmonised rules on fair access to and use of data (Data Act).

The proposed Regulation for a framework for financial data access is designed to establish clear rights and obligations to manage customer data sharing in the financial sector beyond payment accounts.

The proposals include:

- enabling customers to securely share their data with data users (such as financial institutions or fintech firms) to give them access to new, cheaper and better data-driven financial and information products and services (such as financial product comparison tools, personalised online advice);

- requiring customer data holders (such as financial institutions) make this data available to data users, subject to customer permission;

- giving customers full control over who accesses their data and for what purpose. This would include a requirement for dedicated permission dashboards and strengthened protection of customers' personal data in line with the GDPR;

- standardising customer data and required technical interfaces as part of financial data sharing schemes, of which both data holders and data users must become members;

- implementing clear liability for data breaches and dispute resolution mechanisms as part of financial data sharing schemes; and

- additional incentives for data holders to establish high-quality interfaces for data users through reasonable compensation from data users in line with the general principles of business-to-business (B2B) data sharing laid down in the proposed Data Act.

In practice, this proposal is intended to lead to more innovative financial products and services for users and to stimulate competition in the financial sector.

The feedback period on the proposal will close on 25 August 2023.

(g) *Proposal for a directive on a faster and safer relief of excess withholding taxes*

On 19 June 2023, the Commission published its proposal for a Directive to make withholding tax procedures in the EU more efficient and secure for investors, financial intermediaries and member state tax administrations. This initiative is a key element of the Communication on Business Taxation for the 21st Century, and the Commission's CMU Action Plan and is intended to promote fairer taxation, fight tax fraud, and support cross-border investment throughout the EU.

The Commission press release states that the term “withholding tax” refers, to the situation where an investor resident in one EU member state is liable to pay tax on the interest or dividends earned in another Member State, as is often the case for cross-border investors. In such a scenario, in order to avoid double taxation, many EU Member States have signed double taxation treaties, which avoid the same individual or company being taxed twice. These treaties allow a cross-border investor to submit a refund claim for any excess tax paid in another Member State. However, these refund procedures are often lengthy, costly and cumbersome, causing frustration for investors and discouraging cross-border investment within and into the EU. Currently, the withholding tax procedures applied in each member state are very different. Investors have to deal with more than 450 different forms across the EU, most of which are only available in national languages. The Cum /Ex and Cum/Cum scandals have also shown how refund procedures can be abused: the tax losses from these practices have been estimated at €150 billion for the years 2000-2020.

The key measures proposed by the Commission are aimed at making life easier for investors, financial intermediaries and national tax authorities and include:

- a common EU digital tax residence certificate which would make withholding tax relief procedures faster and more efficient. Per the proposal, the digital tax residence certificate would be issued within one working day after the submission of a request;

- two fast track procedures complementing the existing standard refund procedure – this would include a 'relief at source' procedure, as well as a 'quick refund procedure. Member States would be able to choose which one to use – including a combination of both.
    - under the “relief at source” procedure, the tax rate applied at the time of payment of dividends or interest would be directly based on the applicable rules of the double taxation treaty provisions.
    - under the “quick refund” procedure, the initial payment would be made taking into account the withholding tax rate of the Member State where the dividends or interest is paid, but the refund for any overpaid taxes would also be granted within 50 days from the date of payment.

These standardised procedures are estimated to save investors around €5.17 billion per year. A standardised reporting obligation will provide national tax administrations with the necessary tools to check eligibility for the reduced rate and to detect potential abuse. Certified financial intermediaries will have to report the payment of dividends or interest to the relevant tax administration so that the latter can trace the transaction.

In particular, large EU financial intermediaries will be required to join a national register of certified financial intermediaries. This register will also be open to non-EU and smaller EU financial intermediaries on a voluntary basis. Taxpayers investing in the EU through certified financial intermediaries will benefit from fast-track withholding tax procedures and avoid double taxation on dividend payments. The more financial intermediaries register, the easier it will be for tax authorities to process refund requests, regardless of the procedure used.

Once adopted by member states, the proposal should come into force on 1 January 2027.

4.5 Proposed Regulation amending the Central Securities Depositories Regulation 909/2014 ("**CSDR Refit**") *(This is a further update to section 4.4 of the report covering the fourth quarter of 2022)*

On 27 June 2023, the Council of the EU published a press release announcing that it has reached provisional political agreement with the European Parliament on the proposed CSDR Refit Regulation. The press release notes the new law will reduce the financial and regulatory burden on central securities depositories ("**CSDs**") and improve their ability to operate across borders, while also strengthening financial stability.

The press release highlights the following key elements of the provisional agreement:

- a simpler passporting regime;
- better supervision;
- improved settlement efficiency; and
- adjustments to the conditions under which CSDs can access banking-type services.

Under the revised regulation, the preconditions for applying so-called 'mandatory buy-ins' (where if a transaction has failed to settle at the end of an agreed period the buyer of the securities is forced to repurchase them elsewhere) have been amended, making them a last resort measure only in circumstances where the rate of settlement fails in the EU is not improving and is presenting a threat to financial stability.

The final text has yet to be published and remains to be formally approved by the EU’s member states, following which it will then be adopted by the Council at a forthcoming meeting following legal and linguistic revision of the text.

4.6 ESMA & the European Supervisory Authorities (the "**ESAs**")

(a) *Consultation on European long-term investment fund ("**ELTIF**") Regulation RTS* (*This is a further update to section 4.1 of the report covering the first quarter of 2023)*

On 23 May 2023, ESMA launched its consultation on draft regulatory technical standards under the revised ELTIF Regulation ((EU) 2023/606).

Annex IV to the consultation paper contains the full text of the draft RTS which will specify the way the new requirements of the revised ELTIF Regulation, in particular on the redemption policy and matching mechanism, will apply.

In the consultation paper ESMA is seeking stakeholders' views on:

- the circumstances in which the life of a ELTIF is considered compatible with the life-cycles of each of the individual assets, as well as different features of the redemption policy of the ELTIF;

- the circumstances for the use of the matching mechanism, i.e. the possibility of full or partial matching (before the end of the life of the ELTIF) of transfer requests of units or shares of the ELTIF by exiting ELTIF investors with transfer requests by potential investors; and

- the costs disclosure.

The consultation period will close on 24 August 2023. ESMA will then consider the feedback it receives to this consultation in Q3/Q4 2023 and expects to publish a final report and submit the draft technical standards to the Commission for endorsement by 10 January 2024 (being the application date of the revised ELTIF Regulation).

(b) *Opinion on legislative provisions under the UCITS Directive and AIFMD relating to undue costs*

On 18 May 2023, ESMA published its Opinion to the Commission seeking clarifications to the legislative provisions under the UCITS Directive and AIFMD to clarify the concept of undue costs charged to investors.

In its opinion, the key legislative recommendations are that:

- Eligibility: the term undue costs should be defined and harmonised under a common framework. The Commission should clarify the eligibility of fund costs in light of the list of costs included in the PRIIPs Regulation RTS. The assessment regarding the eligibility of the cost ("eligibility test") should also take into account the type of fund, as there are some costs that can be borne by some types of AIFs and their investors, but not by UCITS and their investors. To ensure that the eligibility test is meaningful, it is important for the fund manager to assess the appropriateness of the costs on a case-by-case basis in light of the (i) type of fund and (ii) its investment policy.

- Quantum: ensuring that the assessment regarding whether a cost is "due" or "undue" should take into consideration the amount of the cost (not just the eligibility of the cost);

- Pricing process: The Commission should introduce obligations for fund management companies to develop a pricing process which would require them to develop and periodically review a structured pricing process that:

  - clearly demonstrates that all charged costs are due; and
  - allocates clear responsibilities to the management body of such management companies for determining and reviewing the costs charged to investors;

- Compensation: FMCs should reimburse or indemnify investors without undue delay where undue costs have been charged, including cases where costs have been wrongly calculated to the detriment of investors.

- Sanctions: Where a FMC has intentionally or negligently committed an infringement, it should be sanctioned with a fine that is proportionate to the harm caused to investors. In this context, ESMA is of the view that NCAs should be empowered with a stronger basis to impose sanctions of a minimum given percentage which should be proportionate to the unduly charged fees.

ESMA deems that a lack of supervisory convergence on this topic leaves room for regulatory arbitrage, different levels of investor protection and risks hampering competition in the EU market.

ESMA's opinion has been taken into consideration in the Commission's legislative proposals on the RIS (as outlined at section 4.4(c) of this report).

