

Chambers

GLOBAL PRACTICE GUIDES

Definitive global law guides offering
comparative analysis from top-ranked lawyers

Alternative Funds

Luxembourg: Trends and Developments

Evelyn Maher, Isabel Høg-Jensen,
Marylou Poncin and Christoforos Soteriou
Bonn Steichen & Partners

chambers.com

2020

Trends and Developments

Contributed by:

*Evelyn Maher, Isabel Høg-Jensen, Marylou Poncin
and Christoforos Soteriou*

Bonn Steichen & Partners see p.7

The recent international consensus is that integrating environmental, social and governance (ESG) considerations into financial decision-making will lead to increased investment in longer-term and sustainable activities. Sustainable finance takes into account ESG considerations in the process of financial decision-making, aiming towards a financial system that supports sustainable growth. Environmental considerations refer to climate change mitigation and adaptation, as well as related risks, such as natural disasters. Social considerations include issues such as inequality, inclusiveness and labour relations. Governance refers to the management of public and private institutions, covering employee relations and executive remuneration.

ESG at the Core of the Financial System

The United Nations 2030 Agenda for Sustainable Development introduced in September 2015 (UN Agenda), followed by the adoption of the Paris Agreement on Climate Change (Paris Agreement) later in the same year, created a path towards the development of a more sustainable economy and society. Adopted by all UN member countries, the UN Agenda presented a collection of 17 global goals (including no poverty, zero hunger, sustainable cities and communities and climate action) designed to be a blueprint to achieve a more sustainable future for all. The Paris Agreement includes a collective commitment to align financial flows in such a manner that will result in a low-carbon and climate-resilient environment.

In March 2018, the EC adopted an action plan on sustainable finance (EU Action Plan), aiming to reorient capital flows towards a more sustainable economy. A couple of months later, the EC proposed a package of legislative measures (discussed here) in an effort to fill out this vision. A technical expert group on sustainable finance (TEG) was established in July 2018 to assist the EC in developing, in line with the legislative proposals, a unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low-carbon indices, and metrics for climate-related disclosure.

Luxembourg is the European leader in responsible investment fund assets, accounting for 34% of responsible funds across Europe and 35% of all assets under management in socially responsible investment mandates, ranking among the top green financial centres in the global Green Finance Index published in 2020. Luxembourg is also undisputedly the green bond capital of the world, as over 50% of all green, social and sustainability

bonds worldwide are listed on the Luxembourg Green Exchange (LGX), the world's first trading platform exclusively for sustainable financial instruments. The Luxembourg Finance Labelling Agency (LuxFLAG) has launched a dedicated Climate Finance quality label to ensure the effective climate focus of investment funds in the implementation of their investment policy, and specific Green Bond labelling as a means to boost green investments. The Luxembourg Climate Finance Accelerator, set up in 2018, helps fund managers specialising in climate action by offering various forms of financial and operational support during the launch phase of a new fund structure.

The Association of the Luxembourg Fund Industry (ALFI) has also been raising awareness about sustainable finance over the past years. The ALFI Responsible Investing Technical Committee produced guidance on sustainability disclosures in January 2020, with the objective of providing guidance to asset managers pertaining to the ESG regime. Luxembourg also launched the Luxembourg sustainable finance roadmap drawing up an inventory of existing initiatives in Luxembourg in the field of sustainable finance and laying the foundations for a sustainable financial strategy, contributing to the UN Agenda and the objectives of the Paris Agreement.

Key Legislative Developments

The Disclosure Regulation

Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (Disclosure Regulation) published in December 2019 marked a new milestone in the journey towards a more sustainable financial sector. The majority of the disclosure requirements under the Disclosure Regulation will apply from 10 March 2021, and upcoming regulatory technical standards will soon be developed to address specific obligations therein.

The Disclosure Regulation broadly applies to:

- financial market participants (FMPs), which includes Alternative Investment Fund Managers (AIFMs), Undertakings for Collective Investment in Transferable Securities (UCITS), management companies and investment firms providing portfolio management as defined in the EU Directive 2014/65 on Markets in Financial Instruments (MiFID II); and

LUXEMBOURG TRENDS AND DEVELOPMENTS

Contributed by: Evelyn Maher, Isabel Høg-Jensen, Marylou Poncin and Christoforos Soteriou, Bonn Steichen & Partners

- financial advisers (FAs), including investment firms as defined in MiFID II, as well as AIFMs and UCITS management companies that provide investment advice.

