A SUSTAINABILITY CRISIS MAKES BAD LAWS - TOWARDS SANDBOX-THINKING IN EU SUSTAINABLE FINANCE REGULATION

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ABSTRACT: Focusing on UCITS management companies and managers of alternative investment funds, we analyze the state of EU sustainability-oriented financial law and its implementation. In the course of doing so, we find many reasons for concern. Given the Sustainable Finance Action Plan (SFAP) and its follow-up Sustainable Finance Strategy of 2021 responding to a sustainability crisis, we can testify to the old lawyers' adage that 'crises make bad laws.'

We have identified the main challenges that could hinder the completion, or effective implementation, of Europe's sustainable finance agenda as: (1) a data gap; (2) a lack of recognized models linking financial and sustainability data; (3) a lack of human resources with sustainability skills; (4) a costly taxonomy approach, suffering from gaps in crucial parts of the legislation while being too detailed in others; (5) legal uncertainty; and (6) national fragmentation emerging from Member States' gold-plating.

We argue that many deficiencies could be overcome by so-called sandbox thinking (a mutual learning approach where supervisors and the financial industry jointly seek good solutions to the challenges associated with innovative sustainable finance law and regulation). For that purpose, regulators and supervisors should establish a phase-in period where both proportionality and an open view as to what is feasible and reasonable are held paramount in day-to-day operations and their supervision.

The paper is structured as follows: Part I provides an introduction; Part II overviews the EU's cross-sectoral sustainable finance agenda; Part III looks at the particularities of sectoral legislation for investment funds and investment fund managers; Part IV lists the pain points of the EU's sustainable finance agenda for fund managers while outlining policy considerations for how best to address these issues; and Part V concludes that, in light of the challenges, a 'sandbox thinking' focused on mutual learning would enable the sustainability transformation of the EU's financial sector.

Keywords: Sustainable Finance, Financial Regulation, Data, (revised) Sustainable Finance Strategy 2021, EU Green Deal, Investment Funds.

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I. INTRODUCTION

The EU Commission appointed in late 2019 promised to implement the Green Deal Action Plan[1] and adopted a revised Sustainable Finance Action Plan (SFAP) comprising two steps, one in April 2021[2] and the second in July 2021,[3] with a view to accelerating the efforts which the Commission had previously proposed with the Sustainable Finance Action Plan in March 2018 (hereafter, the SFAP 2018).[4] Following the implementation of the SFAP, the EU's sustainable finance regulation consists, as of now, of some groundbreaking pieces of cross-sectoral legislation, in particular the Sustainable Finance Disclosure Regulation (SFDR) of 2019 and the Taxonomy Regulation of 2020.

On top of this come changes to sectoral legislation. For investment funds, the legislative package of April 2021 and the draft AIFMD II and UCITS VI of November 2021 have impacted on the UCITSD and AIFMD frameworks. At the same time, and running parallel to the SFAP, several pieces of legislation concerning investment funds were up for revision. Most notably, the revision of the Directive on Alternative Investment Fund Managers 2011/61/EU ('AIFMD'), which had been long expected, was prepared through several reports and rounds of consultations originally unrelated to sustainable finance.[5]

We analyze herein how the two subject matters of financial regulation – sustainable finance on the one hand, investment funds on the other – interrelate and to what extent sectoral legislation supports the cross-sectoral agenda, inter alia, by removing obstacles to the implementation of the SFDR and the Taxonomy Regulation. Finding that the latest wave of legislative action is silent on some key challenges for investment funds and their managers, we make policy proposals that could assist in linking the regulation of investment funds to the sustainable finance roadmap, and accelerate the transformation of the EU economy towards greater sustainability through the hidden hands of financial markets.

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[1] *See* EUROPEAN COMMISSION, THE EUROPEAN GREEN DEAL (11 Dec. 2019), final.

[2] See EUROPEAN COMMISSION, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal, Brussels, 21.4.2021 COM(2021) 188 final.

[3] See EUROPEAN COMMISSION, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Strategy for Financing the Transition to a Sustainable Economy, Strasbourg, 6.7.2021 COM(2021) 390 final.

[4] *See* EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final.

[5] *See* EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final.

The paper is structured as follows: the introduction (Part I) precedes an overview of the European Commission's sustainable finance strategies of 2018 and 2021 (Part II), before we introduce the amendments to investment fund regulations adopted with the April 2021 package as well as the AIFMD II / UCITS VI drafts of November 2021 (Part III). Thereafter, Part IV identifies the main challenges remaining, and provides policy considerations on how best to address them. Part V concludes by arguing in favor of a form of sandbox thinking that asks regulators and the financial industry to engage in a mutual learning exercise to overcome the obstacles at hand.