(c) *ESMA Chair's remarks on the RIS*

On 29 June 2023, ESMA published remarks delivered by Verena Ross, ESMA Chair at the EU Parliament's Economic and Monetary Affairs Committee

Ms Ross noted that one of the ambitions of the CMU Action Plan was to make the Union a safer place for citizens to save and invest long-term and that these efforts have now materialised into concrete proposals with a focus on retail investors' interests.

Ms Ross highlighted a number of areas that need to be improved including (but not limited to):

- *On digitisation* – ESMA has called for adjustments to existing disclosures to make them more fit for the digital age;

- *On the PRIIPs Regulation* –ESMA notes a broader review of the Regulation would have been preferable;

- *On costs* - high costs remain a key disincentive for retail participation in the EU capital markets; and

- *On cross-border co-operation* – ESMA would support providing supervisors with more data on firms' cross-border activities to protect retail investors, regardless of whether the firm they deal with is located in their country or somewhere else.

(d) *Statement on investment firms providing unregulated services*

On 25 May 2023, ESMA issued a public statement warning investors of risks that arise when investment firms offer both regulated and unregulated products and/or services.

The statement outlines that retail investors often rely solely on the reputation of an investment firm which makes them susceptible to overlooking potential risks of the unregulated products and/or services offered by investment firms (*so-called 'halo effect'*). This is especially so where the unregulated products have a purpose similar to financial instruments regulated under MiFID II and the investor is investing for return or hedging purposes. Examples that, in some jurisdictions, fall outside the scope of financial services regulation, include crypto-assets, real estate, gold, raw materials and certain non-transferable securities. ESMA is concerned that this practice gives rise to both investor protection and prudential risks.

The statement highlights some of the risks that may arise and the issues to which investment firms should pay particular attention when providing unregulated products and services. ESMA sets out steps to mitigate these risks to make investors fully aware of the unregulated status of these products and services and of the fact that they may not benefit from the regulatory protections that apply to investments in a regulated product. It recommends that investment firms:

- take all necessary measures to ensure that clients are fully aware of the regulatory status of the product or service they are receiving; and

- clearly disclose to clients when regulatory protections do not apply to the product or service provided.

ESMA also details the behaviours expected when investment firms are providing, together with investment services, unregulated products and services to investors, to ensure that no confusion arises:

- the regulatory status of the product and/or service is clearly and effectively communicated in all dealings with clients, and at every stage of the sales process. For example, all marketing communications should indicate clearly if a product and/or service offered by an investment firm is regulated or not;

- the information about the regulatory status of the product and/or service is fair, clear and not misleading. The terminology used does not imply that the product and/or service is regulated or protected in any way where this is not the case;

- the information provided explicitly states what investor protections are lost/not applicable when investing in a product and/or service deemed to be out of scope of financial regulation, including: compensation schemes, client assets protections, supervision by the NCA and recourse to any national regulatory authorities;

- the investment firm's regulatory status is not used as a promotional tool. When engaging in unregulated activities, information provided to the client or potential client, including marketing materials and other documentation, does not include a reference to the investment firm being authorised/regulated by an NCA; and

- any information on an investment firm's website related to unregulated activities is clearly distinguished from regulated activities i.e. investment firms have separate sections on any website they operate for regulated activities and any other activities which they carry out. Client documentation is distinguished accordingly in order to ensure that clients are sufficiently aware of the differences in protection.

Investment firms must be particularly careful in circumstances where the scale of unregulated activity might have material impact on their overall risk profile. ESMA recommends that investment firms take into consideration the impact that their unregulated activities may have on their overall business activity in terms of risk management systems and policies.

(e) *Report on the common supervisory action ('**CSA**') on asset valuation rules* (*This is a further update to sections 4.9(b) and 2.5 of the reports covering the first and second quarters of 2022 respectively)*

On 24 May 2023, ESMA published its report on the CSA with NCAs on the supervision of the asset valuation rules under the UCITS and AIFM Directives. The CSA was launched in January 2022, with the aim of assessing, fostering and enforcing the compliance of supervised entities with the organisational requirements with respect to asset valuation. The CSA also looked at their adherence to valuation principles and methodologies with a view to reflecting a true and fair value of their financial positions both under normal and stressed market conditions in line with the applicable rules.

In the final report ESMA presents its analysis and conclusions from the CSA exercise and notes room for improvement in the following areas:

- the appropriateness of valuation policies and procedures;

- valuation under stressed market conditions;

- independence of the valuation function and use of third-party valuers; and

- early detection mechanisms for valuation errors and compensation to investors.

ESMA notes that in light of the current economic environment, it is important that NCAs' supervision addresses the deficiencies identified in the course of the CSA exercise and keeps paying close attention to potential valuation issues arising from less liquid assets, whose nature can amplify the structural liquidity mismatches of certain types of investment funds. This is particularly true for funds investing in private equity and real estate assets that might be more exposed to revaluation risks in light of the heavy reliance on long-term models and the illiquidity of their assets.

Building on the findings of the CSA exercise, ESMA will facilitate discussions among NCAs on the topic of asset valuation, particularly under stressed market conditions, in order to ensure that both market participants and NCAs are better prepared to address valuation-related challenges in future periods of stress.

ESMA welcomes that NCAs have planned to follow-up on the deficiencies identified in the course of the CSA and encourages the use of enforcement, where appropriate. It is to be expected that the Central Bank will be proactive in preparing an industry letter/circulars to address the identified shortcomings as part of thematic reviews, with recommendations on specific topics (e.g.: valuation of hard-to value assets, valuation frequency and the controls over the external valuation function).

(f) *DORA discussion paper on the criteria for critical information and communications technology ("**ICT**") third-party service providers and oversight fees (This is a further update to section 4.5 of the report covering the first quarter of 2023)*

On 26 May 2023, the ESAs published a discussion paper on their advice to the Commission on two delegated acts specifying further criteria for critical ICTs, third-party service providers ("**CTPPs**") and determining oversight fees levied on such providers, under Articles 31 and 43 of DORA.

In light of the two delegated acts envisaged in DORA, the Commission had called for the ESAs' technical advice to further specify the relevant criteria. Accordingly, the paper is separated into two parts:

(i) proposals covering the criteria to be considered by the ESAs when assessing the critical nature of ICT third-party service providers, in particular, a number of relevant quantitative and qualitative indicators for each of the criticality criteria, along with the necessary information to construct such indicators.

(ii) proposals in relation to the amount of the fees levied on CTPPs and the way in which they are to be paid, in particular the types of expenditure that shall be covered by fees as well as the appropriate method, basis and information for determining the applicable turnover of the CTPPs, which will form the basis of fee calculation. The ESAs are also seeking input on the fee calculation method and other practical issues regarding the payment of fees.

Market participants are invited to provide their feedback on the proposals, which will be considered by the ESAs in finalising the joint technical advice to the Commission. Responses were sought by 23 June 2023. The ESAs will deliver their technical advice by 30 September 2023.

(g) *ESAs consultation on DORA policy products*

On 19 June 2023, the ESAs launched a public consultation on the first batch of policy products under DORA. This includes four draft RTS and one set of draft implementing technical standards ("**ITS**"). The technical standards aim to ensure a consistent and harmonised legal framework in the key areas of ICT risk management, major ICT-related incident reporting and ICT third-party risk management.

The DORA regulatory framework covers key areas such as ICT risk management, ICT-related incident management and reporting, digital operational resilience testing and the management of ICT third-party risk. The first batch of technical standards are as follow:

- RTS on ICT risk management framework and RTS on simplified ICT management framework;
- RTS on criteria for the classification of ICT-related incidents;

- RTS to specify the policy on ICT services performed by ICT third-party providers; and

- ITS to establish the templates for the register of information.

The consultation period runs until 11 September 2023 and a public hearing is scheduled via webinar on 13 July 2023.

(h) *Final report on review of the RTS on the information to be provided in an application for authorisation and registration under the Benchmarks Regulation (EU) 2016/1011* (*This is a further update to section 4.6(i) of the report covering the fourth quarter of 2022)*

On 30 May 2023, ESMA published its final report on the review of the RTS on the information to be provided in an application for authorisation and registration under the Benchmarks Regulation. The amended draft RTS will be submitted to the Commission, which has three months to decide whether to endorse them.

The final report covers:

- the background information on ESMA's legal mandate to develop the draft RTS;

- the feedback received to the open public consultation; and

- the final proposal for the draft technical standards.