It can also apply to non-EU asset managers; eg, the manager of a non-EU AIF marketed in the EU on a private placement basis will be in-scope for certain aspects of the Disclosure Regulation. The Disclosure Regulation does, however, offer limited exemptions from its scope, such as investment firms which provide investment advice, provided they employ fewer than three people.

The Disclosure Regulation lays down harmonised rules on transparency with a view to promoting the integration of sustainability risks into investment processes and the disclosure of such risks to investors. “Sustainability risk” is defined as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of an investment”.

FMPs are obliged to publish on their websites various new information such as:

- information about their policies on the integration of sustainability risks into their investment decision-making process;
- either a statement on the due diligence policies they use to consider the principal adverse impacts of investment decisions on “sustainability factors” (ie, environmental, social or employee issues), or explain why they are not considering such impacts for the time being (“comply or explain”); however, from 30 June 2021, FMPs with more than 500 employees (alone or on a group basis) will compulsorily have to publish and maintain a statement on their websites on their due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors; and
- information on how their remuneration policies are consistent with the integration of sustainability risks.

Should an FMP make available a “financial product” (ie, an AIF, a UCITS, portfolios managed by investment firms) that promotes ESG characteristics, or has sustainable investment or carbon-emission reduction as an objective, additional information should be published on its website, including a description of the relevant ESG characteristics and/or ESG objective of the product, the methodologies used to assess, measure and monitor the ESG characteristics of the product and/or the impact of the product on the ESG objective and, where an index is designated as a reference benchmark for ESG characteristics, whether and how the index is consistent with those characteristics.

Both FMPs and FAs must include, in precontractual disclosures (eg, in prospectuses for AIFs/UCITS or other precontractual documentation as required by MiFID II), descriptions on:

- the manner in which sustainability risks are integrated into their investment decisions; and
- the results of an assessment of the likely impacts of sustainability risks on the financial products they make available (or advise on, if an FA).

Where a financial product promotes ESG characteristics, the disclosures must include information on how those characteristics are met, and whether and how any benchmark index referred to is consistent with those characteristics. Similar requirements arise in relation to financial products with ESG objectives. From 30 December 2022, FMPs that consider the principal adverse impacts of investment decisions on sustainability factors must also include in their precontractual disclosures a clear and reasoned explanation of whether and, if so, how, their financial products consider principal adverse impacts on sustainability factors. If they do not do this, they need to include a statement to this effect and supply reasons why they have not included an explanation.

For financial products with ESG characteristics, FMPs must also describe in periodic reports the extent to which these characteristics have been met, including, as applicable, a comparison between the product and its benchmark, or the overall sustainability-related impact of the product, with reference to relevant sustainability indicators.

FAs must publish on their websites:

- information about their policies on the integration of sustainability risks in their investment advice; as well as
- information as to whether, taking account of their activities and financial products, they consider the principal adverse impacts on sustainability factors in their investment advice, or reasons why they do not presently consider such adverse impacts.

Additionally, they need to publish on their websites information on how their remuneration policies are consistent with the integration of sustainability risks.

The Taxonomy Regulation

Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (Taxonomy Regulation) published in June 2020, establishes an EU-wide classification system intended to provide a common framework to identify to what extent economic activities can be considered environmentally sustainable. Certain provisions of the Taxonomy Regulation

TRENDS AND DEVELOPMENTS LUXEMBOURG

Contributed by: Evelyn Maher, Isabel Høg-Jensen, Marylou Poncin and Christoforos Soteriou, Bonn Steichen & Partners

already came into force on 12 July 2020, but many of its key provisions will not apply until a later date. The EC will soon adopt delegated Acts supplementing the Taxonomy Regulation.

The Taxonomy Regulation affects FMPs or issuers who make available a financial product (as defined in the Disclosure Regulation) which either (a) has environmental sustainability as its objective, or (b) promotes environmental characteristics. It supplements the disclosure obligations which apply to FMPs under the Disclosure Regulation and to corporates (ie, large public-interest companies with more than 500 employees such as listed companies, banks and insurance companies) under EU Directive 2014/95 as regards disclosure of non-financial and diversity information by certain large undertakings and groups (Non-Financial Reporting Directive). Where a financial product made available in the EU has sustainable investment as its objective or promotes ESG characteristics, and such a product invests in an economic activity that contributes to an environmental objective, the precontractual and ongoing disclosures related to such a financial product will need to contain:

- information on the environmental objective(s) set out in the Taxonomy Regulation, to which the investment underlying the financial product contributes; and
- a description of how and to what extent the investments underlying the financial product are in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

If they do not take into account the EU criteria for environmentally sustainable economic activities, then the precontractual and ongoing disclosures related to such financial products will need to include a statement to this effect.