II. THE CROSS-SECTORAL MEASURES OF THE EU'S SUSTAINABLE FINANCE AGENDA

The cross-sectoral EU sustainable finance regulation so far consists of the six building blocks stipulated by the SFAP 2018 (infra, at 1.). These have since been further developed with the EU's Green Deal and the revised Sustainable Finance Agenda of 2021 (infra, at 2.).

1. Six building blocks of the SFAP 2018

At the heart of the SFAP stands the Taxonomy Regulation (EU) 2020/852,[6] introducing joint terminology and a standardized approach to "environmental sustainability." The taxonomy is cross-sectoral in that it calls for obedience in all parts of the financial services value chain but also covers issuers of corporate bonds as well as large stock corporations and limited liability companies.[7] In particular, the taxonomy covers in principle all UCITS management companies as well as all managers of alternative investment funds (AIFMs).[8]

In addition, four legislative measures have aimed to enhance, harmonize, and provide for comparable disclosures relating to sustainability. Specifically, these measures comprise the following:

- The Sustainable Finance Disclosure Regulation (EU) 2019/2088[9] (hereafter, the SFDR), introducing mandatory disclosure for financial market participants and financial advisers on sustainability factors as defined also by the Taxonomy Regulation.

[6] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OJ L 198, 22.6.2020, p. 13-43.
[7] See Article 1(2) Taxonomy Regulation (EU) 2020/852.
[8] See Marco Bodellini and Dalvinder Singh, Sustainability and finance: utopian oxymoron or achievable companionship?, in Law and Economics Yearly Review, 2021, *passim*.
[9] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019, p. 1–16.

- The revised Benchmark Regulation (EU) 2019/2089,[10] adding provisions on sustainability benchmarks to the EU rules on benchmark providers.
- The proposed revisions to EU product distribution rules (in IDD II, MiFID II), demanding that sustainability factors are considered when the suitability of a product for clients is assessed by insurance distributors and investment firms.[11]
- The proposed revision of Directive 2014/95/EU on non-financial reporting ('NFRD').[12]

All of these measures have had a direct impact on UCITS ManCos and AIFMs, as well as the UCITS and AIFs they manage. In particular, the SFDR applies to 'financial market participants,' with UCITS ManCos and AIFMs defined as such in Art. 2 No. 1 SFDR. Many UCITS and AIFs make use of sustainability indices and benchmarks as now regulated by the revised Benchmark Regulation. Furthermore, UCITS ManCos and AIFMs, by virtue of their license for side services,[13] are also subject to MiFID-style product distribution rules. Finally, large UCITS ManCos and AIFMs may be reporting entities under the NFRD and thus subject to Article 8 Taxonomy Reporting and Annex III of Commission Delegated Act on Taxonomy-related Disclosures.

However, it is the fifth measure of the SFAP 2018 that has had the greatest impact on fund managers: this encompasses legislative measures on the set-up and operational conditions of financial intermediaries, with a view to embedding sustainability risks into financial intermediaries' investment policies and risk management[13] to combat undue short-

[10] Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks, OJ L 317, 9.12.2019, p. 17–27.

[11] See EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final, at 2.5. The SFAP 2018 resulted in two legislative proposals, yet the proposals have not been adopted by the old European Commission, leaving this work strand for the new European Commission appointed in late 2019.

[12] See EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final, at 4.1. A consultation preparing the revision was then performed under the new European Commission appointed in late 2019; See also proposed amendments to the NFRD: Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM/2021/189 final.

[13] *See* EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final, at 3. The Juncker EU Commission collected feedback in consultations. The implementation was left to the new Commission. See, for instance, *ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II*, https://www.esma.europa.eu/sites/default/files/library/esma35-43-1737_final_report_on_integrating_sustainability_risks_and_factors_in_the_mifid_ii.pdf; *ESMA's technical advice to the European Commission on integrating sustainability risks*

termism.[14] Yet, the previous European Commission in charge of the SFAP 2018 did not present (draft) legislation on this matter.

2. The Green Deal and the Renewed SF Strategy of 2021

Presenting draft legislation on the intermediaries' organization remained the responsibility of the new EU Commission as part of the New Green Deal and the Revised SF Strategy of 2021.

a) The Green Deal

The EU Green Deal agenda started with two consultations. The first comprised a consultation on the proposed review of the Non-Financial Reporting Directive focusing on enhancing disclosures and rendering disclosures of listed companies on sustainability issues more comparable by implementing the EU Sustainability Taxonomy.[15] In March 2020, the EU Commission initiated a new consultation on the Renewed Sustainable Finance Strategy[16] to identify how to accelerate the transformation towards greater sustainability.