The final report also includes in the annexes the draft amendments to the technical standards together with a marked-up consolidated version and a cost and benefit analysis.

(i) *ESA joint committee annual report for 2022*

On 23 May 2023, the ESAs published the 2022 annual report of the joint committee of the ESAs. The main areas of cross-sectoral focus across the three ESAs, the Commission and the ESRB continued to be joint risk assessment, sustainable finance, digitalisation, consumer protection, securitisation, financial conglomerates, and central clearing. The committee's main deliverables concerned the Sustainable Finance Disclosure Regulation ("**SFDR**") and DORA.

(j) *ESMA study on the gas derivatives market*

On 12 May 2023, ESMA published a study on the structure and functioning of EU natural gas derivatives markets, and potential risks for financial stability.

The study finds that the market is characterised by a high degree of concentration of market participants active in clearing and trading activity, and some energy firms hold relatively large derivative positions. Liquidity and concentration risks are among the main vulnerabilities identified, along with data fragmentation and data gaps.

(k) *ESMA de-prioritisation of certain deliverables* (*This is a further update to section 4.6(c) of the report covering the fourth quarter of 2022)*

On 10 May 2023, ESMA published a letter to the Commission identifying among its planned 2023 work programme a set of deliverables which could be deprioritised or postponed. They consist principally of reports from ESMA to the Commission under various pieces of sectoral legislation as well as a request for technical advice on EuVECA/EuSEF, the amendment of the European Single Electronic Format (ESEF) RTS and an annual peer review relating to supervision of central counterparties under the European Market Infrastructure Regulation ("**EMIR**"). Specific reasons for the de-prioritisation of each of these deliverables are summarised in the annex to the letter.

ESMA states the primary external factors affecting it in 2023 are:

- the high concentration of time-critical deliverables under of DORA and MiCA;
- ongoing crisis management linked to the measures taken following the energy crisis and recent market volatility; and
- overall resource constraints.

(l) *Speech on European capital markets*

On 25 May 2023, ESMA Chair, Verena Ross delivered remarks on *"European Capital Markets: need for strength in uncertain times" which outlined ESMA's focus on* reserving financial stability, orderly markets and investor protection and touches on the implementation of MiCA and DORA.

(m) *Opinion on market outages* (*This is a further update to section 4.4(m) of the report covering the third quarter of 2022)*

On 24 May 2023, ESMA published its final report including an opinion on market outages (the "**Opinion**"), highlighting the importance for trading venues of having an appropriate outage plan to communicate to their members, participants, and the public.

In the Opinion, ESMA also sets out steps trading venues should take to reopen trading in an orderly manner. NCAs should ensure that trading venues have appropriate communication protocols in place, which arrangements should be in place to avoid an outage affecting the closing auction and how trading venues should ensure the market is provided with an official closing price. In addition, the Opinion also provides considerations on non-equity instruments, in particular for derivatives markets.

ESMA expects that, considering the guidance provided in this Opinion, NCAs ensure that trading venues have in place an appropriate outage plan ready to be deployed in case of an outage.

(n) *Consolidated version of the PRIIPs KID Q&As* (*This is a further update to section 4.13 of the report covering the fourth quarter of 2022)*

On 17 May 2023, ESMA published a consolidated versions of the Q&As on the PRIIPs KID. The consolidated Q&A contains:

- responses given by the Commission to questions requiring interpretation of EU law (in blue); and
- responses generated by the ESAs, which relate to the practical application or implementation of the relevant rules (uncoloured).

The consolidated Q&A document does not add new guidance or interpretations.

(o) *Central counterparties ("**CCP**") stress test*

On 31 May 2023, ESMA launched its fifth stress test exercise for CCPs under Regulation (648/2012). Fourteen CCPs authorised in the EU and two UK CCPs classified as tier 2 (LCH Ltd and ICE Clear Europe Ltd) are included in this framework exercise. ESMA periodically assesses the resilience and safety of authorised EU and tier 2 third country CCPs to adverse market developments with the aim of identifying any potential shortcomings in their set-up/risk management.

ESMA Chair, Verena Ross noted that "the CCP stress test is a key supervisory tool for ESMA. The fifth Stress Test exercise examines core risk categories in light of ESMA’s evolving mandates and takes a closer look at the impact of a possible spill over of risks to financial markets. We are not only stress testing CCPs, but also measuring potential risks to the broader financial eco-system."

The data submitted by the reporting entities will first be validated by ESMA and the NCAs and later analysed. The results are scheduled to be published in a final report in H2 2024.

(p) *Follow-up peer report Guidelines on ETFs and other UCITS Issues*

On 6 June 2023, ESMA published its follow-up report to the 2018 peer review on the Guidelines on ETFs and other UCITS issues. The report welcomes that NCAs examined have strengthened their supervisory practices, enhanced internal and external guidance, and performed supervisory work in the area of ETFs and other UCITS since the 2018 peer review findings and recommendations. At the same time, ESMA notes that there are still concerns in relation to the level of costs for some UCITS using efficient portfolio management techniques ("**EPM**").

The report assessed whether BaFin, EFSA, and CSSF improved their practices based on the 2018 peer review findings and recommendations. ESMA also assessed the supervisory work carried out by the AMF, BaFin, the Central Bank, and CSSF in relation to the attribution of revenues and costs derived from securities lending activities by UCITS.

ESMA's recommendations to the Central Bank (contained at section 3.4 of the report) are to continue:

- monitoring the adequacy and implementation of its supervisory practices,
- keeping track of and build on market information, and
- investigating cases of high EPM costs and contraventions of the Guidelines, taking stringent supervisory action where needed. This holds especially true in regard of UCITS management companies and UCITS that show higher costs and high variability of fees in comparison with market rate, and where UCITS management companies use related parties to perform EPM. With the aim to reduce costs levels for investors, ESMA recommends the CBI continue monitoring UCITS costs setups, including requesting, when needed, the review of securities lending fee arrangements to ensure that the cost set-up of UCITS is in line with fair market rates.

NCAs are expected to continue monitoring the effective application of the Guidelines and the effectiveness of the supervisory practices implemented taking supervisory action when needed. ESMA Notes that further work notably in the areas of costs, fees and revenues for efficient portfolio management techniques and instruments could continue at EU level.

(q) *Q&A on Securities Financing Transactions Regulation ("**SFTR**") Reporting*

On 7 June 2023, ESMA published updated Q&As on data reporting under Articles 4 and 5 of the EU SFTR. ESMA has added new Q&As (number 16) on reporting of the jurisdiction of the issuer and securities financing transactions (SFTs) concluded by institutions for occupational retirement provision (IORPs) and personal pension funds.

(r) *Money market funds ("**MMF**") stress test*

On 6 June 2023, ESMA published an article on the results of the MMF stress tests reported to ESMA at the end of 2021, drawing lessons from the stress episode affecting MMFs in March 2020 in a context of deep global recession caused by the COVID-19 pandemic.

The results show that liquidity and credit risks would be the most impactful for MMFs, in the context of the adverse scenario. The different redemption scenarios tested however show the capability of MMFs to meet redemption requests under adverse circumstances, despite a calibration reflecting the intensity of the March 2020 stress episode. In the article ESMA also highlights the relative proximity of the LVNAV 20bps threshold, which would be exceeded in the liquidity and credit risk scenarios. While this possibility is foreseen in Regulation (EU) 2017/1131 on money markets funds (the "**MMF Regulation**"), these findings support the concerns expressed in the ESMA opinion in February 2022 on the review of the MMF Regulation regarding the consequences of funds breaching the threshold.

As a reminder the ESMA Guidelines on MMF stress tests provide risk parameters to fund managers, which are updated on an annual basis according to an adverse scenario. MMF managers in the EU are required to undertake stress tests in accordance with these rules and report the results of their simulations back to their national authorities and ESMA as part of their regular regulatory reporting.

NCAs use MMF stress test results on an ongoing basis for their supervision. Evidence from this article will inform future enhancements of the MMF stress testing framework, in 2023 and onwards.

(s) *ESA's risk and vulnerabilities report (This is a further update to section 4.8(j) of the quarterly report covering the first quarter of 2023)*

On 25 April 2023, the Joint Committee of the ESAs issued their Spring 2023 Joint Committee Report on risks and vulnerabilities in the EU financial system. While noting that EU financial markets remained broadly stable despite the challenging macro environment and recent market pressure in the banking sector, the three Authorities are calling on national supervisors, financial institutions and market participants to remain vigilant in the face of mounting risks.