An economic activity is environmentally sustainable if:

- it makes a substantial contribution to one of the following:
 - (a) climate change mitigation;
 - (b) climate change adaptation;
 - (c) sustainable use and protection of water and marine resources;
 - (d) transition to a circular economy;
 - (e) pollution prevention and control; and
 - (f) protection and restoration of biodiversity and ecosystems;
- it does “no significant harm” to any of these six listed environmental objectives;
- it is carried out in compliance with the minimum safeguards mentioned in the Taxonomy Regulation (ie, UN Guiding Principles on Business and Human Rights); and
- it complies with technical screening criteria which will be developed using delegated legislation later on.

The Taxonomy Regulation will also impact non-European asset managers offering financial products into the EU.

Corporates that are subject to disclosure obligations under the Non-Financial Reporting Directive will also be required to include in their annual reports (as part of their non-financial statements) information on how and to what extent the corporate’s activities are associated with economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

The Climate Benchmark Regulation

Regulation (EU) 2019/2089 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (Climate Benchmark Regulation) came into effect on 30 April 2020, amending EU Regulation 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (Benchmark Regulation). The aim of the Climate Benchmark Regulation is to increase transparency and uniformity in the use of low-carbon indices. Obligations under the said regulation take effect at different times, with most of them applying since 30 April 2020.

The Benchmark Regulation applies to the provision of benchmarks, the contribution of input data to a benchmark and the use of a benchmark within the EU.

In an effort to minimise “green washing”, the Climate Benchmark Regulation introduces two new categories of benchmarks: the EU Climate Transition Benchmarks (EUCT Benchmark) and the EU Paris-aligned Benchmarks (EUPA Benchmark). The EUCT Benchmark is an index whose underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory, ie, a measurable, science-based and time-bound trajectory towards alignment with the objectives of the Paris Agreement by reducing carbon emissions. The EUPA Benchmark is an index whose underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio’s carbon emissions are aligned with the objectives of the Paris Agreement and do not significantly harm other ESG objectives.

The Climate Benchmark Regulation obliges all benchmark (or families of benchmarks) administrators, with the exception of administrators of interest rate and foreign exchange benchmarks, to provide the following disclosures:

- by 30 April 2020, an explanation of how the key elements of the benchmark methodology reflect ESG factors;

LUXEMBOURG TRENDS AND DEVELOPMENTS

Contributed by: Evelyn Maher, Isabel Høg-Jensen, Marylou Poncin and Christoforos Soteriou, Bonn Steichen & Partners

- by 30 April 2020, inclusion in the benchmark statement of an explanation of how ESG factors are reflected in each benchmark;
- by 31 December 2021, inclusion in the benchmark statement, of information on the degree of alignment with the target of carbon-emission reductions, or attainment of the long-term global warming target of the Paris Agreement.

By 30 April 2020, EUCT and EUPA benchmark administrators were obliged to document and make public any methodology used for the calculation of the benchmark, giving the information listed in Annex III of the Climate Benchmark Regulation for each of the EUCT and EUPA Benchmarks. Moreover, administrators located in the EU and providing significant benchmarks are required to endeavour to provide one or more EUCT Benchmarks by 1 January 2022. Lastly, administrators of EUCT Benchmarks are required to select, weight or exclude underlying assets issued by companies that follow a decarbonisation trajectory by 31 December 2022, in accordance with certain requirements.

On 17 July 2020, the EC adopted three delegated regulations (not yet in force) under the Benchmark Regulation specifying new disclosure rules for benchmark statements and benchmark methodologies, and prescribing minimum requirements for the EUCT and EUPA Benchmarks.

The EU green bond standard

An EU green bond standard is one of the central planks of the EU Action Plan as green bonds play an increasingly important role in financing assets needed for the low-carbon transition envisaged by the Paris Agreement. For the time being, there is no uniform green bond standard within the EU, although it was recommended in the final report of the EC's High-Level Expert Group on Sustainable Finance on 31 January 2018 that such an EU green bond should be established.