The renewed strategy focused on the following three items:[17]

"1. Strengthening the foundations for sustainable investment by creating an enabling framework, with appropriate tools and structures. Many financial and non-financial companies still focus excessively on short-term financial performance instead of their long-term development and sustainability-related challenges and opportunities. (…)

2. Increased opportunities to have a positive impact on sustainability for citizens, financial institutions and corporates. This second pillar aims at maximising the impact of the frameworks and tools in our arsenal in order to "finance green". (…)

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and factors in the UCITS Directive and AIFMD, https://www.esma.europa.eu/sites/default/files/library/esma34-45-688_final_report_on_integrating_sustainability_risks_and_factors_in_the_ucits_directive_and_the_aifmd.pdf.

[14] *See* EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final, at 4.2.

[15] See European Commission, Consultation strategy for the revision of the Non-Financial Reporting Directive (Feb. 2020); European Commission, Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive 20 February 2020 - 11 June 2020, Ref. Ares(2020)3997889 - 29/07/2020.

[16] European Commission, Consultation Document - The Renewed Sustainable Finance Strategy 4 (Mar. 2020).

[17] European Commission, Consultation Document - The Renewed Sustainable Finance Strategy 4 (Mar. 2020), at 4.

3. Climate and environmental risks will need to be fully managed and integrated into financial institutions and the financial system as a whole, while ensuring social risks are duly taken into account where relevant."

The related discussion document raised a number of issues. Of particular interest for investment funds were:

▪ How can green funds be enhanced?[18]

▪ What should be done to counter short-termism?[19]

▪ What role does passive index investing play in the context of sustainable finance? [20]

▪ How should rules be adapted on: a) asset managers' fiduciary duties, b) the investors' best interest, c) the prudent person rule guiding investment decisions of financial intermediaries, d) risk management, and, e) internal structures and processes to directly require financial intermediaries to consider and integrate adverse impacts of investment decisions on sustainability factors (negative externalities)?[21]

b) Revised SF Strategy of 2021

The consultation resulted in a newly-revised Sustainable Finance Action Plan, disseminated on 21 April 2021[22] and July 2021.[23]

Its four key components are meant to "help drive a greener, fairer, and more sustainable Europe and support the implementation of the Sustainable Development Goals." Of specific relevance for investment funds were the policy goals to add sustainability considerations in product governance as well as financial intermediaries' fiduciary duties. In particular, fund managers will need to consider sustainability risks, such as the impact of climate change and environmental degradation on the value of investments in their investment decisions, and – where the fund

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[18] European Commission, Consultation Document - The Renewed Sustainable Finance Strategy 4 (Mar. 2020), at 15.
[19] European Commission, Consultation Document - The Renewed Sustainable Finance Strategy 4 (Mar. 2020), at 17.
[20] European Commission, Consultation Document - The Renewed Sustainable Finance Strategy 4 (Mar. 2020), at 19.
[21] European Commission, Consultation Document - The Renewed Sustainable Finance Strategy 4 (Mar. 2020), at 33.
[22] European Commission, *EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal*, COM/2021/188 final (21 April 2021).
[23] See EUROPEAN COMMISSION, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Strategy for Financing the Transition to a Sustainable Economy, Strasbourg, 6.7.2021 COM(2021) 390 final.

documentation includes statements in that regard – will have to consider the impact of investment decisions on sustainability factors as well.[24]

III. CHANGES TO THE SECTORAL UCITSD AND AIFMD L2

In light of the considerations regarding the EU financial services legislation displayed in the Green Deal of 2019, it is worth analyzing the extent to which sustainable finance has found its way into the sectoral EU framework for collective investment schemes. For that purpose we look, firstly, at the amendments relating to fund managers' fiduciary duties adopted in April 2021, applicable from 1 August 2022 onwards,[25] and, secondly, at the AIFMD II and UCITS VI drafts of 25 November 2021.[26]

1. Fiduciary Duties and the Amended AIFMR (April 2021)

a) Legislative Background

In the context of the Green Deal and the Revised Sustainable Finance Strategy of July 2021, the European Commission proposed six delegated acts in April 2021[27] which required sustainability risks to be included in all financial intermediaries' activities and, where required under Article 4

[24] See European Commission, EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal, COM/2021/188 final (21 April 2021).

[25] European Commission, COMMISSION DELEGATED REGULATION (EU) 2021/1255 of 21 April 2021 amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers, O.J. L277/1 of 2 Aug 2021.

[26] See European Commission, Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds, Brussels, 25.11.2021, COM(2021) 721 final 2021/0376 (COD).