The report notes that the second half of 2022 witnessed a worsening of the macro environment due to high inflation and tighter financial conditions, and the economic outlook remains uncertain. Recent market pressure on banks following the collapse of a few midsize banks in the United States and the emergency merger of the distressed Credit Suisse with the Union Bank of Switzerland (UBS) highlighted continued high market uncertainty, the sensitivity of the European financial system to exogenous shocks and potential risks related to the end of over a decade of very low interest rates.

Asset prices were highly volatile over the past months with market liquidity fragile. Sharp movements in prices triggered sizeable margin calls and put some market participants under liquidity strains, notably non-financial corporations and non-bank financial institutions. High levels of uncertainty and imbalances in the supply and demand of liquidity are a drag on the financial system's resilience against further external shocks. In addition to these risks, geopolitical tensions, environmental threats and an increase in the frequency and sophistication of cyberattacks further complicate the risk landscape.

Against the backdrop of these risks and vulnerabilities, the Joint Committee of the ESAs advises national supervisors, financial institutions and market participants to take the following policy actions:

- financial institutions and supervisors should remain prepared for a deterioration in asset quality and supervisors should keep a close eye on loan loss provisioning;
- the broader impact of policy rate increases and sudden rises in risk premia on financial institutions and market participants should be considered and accounted for in (liquidity) risk management;
- liquidity risks arising from investments in leveraged funds and the use of interest rate derivatives should be monitored closely;
- financial institutions and supervisors should closely monitor the impacts of inflation risk. Inflation can have an impact on asset valuation and asset quality as borrower debt servicing is affected. Inflationary trends should be taken into account in product testing, product monitoring and product review phases and investors should be made aware of the effects of inflation on real returns;
- banks should pursue prudent capital distribution policies to ensure their long-term financial resilience given the uncertain medium-term outlook for profitability;
- the strong regulatory frameworks that underpin the resilience of the financial sector are to be maintained, including by faithfully implementing the finalization of Basel III in the EU without delay and with as little deviation as possible, and by avoiding further deviations from EIOPA's advice on the Solvency II review;
- risk management capabilities and disclosures for environmental, social and governance ("**ESG**") risks should be enhanced as these risks are increasingly becoming a source of financial risk; and
- financial institutions should allocate adequate resources and skills to ensure the security of their ICT infrastructures and adequate ICT risk management.

(t) *ESMA report on data quality*

On 19 April 2023, ESMA published the third edition of its Data Quality Report under the EMIR and the Securities Financing Transactions Regulation ("**SFTR**") reporting regimes. The report highlights the increased use of transaction data by EU financial regulatory authorities in their day-to-day supervision and identifies significant quality improvements following a new approach to data monitoring. In addition, it sets out how ESMA, together with the NCAs, the European Central Bank and the European Systemic Risk Board have incorporated key insights from its data monitoring in several internal workstreams.

ESMA and the NCAs will continue to work on extending the new monitoring framework beyond EMIR and SFTR in 2023.

(u) *ESMA speech on regulatory convergence*

On 19 April 2023, ESMA published a speech delivered by the ESMA executive director entitled "*Financial markets regulation in Europe and the US: more in common than meets the eye*".

Ms Cazenave's remarks focused on the benefits of global regulatory convergence and recent examples of convergence in financial markets regulation, namely in the EU – with the MiFIR review and related ESMA workstreams – in the UK – with the Financial Services and Markets Bill, and the Wholesale Markets Review – and in the US – with the SEC rule proposal on equity market structure.

(v) *ESMA launches data strategy*

On 15 June 2023, ESMA published its Data Strategy for 2023-2028. Over the period ESMA will work to facilitate the use of new data-related technologies, reduce reporting compliance costs by regulated entities, enable the effective use of data at both EU and national level; and make data more broadly available to the public. The objectives of the Data Strategy are to:

- bolster ESMA as EU securities markets data hub;
- ensure access to data of public interest to market participants;
- promote data-driven supervision;
- increase data collaboration;
- produce efficient data policy output; and
- facilitate systematic data use.

(w) *ESMA annual report 2022*

On 16 June 2023, ESMA published a press release in conjunction with the release of its 2022 Annual Report. The release centred on ESMA's *'Focus on financial stability and investor protection'* and provides examples of ESMA delivering on its mandate throughout the year. Key deliverables, include:

- peer reviews on the supervision of cross-border services, on prospectus and on the Brexit relocation process;
- responses to the geopolitical challenges of the Russian invasion and ensuing the energy crisis; and
- the first ever mystery shopping exercise coordinated amongst multiple NCAs.

Additionally, ESMA notes three cross cutting priorities for 2022: supporting the development of sound capital markets, promoting sustainable finance and innovation and fostering innovation and digitalisation.

(x) *AIFMD reporting IT technical guidance (This is a further update to section 4.8(g) of the quarterly report covering the first quarter of 2023)*

On 18 June 2023, ESMA published its AIFMD reporting IT technical guidance, revision six. The new IT technical guidance revision 6 introduces new validation rules making more fields mandatory or with stricter rules to improve data quality. Reporting entities should use the version revision 6 to submit reports required under Articles 3(3)(d) and 24(1), (2) and (4) of AIFMD by November 2023.

The IT technical guidance revision 6 will be applicable from November 2023 onwards. The exact date will be published at a later stage.

4.7 ESRB NBFI Risk Monitor 2023

On 6 June 2023, the ESRB published the annual EU Non-bank Financial Intermediation Risk Monitor 2023 (NBFI Monitor) monitoring systemic risks and vulnerabilities associated with investment funds and other financial institutions. The NBFI Monitor highlights three main risks and vulnerabilities:

1. An economic slowdown and tightening financial conditions could increase credit risk. This is particularly relevant for investment funds exposed to low-rated bonds and loans. If credit risk were to materialise it could lead to losses, which in the case of investment funds could result in large outflows and liquidity strains.
2. Market liquidity risk could put further pressure on non-bank financial intermediaries engaged in liquidity transformation. Several indicators show that liquidity conditions in EU bond markets deteriorated in 2022. Alongside cyclical liquidity risk, the monitor also identifies persistent challenges related to structural changes in liquidity provision and demand. These structural changes are linked, for instance, to open-ended funds offering daily redemptions.
3. Excessive use of leverage could amplify liquidity and market risks, lead to contagion and magnify shocks to financial stability. This vulnerability affects the traditional non-bank entities discussed in the report as well as crypto intermediaries, since both use leverage and rely on collateral.

To help identify risk, the NBFI Monitor 2023 includes the following special features:

- On stress related to liability-driven investment (LDI) strategies, it provides insights into how risks associated with liquidity and leverage materialise. It investigates the extent to which EU-domiciled LDI funds were prepared for margin and collateral calls related to the rise in interest rates.

- For the first time it extends the monitoring universe to crypto-assets and associated intermediaries (namely stablecoins, centralised finance platforms and decentralised finance protocols) On vulnerabilities affecting crypto-assets and associated intermediaries that are similar to those among traditional non-bank financial intermediaries it considers how the crypto ecosystem uses leverage and engages in credit intermediation, and liquidity and maturity transformation. It also examines its interconnectedness.

4.8 EMIR

(a) *Bilateral margining framework and equity options*

On 13 June 2023, the ESAs published a letter to the Commission in respect of the EMIR bilateral margining framework and equity options. The ESAs noted that, under EMIR, they have the mandate to develop draft RTS on the risk-mitigation techniques for OTC derivative contracts not cleared by central counterparty (bilateral margin RTS). The RTS under Commission Delegated Regulation (EU) 2016/2251 on the risk-mitigation techniques for OTC derivative contracts not cleared by central counterparty (Bilateral Margin RTS) implemented the international reforms agreed upon in this area.

The Bilateral Margin RTS include a deferred date of application for non-centrally cleared OTC derivatives which are single-stock equity options or index options (‘equity options’). This deferred date of application was initially introduced and subsequently extended via amendments to the RTS in order to take into account that other jurisdictions have permanently or temporarily exempted these products from bilateral margin requirements. The exemption is set to expire on 4 January 2024.

In the letter, the ESA haves sought clarity from the Commission and co-legislators on what the permanent treatment of equity options should be with respect to bilateral margining. They noted that the one hand, it could be argued that there are no prudential grounds for an exemption, neither in the EU nor in the internationally agreed framework and on the other hand, the equity option exemption would be consistent with the approaches taken in other jurisdictions and preserve the competitiveness of EU counterparties in this area.