Instructed by the EU Action Plan, the TEG provided detailed input on what an EU green bond standard could look like in its proposal in June 2019 (TEG EU-GBS) and in its usability guide published in March 2020 (the EU-GBS Usability Guide). The TEG EU-GBS largely mirrors the regime under the Green Bond Principles (formulated by the International Capital Market Association – ICMA), the most widely utilised green bond standard currently in the market. The EU-GBS Usability Guide provides TEG's views to potential issuers, verifiers and investors of EU green bonds on the practical application of the TEG EU-GBS. The TEG EU-GBS could be adopted by any issuer of listed or unlisted bonds or capital market debt instrument, whether domiciled in Europe or not.

The TEG EU-GBS contains a concrete list of substantive activities that can be categorised as green by cross-referring to the Taxonomy Regulation. It requires mandatory reporting on the environmental impact of projects, in addition to how proceeds are allocated. Moreover, the TEG EU-GBS requires mandatory post-issuance verification of use of proceeds and relevant allocation reports by ESMA's accredited and supervised external reviewers.

Despite its present voluntary "opt-in" option, the EC has recently stated that it will explore the possibility of a legally binding initiative for the TEG EU-GBS. In August 2020, Luxembourg launched its own Sustainability Bond Framework, the first in the world to fully comply with the TEG EU-GBS. Luxembourg aims to lead by example in order to support the development of a responsible capital market with the issuance of safe (AAA-rated) and liquid sovereign ESG bonds, and the Luxembourg government has already engaged a number of reputable credit institutions to float the bonds.

On 8 June 2020, the EC published a set of draft delegated acts, which, once implemented, will amend:

- the EU Delegated Regulation 231/2013 (re AIFMs);
- EU Directive 2010/43/EU (re UCITS); and
- both EU Delegated Regulations 2017/565 and 2017/593 (re MiFID II).

EU AIFMs, UCITS management companies, and MiFID II investment firms will be affected by these upcoming changes. The proposed changes will require such entities to update their existing rules pertaining to decision-making procedures, organisational structures, reporting lines and control mechanisms so that they take into account sustainability risks when complying with these organisational requirements. Additionally, such entities will need to update their existing rules on identifying and managing conflicts of interest, so they will be able to identify conflicts which may arise from the integration of sustainability risks, or a client's sustainability preferences.

Moreover, in-scope entities under the AIFMD and UCITS regimes will need to revamp their existing rules relating to due diligence processes when making investment decisions, so as to take into account sustainability risks when investing. In addition, entities which are within scope of the Disclosure Regulation and which have implemented principal adverse impact policies, must also update their investment due diligence processes to specifically take into account their principal adverse impact policies.

MiFID II investment firms (including UCITS management companies and AIFMs that opt-in for the dual licence to per-

form MiFID II services such as portfolio management and investment advice) will also have to take into account their clients' "sustainability preferences" when carrying out a suitability assessment of the products offered to such clients. Additionally, manufacturers and distributors of financial products will need to take into account the sustainability preferences of the target market, which will necessitate updating their product origination, marketing and distribution strategies.

As part of the EU Action Plan, the EC also aims to expand the EU Ecolabel, which currently exists for a range of goods and services, including financial products. Labelling of "green" or "environmentally focused" financial products has increased in recent years. For example, the LuxFLAG Climate Finance Label reassures investors that the selected investment product invests at least 75% of total assets in investments related, with a clear and direct link, to mitigation and/or adaptation of climate change or cross-cutting activities. The upcoming EU Ecolabel for financial products will serve as a new, EU-wide label, and will thus elevate market transparency and enhance consumer choice.

Future of the ESG Regime

ALFI has recently submitted its thoughts on a consultation regarding the Renewed Sustainable Finance Strategy published in April 2020, a roadmap proposed by the EGD that builds on the ten actions put forward in the EU Action Plan. ALFI suggested that mainstreaming sustainability in the financial sector over the coming decade will create certain challenges, emphasising that a lack of robust, reliable and accessible ESG data is one of the biggest issues for asset owners and managers. This could be tackled as more historical data and research accumulates internally or is provided by external data providers over

the years. Moreover, concerns were raised on whether credit rating agencies will be obliged to integrate ESG criteria into their analysis of issuers' credit worthiness. In July 2019, ESMA published technical advice on sustainability considerations in the credit rating market and its final guidelines on disclosure requirements applicable to credit ratings as a means to tackle this problem, but it remains to be seen whether EU-wide legislation will be implemented to this end. ALFI also noted that incorporating ESG factors into investment decision-making requires specialist skills and that affected entities will incur additional costs in having to recruit or develop investment talent with the appropriate mix of skills. On the other hand, as ESMA pointed out in their response to the same consultation, the ESG regime will also result in opportunities. For example, it will build resilience in the financial system by improving awareness of the risks relating to different sustainability factors, thus triggering better management and preparation to address the consequences of severe events triggered by environmental and social crises. Additionally, it will strengthen financial education by increasing financial literacy on sustainability matters, crucial for both investors and finance professionals.