[27] European Commission, Proposal for a Commission Delegated Directive amending 1) Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for Undertakings for Collective Investment in Transferable Securities (UCITS); 2) Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers; 3) Delegated Regulations (EU) 2017/2358 and (EU) 2017/2359 as regards the integration of sustainability factors, risks and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business and investment advice for insurance-based investment products; 4) Delegated Directive (EU) 2017/593 as regards the integration of sustainability factors into the product governance obligations; 5) Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings; 6) Delegated Regulation (EU) 2017/565 as regards the integration of sustainability factors, risks and preferences into certain organisational requirements and operating conditions for investment firms (all proposals as of 21 April 2021).

SFDR, to take into account principal adverse impacts on sustainability factors when complying with intermediaries' requirements with respect to investment processes, their conflicts of interest policy as well as their risk management due diligence requirements set out in the sectoral legislation. These items together are broadly understood by the European Commission as a collective description of intermediaries' fiduciary duties.[28]

Specifically for collective investment schemes, the European Commission adopted on 21 April 2021 Delegated Regulation Amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by AIFMs,[29] as well as the Commission Delegated Directive (EU) 2021/1270 Amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for UCITS (collectively referred to hereafter as the 'April Package'). The April Package will be applicable from 1 August 2022.

b) Subject Matter

The April Package entails implementation of the proposals laid out in the ESMA's technical advice of 30 April 2019 on integrating sustainability risks and factors in the EU investment fund law.[30] The fact that the original AIFMR (adopted in 2013) as well as the UCITSD L2 (adopted in 2010), were silent on sustainability risks and sustainability factors was considered as incompatible with the abundant use of these terms following the double materiality perspective applied throughout the SFDR and Taxonomy Regulation. Hence, the April Package emphasizes double materiality aspects, namely sustainability risks and sustainability factors, in the context of investment and risk management, operational requirements, conflicts of interest, and management responsibility.

(1) Defining Key Terms relating to Double Materiality

First of all, the terms "sustainability risks" and "sustainability factors" have been added to the list of defined terms in Art. 1 AIFMR as new items (6) and (7) and in Art. 3 Directive 2010/43/EU as new items (11) and (12). The April Package limits itself to referring to the (broad) definitions of

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[28] European Commission, *EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal*, COM/2021/188 final (21 April 2021), at 13.

[29] European Commission, COMMISSION DELEGATED REGULATION (EU) 2021/1255 of 21 April 2021 amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers, O.J. L277/11 of 2 Aug 2021.

[30] ESMA, ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD, Final Report, 30 April 2019, ESMA34-45-688.

sustainability risks and sustainability factors already provided in the SFDR.[31] Under the new definitions, environmental and social aspects may trigger qualification as sustainability risks or sustainability factors, respectively.

(2) Investment Due Diligence and Risk Management

Within Article 18 AIFMR which defines the AIFM's due diligence requirements where details on the 'cardinal principles' laid out in Art. 12 (1) AIFMD are specified, two items have been added. On the one hand, 'AIFMs shall take into account sustainability risks when complying with the requirements set out in [Art. 18 (1) to (3) AIFMR].' On the other hand, where AIFMs consider principal adverse impacts of investment decisions on sustainability factors as described in [Art. 4(1) lit. a) or (3), (4) SFDR], those AIFMs shall take into account such principal adverse impacts when complying with the [due diligence] requirements set out in [Art. 18 (1) to (3) AIFMR]. Likewise, with regard to UCITS ManCos, the amended Art. 23 of Directive 2010/43/EU requires them to take into account sustainability risks and, where applicable, the principal adverse impacts of investment decisions on sustainability factors.

The term 'taking into account' here means only that fund managers must consider sustainability risks and, where applicable due to their relevance under the SFDR, the impact on sustainability factors, in the course of their selection and ongoing monitoring of investments. To do so, they must have adequate knowledge and understanding of the assets in which their funds are invested with regard to sustainability risks and, where applicable due to Art. 4 SFDR, of the assets' impact on sustainability factors. Finally, the due diligence and investment procedures conducted by fund managers on behalf of their funds must also consider sustainability risks and, where applicable due to Art. 4 SFDR, the assets' impact on sustainability factors. The main difference in this respect between the two frameworks (the UCITS framework and the AIFM framework) is that the former makes a clear reference to the proportionality principle[32] in that investment companies are requested to integrate sustainability risks in the management of UCITS while taking into account the nature, scale, and complexity of their business.[33]

In relation to risk management, Art. 40 (2) AIFMR defining risk management duties under Art. 15 AIFMD and Art. 38 (1) of Directive

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[31] Art. 1(1) of Regulation (EU) 2021/1255.

[32] A more precise reference to the proportionality principle is made in recital 4 of Directive 2010/43/EU where it is stated that 'To avoid an uneven playing field for management companies, and investment companies that have not designated a management company, and to avoid related fragmentation, inconsistency and unpredictability in the functioning of the internal market, the rules regarding the integration of sustainability risks should also apply to investment companies, taking into account the principle of proportionality'.