(b) *European Central Bank ("**ECB**") opinion on proposal for EMIR 3.0 (This is a further update to sections 4.1(d) and 4.7(d)of the reports covering the fourth quarter of 2022 and the first quarter of 2023 respectively)*

On 28 April 2023, the ECB published its opinion on the Commission's proposed reform to EU EMIR (commonly referred to as EMIR 3.0). The ECB noted that if the reforms are implemented in their current form they will have significant consequences for market participants, including:

- firms that benefit from the intragroup reporting exemption for transactions involving a non-financial counterparty or third-country equivalent will lose the exemption and will need to report;
- EU firms that currently clear through non-EU CCPs will need to monitor their levels of EU and non-EU clearing and maintain prescribed EU clearing levels. This may require the transfer of cleared trades from non-EU CCPs to EU CCPs; and
- non-financial counterparties that become subject to the margin rules for the first time will benefit from a four-month "grace period" to establish the necessary contractual and operational arrangements.

The ECB is generally in favour of the proposals but suggests modifications in places. Key elements of their opinion include:

- the ECB supports the proposed "active account" requirement for EU entities subject to the clearing obligation to clear a proportion of certain types of transaction through an EU CCP, subject to an appropriate phase-in period;
- the ECB supports the proposed requirement for in-scope entities to report their compliance with the active account requirement but would like the reporting frequency to be quarterly rather than annually;
- the ECB supports the proposed requirement for EU clearing members and clients that offer clearing through both EU and non-EU CCPs to inform clients and prospective clients of the possibility of clearing through an EU CCP;
- the ECB supports the introduction of a four-month implementation period for non-financial counterparties coming into scope of the margin rules for the first time;
- the ECB supports the removal of the reporting exemption for intragroup transactions involving a non-financial counterparty or third-country equivalent;
- the ECB opposes the removal of equivalence as a pre-condition to availability of the intragroup exemption and its replacement with a third country "blacklist" regime; and
- the ECB has proposed the introduction of a competent authority right of veto of in-scope counterparties' proposed initial margin models.

4.9 Financial Action Task Force ("**FATF**")

On 31 May 2023, FATF published its consolidated assessment ratings on AML/CFT measures, which provides an up-to-date overview of the ratings that assessed countries have obtained in its peer reviews for effectiveness and technical compliance.

On 23 June 2023, FATF announced that it is actively working with jurisdictions placed under increased monitoring to address strategic deficiencies in their regimes, in order to counter ML/TF and proliferation financing. Following FATF review, Cameroon, Croatia and Vietnam have been identified as additional jurisdictions under increased monitoring.

4.10 IOSCO

(a) *Good practice guide for Exchange Traded Funds ("**ETFs**")*

On 12 May 2023, IOSCO published its final report on good practices relating to the implementation of its Principles for the Regulation of ETFs (ETF Principles). The good practices are to accompany the existing ETF principles, which were first issued in 2013, which remain relevant and appropriate. IOSCO has noted differences among jurisdictions in the way that ETFs operate, how they are regulated and the markets in which they trade.

IOSCO has identified a set of 11 good practices, which are organised under the following four categories:

- effective product structuring;
- disclosure;
- liquidity provision; and
- volatility control mechanisms.

IOSCO encourages regulators, responsible entities and trading venues to review and adopt the good practices, where appropriate, within each jurisdiction's regulatory framework.

(b) *Report on special purpose acquisition companies ("**SPACs**")* (*This is a further update to section 1.3 of the report covering the fourth quarter of 2022)*

On 10 May 2023, IOSCO published a final report on SPACs, aiming to assist IOSCO members review or improve their regulatory approach to SPACs. IOSCO notes the recent surge in SPACs raises concerns about investor protection and market integrity, and while they pose similar risks to investors as traditional initial public offerings, the complexity and uncertainty inherent in SPAC structures raises a number of different and critical risks.

The report identifies a set of common approaches and sets out some considerations for designing or fine-tuning SPAC regulatory frameworks.

(c) *IOSCO Work Program for 2023-2024*

On 5 April 2023, IOSCO issued a statement announcing the publication of its Work Program for 2023-2024 including its commitment to deliver on sustainability disclosures and crypto exchanges in 2023 – 2024.

The IOSCO workstreams are organised under the following five themes:

- **Strengthening financial resilience.** Financial stability is important in ensuring the proper functioning of the capital markets. IOSCO will continue to address issues related to NBFI activities. Also falling under this theme is work on private finance, liquidity risk and MMFs.
- **Supporting market effectiveness.** It is important that capital markets are resilient and effective, particularly in the face of increasing episodes of market volatility and the changing macro-financial environment. This theme includes work aimed at enhancing operational and securities market resilience, including work on market outages, the use of post trade risk reduction services and alternative benchmarks.
- **Protecting investors.** Protecting investors, particularly retail investors, is a critical objective of capital markets regulation. This theme includes work on conduct in retail markets and issues related to index providers.
- **Addressing new risks in sustainability and FinTech.** It is essential for securities regulators to deal with emerging issues. This theme includes work on sustainability, FinTech, cryptoassets and decentralise finance.

- **Promoting regulatory co-operation and effectiveness.** IOSCO seeks to promote and facilitate co-operation among securities regulators, encourage the adoption of best practices and strengthen compliance with the enforcement of securities laws and regulations. This theme includes work on promoting good practices in sustainable finance and reviewing implementation of IOSCO's standards.

4.11 Financial Stability Board

(a) *Report on climate-related metrics in compensation frameworks*

On 20 April 2023, the FSB published a report on climate-related financial risk factors in compensation frameworks. Following the FSB progress report in 2021 on the effective implementation of FSB Principles for Sound Compensation Practices and Implementation Standards, the FSB noted the emerging trend of financial institutions increasingly using non-financial measures, including ESG aspects, to drive accountability for delivering outcomes. This report sets out the findings of the FSB's Compensation Monitoring Contact Group in relation to the emerging trend of climate-related financial risk factors in compensation frameworks.

- Climate-related metrics are often part of an ESG category that incorporates broader factors (such as diversity and inclusion), but there may be separate climate-specific categories. Metrics incorporated in compensation frameworks include the reduction of carbon footprint, provision of sustainable finance and products, and accountability-type measures, such as leadership in the climate-related area.
- In compensation frameworks, climate-related metrics are generally applicable at individual or collective level for executives and senior management only. They are incorporated primarily in short-term incentive plans and to a lesser extent in long-term incentive plans. Currently, the impact on total compensation outcomes is relatively modest, but some financial institutions are increasing the weights for these metrics and moving them to a main component instead of a modifier.
- Climate-related goals will take time to achieve, meaning there may be an inherent misalignment between a relatively short performance evaluation period of compensation frameworks and a relatively long period for materialisation of climate-related results. These challenges could be overcome by setting short-term milestones to reward short-term progress against long-term climate goals.
- Geographical differences are more evident than sectoral differences in explaining progress in adopting climate-related metrics in compensation frameworks, reflecting the different stages of development in climate initiatives among financial institutions.
- Incorporating climate-related metrics into compensation frameworks is expected to evolve further, with climate change increasingly a strategic priority for financial institutions, regulators and other stakeholders. Regulators are urged to assist by sharing best practices.

The FSB report aims to identify challenges and to provide ‘an early insight in a fast-moving field to assist ongoing initiatives of regulators and financial institutions’.

(b) *Recommendations to achieve greater convergence in cyber incident reporting: final report*

On 13 April 2023, the FSB published a final report setting out 16 recommendations that aim to promote convergence and best practices among cyber incident reporting (CIR) frameworks. The FSB states that financial authorities and financial institutions can choose to adopt these recommendations as appropriate and relevant, consistent with their legal and regulatory framework. The FSB also updated its cyber lexicon and published a further report on the concept of developing a common format for incident reporting exchange ("**FIRE**"), which includes feedback on its consultation on the topic.

The FSB will publish a detailed workplan on FIRE during summer 2023.

(c) *Toolkit for third-party risk management and oversight*

On 22 June 2023, the FSB published a consultation concerning a toolkit for financial authorities and financial institutions as well as service providers for their third-party risk management and oversight.

The toolkit has been developed against a backdrop of digitalisation of the financial services sector and growing reliance of financial institutions on third-party service providers for a range of services.

In response to concerns over the risks related to outsourcing and third-party service relationships, the FSB has developed a toolkit for financial authorities and financial institutions as well as service providers for their third-party risk management and oversight.