For the Luxembourg asset management industry, the EC's legislative push in integrating ESG criteria into investments is not a trend, but the continuation of long-standing efforts to promote this culture in financial decision-making. Initiatives such as the LGX, a joint climate investment platform with the EIB, a Luxembourg climate finance accelerator for fund managers, and a dedicated climate label for investment funds indicate that Luxembourg has not only proved its commitment to help raise finance to meet global climate-related challenges, but has demonstrated its ability to innovate.

LUXEMBOURG TRENDS AND DEVELOPMENTS

Contributed by: Evelyn Maher, Isabel Høg-Jensen, Marylou Poncin and Christoforos Soteriou, Bonn Steichen & Partners

Bonn Steichen & Partners is an independent full-service law firm based in Luxembourg that is committed to providing quality legal services to its domestic and international clients in all aspects of Luxembourg business law. Its multilingual lawyers work side by side with clients to help them reach their objectives and to support them with tailor-made legal advice, creating in the process professional relationships based on mutual trust and respect. The team at BSP has developed

particular expertise in banking and finance, capital markets, corporate law, dispute resolution, employment law, investment funds, intellectual property, private wealth, real estate and tax. In these practice areas, as in others, the lawyers' know-how and ability to work in cross-practice teams and to adapt swiftly to new laws and regulations have enabled them to provide their clients with the timely and integrated legal assistance vital to the success of each client's business.

Authors



Evelyn Maher is head of BSP's investment management department. She assists fund promoters and asset managers in relation to the structuring and establishment of a wide range of funds, including private equity, venture capital, loan origination, loan participation and real estate. She

provides advice on compliance with all aspects of the regulatory regime applicable to investment funds and, in particular, the Alternative Investment Fund Managers Directive (AIFMD). Following the launch of a fund, Evelyn offers ongoing assistance in relation to closings, investments, divestments, liquidation and general issues arising throughout the life of the fund. She has also provided assistance in relation to the listing of securities on both the regulated and Euro MTF markets operated by the Luxembourg Stock Exchange. She has extensive experience in relation to Luxembourg regulatory and corporate law.



Isabel Høg-Jensen has been active in the Luxembourg investment fund market since 2001. She assists fund promoters and asset managers in relation to the structuring and establishment of a wide range of funds, including undertakings for collective investment in transferable securities,

private equity, real estate and debt funds. She provides advice on compliance with all aspects of the regulatory regime applicable to investment funds and, in particular, the AIFMD. She also assists alternative investment fund managers in Luxembourg with all regulatory and compliance aspects, including the review of their internal policies and procedures. Isabel is in charge of sustainable finance development and regulatory follow-up in BSP's investment management department.



Marylou Poncin is primarily involved in advising investment funds and management companies with respect to their corporate forms, and in drafting or reviewing all documentation and contracts relating to this. She also handles any required regulatory filings. Her practice

focuses on regulated fund vehicles (including UCITS, SIFs and SICARs) as well as RAIFs and other unregulated vehicles at all stages of their life, from the funds' inception all the way through to their liquidation. Marylou was admitted to the Luxembourg Bar in 2018.



Christoforos Soteriou is qualified to practise law in Cyprus and is also a Luxembourg-registered List IV lawyer (avocat exerçant sous son titre professionnel d'origine). He has a first-class law degree from the University of Manchester and a master's in corporate

and securities law from the London School of Economics and Political Science. Christoforos specialises in the setting-up, ongoing regulatory compliance, restructuring and other transactional matters relating to alternative investment funds and fund management companies.

Bonn Steichen & Partners

2, rue Peternelchen, Immeuble C2
L-2370 Howald
Luxembourg

Tel: +352 26 025 1
Fax: +352 26 025 999
Email: mail@bsp.lu
Web: www.bsp.lu



Right by you in Luxembourg