[33] Art. 5a of Directive 2010/43/EU.

2010/43/EU now consider sustainability risks as a separate risk category. The risk management policy shall comprise such procedures as are necessary to enable AIFMs and UCITS ManCos to assess each AIF and UCITS they manage with regard to the exposure of their fund to market, liquidity, sustainability, and counterparty risks, and the exposure of the fund to all other relevant risks, including operational risks, which may be material for each fund they manage. Since sustainability risks, if quantifiable, were to be considered by AIFMs' and UCITS ManCos' risk management anyway, the new wording prompts the question of how risk managers shall deal with unquantifiable and vague risk types arising from environmental or social changes. It is not the function of professional risk managers to consider anecdotal risks as part of their function of managing risk. Similar to other risk categories, only quantifiable risks reasonably likely to occur shall feed into day-to-day operations. However, unquantifiable and rare risks may feed into the fund manager's stress test, and thus also feed into the fund manager's operating decisions regardless of any lack of data.

(3) Managers' Organization and Additional Resources

It goes without saying that the UCITS ManCos and AIFMs must have additional resources in their organization to effectively meet these requirements. With regard to sustainability risks, this is now explicitly stated in the new Art. 22 (3) AIFMR and Art. 5 (5) of Directive 2010/43/EU. Moreover, if the fund manager considers the impact of its assets on sustainability factors due to one of the cases laid down in Art. 4 SFDR, the same requirements will apply.

Furthermore, Art. 57 (1) AIFMR – defining the cardinal principles on the AIFM's organization as set out in Art. 12, 18 AIFMD – and Art. 4 (1) of Directive 2010/43/EU are extended to require that AIFMs and UCITS ManCos shall take into account sustainability risks when complying with the requirements laid down in Art. 57 (1) AIMFR and Art. 4 of Directive 2010/43/EU.

This broad reference means that AIFMs and UCITS ManCos need to consider sustainability risks, for instance, when setting procedures and designing the organizational set-up of the firm, to ensure that the relevant persons in the firm are aware of these procedures, to implement internal controls to ensure that these procedures are complied with, as well as to produce internal reporting and record-keeping pursuant to that goal. While this all must take place in a proportionate manner, the explicit mention of sustainability risks will require some amendments to the business plan and reporting routines of all fund managers in the EU/EEA.

Again, neither Art. 57 (1) AIFMR nor Art. 4 (1) of Directive 2010/43/EU mention the instances of Art. 4 SFDR; here, the same rationale as above applies – AIFMs and UCITS ManCos that consider the impact on sustainability factors of their investment decisions under Art. 4 SFDR must meet the same requirements in relation to their AIFs and UCITS.

Unsurprisingly for a new set of rules, a number of questions stem from these provisions. For instance, what does necessary expertise entail? Is the regulation's objective met if the fund manager relies upon some legal experts to supervise the portfolio manager's reporting or do the fund managers need to build up their own natural science expertise? For sure, beyond the general expectation that any person in a delegation arrangement must be able to understand and analyze the reports issued by the portfolio management function, in answering those questions the business model of a given fund manager must be taken into account: where portfolio management is delegated, human resources must be qualified and have specific skills to properly supervise the delegated function; in that respect, legal expertise may suffice.

On a different note, those rules also prompt the question in which case hiring external sustainability consultants would qualify as a delegation under the investment fund frameworks. A similar approach to data acquisition in the case of portfolio and risk management would lend itself to the provision of an answer:[34] mere data acquisition and provision of models as such would not entail the assigning of any delegation, but once the responsibility for the decision at stake is granted to a third party, we may well recognize the contract itself as a delegation arrangement.

Finally, where does the duty to consider sustainability risks end in the case of a data gap? Investment and risk management rests on a data-driven analysis of the risk scenarios; AIFMs and UCITS ManCos are required to access and gather data necessary for such quantitative analysis. If these data are not available, we would hold that the fund managers' duty ends where the data trail stops. Thus, we would argue in favor of an inherent limit to the fund managers' fiduciary duty relating to sustainability risks and the principal adverse impact on sustainability factors if the data to be considered are neither provided by the target investment, nor commercially available – that is, at least, as long as regulators exclude the use of estimates for reporting purposes; since what is not reported in a reliable manner may be considered in stress tests, but can hardly be the subject matter of quantitative risk management.[35]

(4) Conflicts of Interest

A new sub-paragraph has been added to Art. 30 AIFMR, implementing Art. 14 AIFMD and to Art. 17 of Directive 2010/43/EU on conflicts of interest; the new sub-paragraph states that when identifying the types of conflicts of interest, the existence of which may damage the interests of an AIF or UCITS, AIFMs and UCITS ManCos shall include those types of conflicts

[34] See Zetzsche and Eckner in Zetzsche, AIFMD, 3rd ed. 2020, on risk management.
[35] See infra, at IV.1., for a more detailed discussion.

of interest that may arise as a result of the integration of sustainability risks in their processes, systems and internal controls.