According to the consultation, the toolkit aims to:

- reduce fragmentation in regulatory and supervisory approaches to financial institutions' third-party risk management across jurisdictions and different areas of the financial services sector;

- strengthen financial institutions' ability to manage third-party risks and financial authorities' ability to monitor and strengthen the resilience of the financial system; and

- facilitate co-ordination among relevant stakeholders (i.e. financial authorities, financial institutions and third-party service providers).

The FSB is inviting comments on this consultative document by 22 August 2023.

4.12 Government Legislation Programme - Summer Session 2023

On 19 April 2023, the Irish government published its summer legislative programme.

- The Miscellaneous Provisions (Transparency and Registration of Limited Partnerships and Business Names) Bill 2023 aimed at modernising the Limited Partnership Act 1907, remains listed in the other legislation (non-priority) list with heads of the bill listed as in preparation.

- The Financial Services and Pensions Ombudsman (Amendment) Bill to amend the Financial Services and Pensions Ombudsman (FSPO) Act 2017, to take account of the 'Zalewski' ruling and update elements where the FSPO could be viewed as administering justice has been included in the priority legislation list with the heads of bill approved.

Companies (Corporate Governance and Regulatory Provisions) Bill

On 7 April 2023, the Department of Enterprise, Trade and Employment announced that a public consultation will be launched to seek views on a proposed Companies (Corporate Governance, Enforcement and Regulatory Provisions) Bill which will focus primarily on four areas of company law - corporate governance, enforcement, administration and insolvency. The primary purpose of the bill is to enhance and strengthen enforcement and regulatory provisions in the Companies Act 2014. The consultation will include a proposal to give companies the option to hold fully virtual AGMs and general meetings on a permanent basis. The Corporate Enforcement Authority has also put forward a number of proposals to enhance its powers and capabilities.

The heads of bill are listed in the programme as being prepared while the public consultation is ongoing.

4.13 Sustainable Finance

(a) *European Commission Q&A responses on SFDR (This is a further update to section 4.10(l) of the quarterly report covering the third quarter of 2022)*

On 14 April 2023, ESMA published the Commission's publication of the following:

- answers to the questions on the interpretation of SFDR submitted on 9 September 2022 by the ESAs; and
- amended answers to those which were adopted on 6 July 2021 and 13 May 2022.

The Commission's responses contain a number of helpful responses on the interpretation of SFDR, summarised as follows.

(i) Definition of “sustainable investment” in Article 2(17)

- Acknowledgement that SFDR “does not set out minimum requirements that qualify concepts such as contribution, do no significant harm, or good governance, i.e. the key parameters of a ‘sustainable investment’. Financial market participants ("**FMPs**") must carry out their own assessment for each investment and disclose their underlying assumptions”. The Commission states that “(t)his policy choice gives FMPs an increased responsibility towards the investment community and means that they should exercise caution when measuring the key parameters of a ‘sustainable investment’.”

- With respect to a transitioning plan, the Commission states that sustainable investments must comply with the 'do no significant harm' test as well and that therefore “referring to a transition plan aiming to achieve that the whole investment does not significantly harm any environmental and social objectives in the future could for instance not be considered as sufficient”.

- The Commission states that the reference to ‘economic activities’ in the definition of sustainable investment set out in Article 2, point (17), SFDR seems to target cases in which funds are allocated to a specific project or activity, or to a company engaged in one single type of activity. However, FMPs in scope of the SFDR can invest in funding instruments that do not specify the use of proceeds, such as the general equity or debt of an investee company.

- The Commission confirms that the SFDR Article 2(17) sustainable investment definition “does not prescribe any specific approach to determine the contribution of an investment to environmental or social objectives. FMPs must disclose the methodology they have applied to carry out their assessment of sustainable investments”.

- The Commission therefore allows the notion of sustainable investment to be measured at the level of a company and not only at the level of a specific activity i.e. both direct and indirect contributions may count towards the definition of a sustainable investment.

(ii) Carbon emissions reductions and other benchmark questions per Article 9(3)

- The Commission confirms that passively tracking an EU Paris-aligned benchmark or climate-transition benchmark will be sufficient for the fund to be treated as an Article 9 product without also needing to comply with the Article 2(17) requirement to exclusively hold sustainable investments.

- Article 8 funds can also consider decarbonisation criteria when making investments without having to become an article 9 fund, provided that a reduction in carbon investments is not a core investment objective of the product. The SFDR does not prevent a product from promoting carbon emissions reductions as part of its investment strategy if the product does not have sustainable investment as its objective. Information disclosed in pre-contractual, website and periodic disclosures as regards the carbon emissions reduction characteristics of the product should not mislead investors into thinking that this aspect is part of the product’s objective and therefore that the product has sustainable investment as its objective as per Article 9(3).

(iii) Principal adverse impact consideration in Article 7(1)(a) at a product level

- FMPs should include on their websites information on the procedures and descriptions of the principal adverse impacts ("**PAI**") and metrics. Consequently, the description related to the adverse impacts shall include both a description of the adverse impacts and the procedures put in place to mitigate those impacts.

- Disclosure of PAI metrics is not sufficient and firms must also additionally disclose the policies and procedures they have put in place to mitigate the PAIs.

(iv) 500 employee PAI threshold in Articles 4(3)-4(4)

- The ESA asked the Commission to clarify how interim workers or workers employed by shared-service centres should be counted for the purposes of the 500-employee threshold for mandatory entity level PAI disclosures. The Commission states that since SFDR does not contain a definition it must be determined by reference to the definition of employee set out in the applicable national law.

- The ESAs asked whether the exemption in Article 23(5) of the Accounting Directive (Directive 2013/34/EU) from drawing up consolidated financial statements and management reports for parent companies which are also subsidiaries of a larger group would apply to the entity level PAI disclosures for "parent undertakings of a large group". The Commission clarifies that this exemption is not relevant to SFDR.

(v) Periodic disclosure frequency for portfolio management services in Article 11(2)(i)

- SFDR periodic reports in a portfolio management context, should just be provided annually, and should be in "every fourth report", allowing flexibility for in-scope portfolio managers to choose their cycle of reporting.

In respect of the amendments to the answers (provided on 26 July 2021), the Commission's revisions largely consist of tidying up citations and tweaking the language used.

Additionally, in the section headed "*Design of financial products subject to Article 9*", the Commission now highlight that its "replies to Q1 clarify that the SFDR does not prescribe a single methodology to account for sustainable investments", and the section headed "*The objective of 'a reduction in carbon emissions*" is deleted in its entirety.

(b) *Remarks on Commission's sustainable finance package*

On 16 May 2023, Commissioner McGuinness announced that the Commission intends to publish a 'significant sustainable finance package' in June 2023. The package would include:

- a proposal for legislation on ESG ratings; and
- new secondary taxonomy legislation.

The proposal under the Taxonomy Regulation (EU) 2020/852 will complete the EU's green taxonomy and include new economic activities covering all six environmental objectives and guidance to make the framework more usable and promote transition finance.

(c) *Commission's package on improving the sustainable finance framework*

On 13 June 2023, the Commission published a package of measures to build on and strengthen the EU sustainable finance framework that aims to:

- ensure the EU sustainable finance framework continues to support companies and the financial sector, while encouraging the private funding of transition projects and technologies;
- increase the transparency of sustainable investments; and
- ensure the usability and inclusiveness of the framework for companies of different sizes, business models and with different starting points in the transition.

The Commission's press release and FAQ outline the key elements of the package of measures.

Proposed Regulation on the transparency and integrity of ESG rating activities

The Commission has adopted a proposed Regulation and associated Annexes on the transparency and integrity of ESG rating activities. The proposed Regulation will require ESG rating providers offering services to investors and companies in the EU to be authorised and supervised by ESMA, as well as creating rules on organisational principles and the prevention of conflicts of interest.

ESG rating providers that are not categorised as small or medium-sized are expected to apply for authorisation within six months after the date of application of the Regulation.

The Council of the EU and the Parliament will now consider the legislative proposal.