While the wording is somewhat imprecise, the provision seems to require the identification of those conflicts of interest resulting from an apparent short-term-oriented remuneration of the AIFM and UCITS ManCo or portfolio manager clashing with the investors' long-term interests to avoid a negative impact on the assets' value due to sustainability risks.

(5) Senior Management Responsibilities

The AIFM's and UCITS ManCo's senior management are now also responsible for the integration of sustainability risks in the general investment policy, investment strategies, valuation policies and procedures, compliance policy, risk management policy, and remuneration policy.[36] While not explicitly mentioned, it would again be awkward if the same responsibility would not follow from one of the cases referred to in Art. 4 SFDR that trigger the duty to consider the impact of the assets and investment policy of the AIFs and UCITS on sustainability factors.

c) Assessment

The new provisions on sustainability risk are, for the most part, merely clarifications given that all investment and risk managers considered the risks of changing ESG circumstances as they were quantifiable or otherwise sufficiently substantiated.

The main new elements of the April Package relate to the principal adverse impact (PAI) on sustainability factors: while the UCITSD L2 and AIFMR do not apply the principles consistently, we argue herein that in cases falling under Art. 4 SFDR, the AIFM and UCITS ManCo must apply the same requirements as with regard to sustainability risks to the impact on sustainability factors to all parts of their organization.

2. The drafts UCITSD VI and AIFMD II (25 November 2021)

On 25 November 2021, the European Commission published its proposal for a reviewed UCITSD (in the numbering of legislative efforts 'UCITS VI') and AIFMD ('AIFMD II').[37]

[36] Art. 60 AIFMR and art 9 of Directive 2010/43/EU.

[37] See European Commission, Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds, Brussels, 25.11.2021, COM(2021) 721 final 2021/0376 (COD).

a) Legislative Processes

The respective drafts are based on some legislative processes started in 2020.

In a letter titled 'Review of the Alternative Investment Fund Managers Directive' sent on 18 August 2020 to the European Commission, even the ESMA dealt with ESG issues, particularly from the reporting perspective.[38] The ESMA highlighted that currently the AIFMD reporting template does not contain any fields relating to ESG data; hence, the AIFMD review marks an excellent opportunity to add ESG factors in the reporting with a view to increasing transparency regarding environmental impacts while also taking into consideration social and governance aspects. In the ESMA's view, such an approach would be in line with the European Commission's Action Plan on Sustainable Finance as well as the ESMA Strategy on Sustainable Finance, and would also address the considerable interest of NCAs in having a common framework to monitor ESG metrics. As a possible solution, the ESMA recommended adding a reference in the AIFMD whereby ESG factors should be considered in the reporting with a view to monitoring ESG-related risks. Moreover, as the metrics used to assess ESG risks are evolving quickly and can be difficult to define, with the ensuring of consistency in mind, the ESMA deemed it preferable to avoid specifying overly detailed requirements in Level 1 legislation and suggested that the Directive could simply introduce a provision mandating the ESMA itself to develop additional technical standards from an AIFM perspective.[39]

The consultation document on the review of the Directive on Alternative Investment Fund Managers 2011/61/EU (AIFMD II), which was initiated in October 2020[40], then indicated what the inclusion of sustainability risks and factors could mean in practice. The AIFMD II consultation document devoted an entire section to ESG investing and sustainability, with reporting to regulators, investment decisions, and quantitative risk management being the key concerns.[41]

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[38] ESMA, Review of the Alternative Investment Fund Managers Directive', 18 August 2020.

[39] ESMA, Review of the Alternative Investment Fund Managers Directive', 18 August 2020.

[40] European Commission, Consultation document: Public consultation on the review of the alternative investment fund managers directive (AIFMD), 22 October 2020, https://ec.europa.eu/info/files/2020-aifmd-review-consultation-document_en.

[41] See European Commission, Consultation document: Public consultation on the review of the alternative investment fund managers directive (AIFMD), 22 October 2020, https://ec.europa.eu/info/files/2020-aifmd-review-consultation-document_en, at 49.

(1) Sustainability Reporting

As for the AIFMR regulatory reporting template, the consultation inquires as to whether a more detailed form of portfolio reporting, in particular on sustainability-related information, should become mandatory.[42] This could include risk exposures and/or the impact of sustainability risk on returns (or vice versa). Examples of enhanced reporting obligations include those on sustainability-related data, in particular on exposure to climate and environmental risks, and physical and transition risks (e.g., shares of assets for which sustainability risks are assessed, types and magnitudes of risks, and forward-looking scenario-based data).