Communication on sustainable finance framework

The Commission's communication on a sustainable finance framework that works on the ground acts as an introduction to the package of measures and explains how the Commission will encourage additional investments into sustainable activities and how it envisages the framework being developed and refined

There are a number of key points to note contained in the communication as follows:

- A consultation on assessing the SFDR will launch in autumn 2023. This will focus on assessing shortcomings in the SFDR to improve legal certainty, enhancing usability and improving the legislation's role in mitigating greenwashing.
- The Commission plans on continuing to provide guidance to support the application of rules in a clear and effective way. It will also assess gaps and usability concerns and how to address them.
- The Commission intends that when a company reports sustainability information in accordance with the European sustainability reporting standards ("**ESRS**"), they will be deemed to be compliant with global standards.
- The Commission plans on adopting another guidance document relating to the Taxonomy Regulation by the end of 2023. The document will focus on taxonomy alignment reporting obligations for financial undertakings, which are required to report their green assets ratio (GAR) and other key performance indicators (KPIs) from 1 January 2024.
- The EU Taxonomy Compass and Taxonomy Calculator will be expanded to cover activities under the wider environmental objectives.

Recommendation on transition finance

The Commission has published a recommendation on facilitating finance for the transition to a sustainable economy. The recommendation is addressed to undertakings that want to contribute to the transition to climate neutrality and environmental sustainability, as well as financial intermediaries, investors, member states and financial supervisory authorities. It clarifies the concept of transition finance and provides guidance and examples for companies and the financial sector, including discussion about transition plans.

FAQs relating to the Taxonomy Regulation and SFDR

The Commission published a notice on the interpretation and implementation of certain legal provisions of the Taxonomy Regulation and links to the SFDR.

The notice contains FAQs which cover:

- the role of minimum safeguards in the Taxonomy Regulation;
- key expectation for undertakings and how minimum safeguards are defined under Article 18 of the Taxonomy Regulation; and
- whether taxonomy-aligned investments qualify as "sustainable investment" under the SFDR. Important for managers of sustainable products the Commission clarifies that investments in

taxonomy-aligned environmentally sustainable economic activities can be automatically qualified as sustainable investment under SFDR.

Expansion of Taxonomy Regulation framework

On 27 June 2023, following a public consultation the Commission adopted a Commission Delegated Regulation amending Delegated Regulation (EU) 2021/2139 (the Taxonomy Climate Delegated Act made under the Taxonomy Regulation establishing additional technical screening criteria for determining the conditions under which certain economic activities qualify as contributing substantially to climate change mitigation or climate change adaptation and for determining whether those activities cause no significant harm to any of the other environmental objectives.

The delegated act creates a new set of taxonomy criteria for economic activities making a substantial contribution to one or more of the remaining four non-climate environmental objectives (the '**Taxo 4**') of the Taxonomy Regulation:

- sustainable use and protection of water and marine resources;
- transition to a circular economy;
- pollution prevention and control; and
- protection and restoration of biodiversity and ecosystems.

The criteria are informed to a large extent by the Taxo 4 recommendations of the Platform on Sustainable Finance, published in March and November 2022. The criteria notably concerns certain manufacturing activities in relation to key components for low carbon transport and electrical equipment, which can help achieve greenhouse gas emissions savings in other target activities in addition to transitional activities in the transport sector where zero-carbon solutions are not yet sufficiently advanced. The inclusion of the technical screening criteria in respect of the latter is intended to represent an effective way to help incentivise improvements.

The Commission also adopted a Commission Delegated Regulation containing complimentary targeted amendments to the Taxonomy Disclosures Delegated Act to clarify the disclosure obligations for the additional activities.

The Taxonomy Delegated Acts have been approved in principle by the Commission and once all EU official languages will be made available, they will be adopted and transmitted to the European Parliament and the Council for their scrutiny (four-month period, extendable once by two additional months). If no objection is raised, the delegated acts will come into force after their publication in the OJ. They are expected to apply as of January 2024.

Our recent advisory EU sustainable finance package - June 2023 provides an overview of this significant sustainable finance package on EU Taxonomy, ESG ratings and transition finance.

(d) *ESA progress reports on greenwashing* (*This is a further update to section 4.15(m) of the report covering the fourth quarter of 2022)*

On 1 June 2023, the ESAs published their respective progress reports (ESMA, EBA and EIOPA) in response to a request for their input from the Commission on Greenwashing in the financial sector. The ESAs subsequently issued a call for evidence in November 2022 from stakeholders to gather information to enable them to understand the key features, drivers and risks associated with greenwashing and to collect examples of potential greenwashing practices.

The ESAs have put forward their common high-level understanding of greenwashing:

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

Some of the core characteristics central to this understanding of greenwashing are as follows:

- communications can be misleading due to the omission of information, or may be due to the actual provision of information, that is false, deceives or is likely to deceive;

- may not only result in a direct claim but also in misleading actions e.g. where clients with sustainability preferences are identified in the target market of non-sustainability products;

- can arise intentionally or unintentionally (e.g. through negligence, or the lack of robustness and appropriateness of due diligence efforts);

- may occur at:
    - an entity level,
    - a financial product level, or
    - a financial service level including advice (e.g., relating to the integration of sustainability-related preferences to the provision of financial advice);

- may occur at any point where sustainability-related statements, declarations, actions or communications are made, including at different stages of the business cycle of financial products or services or of the sustainable finance value chain;

- may relate to entities and products that are either within or outside the remit of the EU regulatory framework;

- can be triggered by the entity to which the sustainability communications relate, by the entity responsible for the product, by the entity providing advice or information on the product, or by third parties (e.g., ESG rating and data providers, or third-party verifiers); and

- may or may not result in immediate damage to individual investors (in particular through mis-selling) or the gain of an unfair competitive advantage.

Regardless of whether adverse outcomes result, if not kept in check, greenwashing may undermine trust in sustainable finance markets and policies.

In ESMA's progress report (the "**Report**"), it assesses which areas of the sustainable investment value chain ("**SIVC**") are more exposed to the risk of greenwashing. The report outlines possible actions to remediate the current regulatory drivers of greenwashing and identifies examples of misleading practices which will be of interest to managers launching and marketing their fund products. The Report's findings show that misleading claims may relate to all key aspects of the sustainability profile of a product or an entity – from governance aspects to sustainability strategy, targets and metrics or claims about impact. The Report also provides sector-specific assessments for key sectors under ESMA's remit i.e. issuers, investment managers, benchmark administrators and investment service providers.

High-Risk Areas for Investment Managers

In the Report ESMA describes the sustainability claims that appear particularly exposed to greenwashing risks in relation to investment managers are those concerning:

- a fund's or the manager's engagement with investee companies;

- ESG strategy;

- policies and credentials;

- ESG governance as well as claims on sustainability impact; and
- fund names, particularly important for retail investors' decisions.

The highest areas of greenwashing risk apply equally to claims about funds and to entity-level claims about the ESG profile of the asset manager.

Based on ESMA findings, specific high-risk areas identified for investment managers include, but are not limited, to impact claims, statements about engagement with investee companies, about a fund or asset manager's ESG strategy (characteristics, objectives, likely holdings etc.) and ESG credentials (such as ESG labels, ESG ratings or ESG certifications), present ESG performance, fund names, and claims about governance around ESG.

The Report lays the ground for future steps towards mitigating greenwashing risks throughout the SIVC in key sectors including investment management. Undoubtedly mitigating greenwashing risks is a key supervisory and investor-driven focus and the risks highlighted in the Report serve as a further important reminder that good governance policies and practices continue to be fundamental for fund clients and boards alike as they embed their approach to ESG matters and mitigation the risk of greenwashing.

Next Steps

Together with the NCAs, the ESAs note they are "working to meet expectations from stakeholders to ensure consumer and investor protection, support market integrity and maintain a trusted environment for sustainable finance". ESMA will continue their evidence gathering work, alongside their strategic focus on ESG disclosures, and intend to publish a final greenwashing report to the Commission in May 2024. The set of final ESA reports on greenwashing will consider recommendations, including on possible changes to the EU regulatory framework while also providing a stocktake of the supervisory response to greenwashing by NCAs and of those convergence activities initiated by the ESAs.

Our recent advisory outlines the next steps on greenwashing supervision and key takeaways from the report of interest to boards and managers launching and marketing their fund products. Walkers will continue to keep firms and boards appraised of supervisory progress on mitigating greenwashing risks and developments in the ESA's strategic focus on ESG disclosures.

(e) *ESMA Chair's speech on greenwashing report*

On 5 June 2023, Verena Ross delivered a speech at the European Financial Congress. Referring to its recent greenwashing report, she noted what matters to supervisors is whether sustainability claims are misleading or have the potential to mislead consumers and investors. With that in mind, the simplification and clarification of ESG-related requirements, together with their effective supervision, are critical outcomes for ESMA.