(2) Investment decisions

Several questions deal with the addition of sustainability as one of the mandatory criteria to guide investment decisions.[43] These questions lead us to ask, for instance, whether:

- Regulation shall require the integration into the investment decision processes of any AIFM the assessment of non-financial materiality (i.e. potential principal adverse sustainability impacts) (Q91);
- AIFMs, when considering investment decisions, should be required to take into account sustainability-related impacts beyond what is currently required by EU law (such as environmental pollution and degradation, climate change, social impacts, and human rights violations) alongside the interests and preferences of investors (Q93);
- The EU Taxonomy Regulation should play a role when AIFMs are making investment decisions, and in particular those regarding sustainability factors (Q94); and
- Other sustainability-related requirements or international principles beyond those laid down in Regulation (EU) 2020/852 should be considered by AIFMs when making investment decisions (Q95).

(3) Quantitative risk management

As a third set of questions, the AIFMD II review asks whether the adverse impacts on sustainability factors should be integrated into the quantification of sustainability risks (Q92).

[42] European Commission, Consultation document: Public consultation on the review of the alternative investment fund managers directive (AIFMD), 22 October 2020, https://ec.europa.eu/info/files/2020-aifmd-review-consultation-document_en, at 77 et seq.
[43] See European Commission, Consultation document: Public consultation on the review of the alternative investment fund managers directive (AIFMD), 22 October 2020, https://ec.europa.eu/info/files/2020-aifmd-review-consultation-document_en, at 77 et seq.

In the course of introducing the questions put forward in the consultation, the Consultation Document points out that while the SFDR[44] does require financial services providers to integrate into their processes the assessment of all relevant sustainability risks that might have a material negative impact on the financial return of an investment, AIFMs are not currently required to integrate the quantification of sustainability risks. On these grounds, the consultation aimed to gather input to facilitate a better understanding and evaluation of the appropriateness of the AIFMD rules concerning the assessment of sustainability risks.[45]

b) Matters unrelated to Sustainable Finance

With this emphasis on sustainability being prominently displayed in the legislative consultations, one would have expected a further push for sustainability-oriented requirements being included in AIFMD II and UCITSD VI. However, the amendments finally proposed by the Commission relate to other key aspects of the UCITSD and AIFMD, namely: a) delegation; b) liquidity management; c) marketing of investment funds and d) loan origination (specifically for AIFs).

At first glance, most of these matters are unrelated to sustainable finance. For instance, the proposal would cause the rules on delegation to be applied to every regulated activity including ancillary services. Moreover, NCAs would be required to notify the ESMA in relation to delegation agreements whereby AIFMs delegate more risk and/or portfolio management activities to third-country entities than the ones they would retain.

With regard to liquidity management, AIFMs managing open-ended AIFs would be requested to adopt at least one liquidity management tool from the list embedded in Annex V, namely: i) suspension of redemptions and subscriptions; ii) redemption gates; iii) notice periods; iv) redemption fees; v) swing pricing; vi) anti-dilution levy; vii) redemptions in kind; and viii) side pockets. Furthermore, while NCAs would be given the power to require AIFMs of open-ended AIFs to either activate or deactivate certain liquidity management tools (such as suspension of redemptions or redemption gates) in times of stress, AIFMs would have to inform their NCA without delay if they were to activate or deactivate a liquidity management tool.

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[44] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector, OJ L 317, 9.12.2019.

[45] European Commission, Consultation document: Public consultation on the review of the alternative investment fund managers directive (AIFMD), 22 October 2020, https://ec.europa.eu/info/files/2020-aifmd-review-consultation-document_en.

As for marketing of AIFs under Articles 36 and 42, the references in the Directive to the FATF list of Non-Cooperative Countries and Territories would be replaced with references to the newly-introduced EU list of noncooperative tax jurisdictions.

Concerning loan origination, when AIFMs engage in lending activities, a number of new requirements would apply with a view to tackling risks typically arising from extending loans. Accordingly, AIFMs would be requested to implement policies, procedures, and processes for the granting of the loan. AIFs whose loans' notional value exceeds 60% of NAV would have to take the form of closed-ended funds, and loans granted to financial institutions would have to be limited to 20% of the AIF's capital.

c) Looking for Sustainable Finance

A search for the terms "sustainability" and "green" in the drafts UCITSD VI and AIFMD II reveals that they are used, all in all, only five times.