(f) *European Commission publishes draft ESRS under the Corporate Sustainability Reporting Directive ("**CSRD**")* (*This is a further update to section 4.14(a) of the report covering the first quarter of 2023)*

On 12 June 2023, the Commission published the draft delegated act containing the first set of ESRS under the CSRD which outline required corporate disclosures detail once the new CSRD regime begins to apply. The draft delegated act specifies the ESRS and is accompanied by annexes setting out cross-cutting standards, standards for the disclosure of environmental, social and governance information and a glossary to be used for the purposes of reporting in accordance with ESRS.

The mandatory reporting standards will ensure that companies are fully transparent about their impact on people and the environment, as well as about the risks they face from climate change and other issues. The Commission's publication highlights that the standards will be a key tool to combat greenwashing and will also help companies to communicate and manage their sustainability performance more efficiently.

The deadline for feedback to be received on the consultation is 7 July 2023.

(g) *Keynote speech on ESMA's role in enabling the transition to a low carbon economy*

On 4 May 2023, Natasha Cazenave, Executive Director of ESMA delivered a speech at the AFME 2nd Annual Sustainable Finance Conference.

Points of interest in the speech include:

- The framework under SFDR remains complex and difficult to navigate for investors. There could be merit in exploring whether labels for sustainable financial products could help better channel savings according to investors' needs and preferences and therefore support an orderly transition. The interest in labels is evidenced by the fact that the market is using Article 8 and Article 9 of the SFDR, which were designed for disclosure purposes only, as actual marketing labels.

- ESMA is of the view that some criteria should be required when naming investment funds that claim to have sustainability characteristics or goals to deal with the risk of greenwashing. The need to enhance investor protection is particularly evident when dealing with investment funds that use terms in their name that suggest an investment focus in companies that meet certain ESG standards such as "sustainable", "impact" and "climate change". Following ESMA's November 2022 consultation on fund names, Ms Cazenave explains there is common agreement on the need to have specific rules that address fund naming.

- ESMA is focusing one of its strategic supervisory priorities on ESG disclosures. ESMA is aiming to promote increased and consistent scrutiny on ESG disclosures across the sustainable investment value chain through a number of supervisory actions that will be carried out by NCAs in parallel across the EU.

(h) *ESAs propose ESG disclosures for simple, transparent and standardised ("**STS**") securitisations (This is a further update to section 4.14(h) of the report covering the first quarter of 2023)*

On 25 May 2023, ESAs have submitted to the Commission a final report on draft RTS on the ESG impact disclosure for STS securitisations under the Securitisation Regulation (EU) 2017/2402. The final draft RTS aim to help market participants make informed decisions about the sustainability impact of their investments.

The key proposals included in the technical standards specify ESG disclosures which would apply to STS securitisations where the underlying exposures are residential loans, auto loans and leases.

The RTS aim to ensure consistency with those developed under the SFDR, which distinguish between the publication of available information on mandatory indicators (e.g. energy efficiency) and on additional indicators (e.g. emissions).

Following the submission of these RTS, the Commission is expected to endorse the RTS within three months of their publication.

(i) *Consolidated Q&A on SFDR (This is a further update to section 4.15(a) of the report covering the fourth quarter of 2022)*

On 17 May 2023, ESMA published consolidated versions of its Q&As on SFDR. The consolidated Q&A contains:

- responses given by the Commission to questions requiring interpretation of EU law (in blue); and
- responses generated by the ESAs, which relate to the practical application or implementation of the relevant rules (uncoloured).

The consolidated Q&A document does not add new guidance or interpretations.

(j) *Bank for International Settlements ("**BIS**") speech on the path to net zero and regulatory expectations*

On 30 May 2023, BIS published a speech by Sabine Mauderer, entitled "*The path to net zero and regulatory expectations*".

Ms. Mauderer outlined out the key features for effective regulation in this area and discussed what regulators expect in terms of disclosure of transition plans. Her remarks discussed the key features for effective regulation in this area and what regulators expect in terms of disclosure of transition plans.

Ms. Mauderer noted that from 2025—for the fiscal year 2024—EU companies falling within the scope of the CSRD will have to disclose transition plans. In the UK, the Financial Conduct Authority already now requires listed companies to disclose transition plans on a 'comply-or-explain' basis.

(k) *ESMA's call for evidence on sustainability preferences under MiFD II (This is a further update to sections 4.10(m) and 4.8(b) of the reports covering the third quarter of 2022 and first quarter of 2023 respectively)*

On 16 June 2023, ESMA published a call for evidence on the integration of sustainability preferences in the suitability assessment and product governance arrangements under the MiFID II Directive.

The objective of the call for evidence is to gather industry feedback that will help better understand the evolution of the market and provide answers as to how firms apply the new MiFID rules on sustainability. It follows ESMA's updates to its Guidelines on suitability and product governance requirements (published in September 2022 and March 2023 respectively), following the inclusion of sustainability-related requirements for investment firms in MiFID II. Note that the updated ESMA guidelines on certain aspects of the MiFID II suitability requirements will apply as from 3 October 2023, (i.e. six months from the date of publication on ESMA's website of the suitability guidelines in the EU official languages).

ESMA states that this call for evidence is not intended as a new consultation on the content of these guidelines. Instead, the call for evidence aims to help ESMA:

- develop a better understanding of how MiFID II requirements are being implemented and applied by firms across the Union and the challenges firms face in their application;
- gain a better understanding of investor experience and reactions to the inclusion of sustainability factors in investment advice and portfolio management services; and
- collect information, views and data on main trends on aspects related to the provision of sustainable investment products and services to retail clients.

The deadline for responses is 15 September 2023. ESMA, together with the NCAs, will assess the responses and continue monitoring the application by firms of the MiFID II requirements on suitability and product governance, including the related ESMA Guidelines.

(l) *ESA joint consultation on proposed amendments to SFDR Delegated Regulation*

On 12 April 2023, the ESAs published a consultation paper outlining proposed amendments to the SFDR Delegated Regulation.

The ESAs have now developed draft SFDR RTS (set out in section 4 of the consultation) and which propose amendments in respect of:

- extending the list of universal social impact indicators for disclosing PAI of investment decisions on the environment and society (such as earnings from non-cooperative tax jurisdictions or interference in the formation of trade unions);

- refining the content of other indicators for adverse impacts and their respective definitions, applicable methodologies and formulae for calculation as well as the presentation of the share of information derived directly from investee companies, sovereigns, supra-nationals or real estate assets; and
- adding product disclosures regarding greenhouse gas emissions reduction targets, including intermediate targets, the level of ambition and how this decarbonisation target will be achieved. The ESAs note that these disclosure requirements should not create any additional burden for products without such targets.

There are also several technical revisions to the SFDR Delegated Regulation such as:

- improving the disclosures on how sustainable investments "do not significantly harm" the environment and society;
- "simplifying pre-contractual and periodic disclosure templates for financial products", including a new ESG "dashboard" for retail investors; and
- introducing other technical adjustments among others, the treatment of derivatives, the definition of equivalent information, and provisions for financial products with underlying investment options.

The consultation will close on 4 July 2023.

(m) *European Commission Taxonomy Navigator*

The Commission has enhanced its Taxonomy Compass and accompanying tools within the EU Taxonomy Navigator with the addition of a Taxonomy calculator (an interactive, educational tool that aims to help users understand and support with the reporting obligations laid down in the Disclosures Delegated Act under Article 8 of the Taxonomy Regulation) and a FAQ repository which sets out all the FAQ documents published on the Taxonomy and its delegated acts to date.

(n) *Deforestation Regulation*

On 31 May 2023, the European Parliament and the Council of the EU adopted Regulation (EU) 2023/1115 (the "**Deforestation Regulation**") regarding the marketing and export of certain commodities and products associated with deforestation and forest degradation from the EU. The Regulation covers seven commodities representing the largest share of Union-driven deforestation and certain products that contain, have been fed with, or have been made using commodities including: palm oil, soya, wood, cocoa, coffee, cattle, and rubber. In accordance with the Deforestation Regulation, operators and traders may not place on the EU market or export from the EU relevant commodities and products without (i) prior submission of a due diligence statement, for which they will assume full responsibility, and without (ii) having ascertained—through due diligence—that there is no risk or only a negligible risk that the relevant commodities and products are not deforestation-free or have not been produced in accordance with the relevant legislation of the country of production.

The Deforestation Regulation was published in the OJ on 9 June 2023 and will enter into force on 29 June 2023 with the main prohibitions and obligations applying from 30 December 2024.