Firstly, this occurs when the European Commission stresses the convergence with the Capital Markets Union Action plan, by holding that '[i]n an efficient and effectively supervised CMU, loan-originating funds are able to provide an alternative source of financing to Europe's corporates and SMEs opening up their access to a wider range of competitively priced funding options. These funds have the potential to support directly job creation, economic growth, innovation, *green* transition and help recover from the Covid-19 pandemic. Loan-originating funds can also serve as a backstop or shock absorber when liquidity is constrained by continuing to provide loan financing when more traditional lenders have pulled back from the market. Therefore, the legislative proposals are aligned with the overall CMU strategy to continue building an internal market for financial services and making financing more accessible to European companies' (italics added by authors).[46]

Secondly, the European Commission posits that '[c]reating an internal market for loan-originating funds is expected to increase the availability of alternative sources of financing to the real economy. The activities of such funds in the credit market are likely to facilitate the transition to the *sustainable* future by investing in the *green* economy, therefore supporting broader objectives of the European Green Deal' (italics added by authors).[47]

Finally, the Commission states that '[i]t was considered whether to propose fewer measures for AIFMs managing loan-originating funds and leave the rest to the national discretion. Diverging national approaches to

[46] European Commission, SEC(2021) 570 final, sub 1., second indent ('consistency with existing policy provisions in the policy area').
[47] European Commission, SEC(2021) 570 final, sub 1., third indent ('consistency with other Union policies').

loan-originating funds, however, would risk not achieving the objective of supporting this sector's safe and *sustainable* development. Therefore, the retained option proposed a minimum number of safeguards for the funds activities and risk profiles' (italics added by authors). [48]

We note a discrepancy here between the Commission's far-reaching plans disclosed in the run-up to the AIFMD II review and the very modest sustainability ambitions in the draft proposals presented in November 2021. We assume that the decision to postpone the additional references to sustainability and ESG matters is attributable to a lack of evidence supporting such a step before the SFDR and its regulatory technical standards are finalized, implemented, and fully operational.[49] In particular, the European Fund and Asset Management Association (EFAMA) argued that the integration of principal adverse impacts and other non-financial considerations in the investment process should always depend on the investment objectives and preferences of fund investors. Extending this obligation to all fund management companies and potentially any product irrespective of the inherent investment features may cause the fund manager to act against its fiduciary duties towards the investors, if the latter do not refer to sustainability.[50] It seems that the Commission shared the EFAMA's position that the integration of sustainability risks into the UCITSD and AIFMD framework are first to be implemented in practice, before including and even expanding those considerations in the context of the UCITSD or AIFMD review.[51]

3. Intermediate Results

Despite significant attention being devoted in the consultation to ESG- and sustainability-related issues, the review proposals, published by the European Commission on 25 November 2021, substantially reduced their focus on this matter.[52] Indeed, references to sustainability are only made in

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[48] European Commission, SEC(2021) 570 final, sub 3., fourth indent ('impact assessment').

[49] European Fund and Asset Management Association, EFAMA's Response to the European Commission Roadmap on the review of EU alternative investment fund managers, 7 January 2021.

[50] European Fund and Asset Management Association, EFAMA's Response to the European Commission Roadmap on the review of EU alternative investment fund managers, 7 January 2021.

[51] European Fund and Asset Management Association, EFAMA's Response to the European Commission Roadmap on the review of EU alternative investment fund managers, 7 January 2021.

[52] See European Commission, Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds, Brussels, 25.11.2021, COM(2021) 721 final 2021/0376 (COD).

the description of the new rules on loan-originating funds, which are expected to support the green transition in line with the European Green Deal.[53]

In light of the plethora of legislative acts and, as we will show infra, the pertinent issues in the field of sustainable finance, the lack of attention afforded to sustainability is remarkable. We thus look, in the next part, for ways to further the sustainable transformation of the EU financial services in the UCITSD and AIFMD frameworks.

IV. THE PAIN POINTS– AND HOW TO ADDRESS THEM

Given the surprising silence of the AIFMD II and UCITS VI package on sustainability matters, we lay out in this section some of the challenges fund managers are facing in implementing the SFAP-related legislation and consider legislative and supervisory solutions thereto, with or without the support of (forthcoming) legislation.

1. Data gap

a) The Issue

A key issue for the implementation of the sustainability agenda is the fact that fund managers have been asked to report certain information (including non-financial information) and use that information to indicate the taxonomy alignment, or sustainability orientation, of financial products while the underlying companies themselves are not yet required to report the data which ought to inform fund managers' reporting. While we expect the EFRAG to develop a harmonized non-financial reporting system for non-financial companies, its development and implementation will only happen gradually, over the coming years.[54]

This sequencing issue leaves fund managers with significant operational challenges when attempting to calculate taxonomy alignment, or sustainability risks at large, for purposes of either the annual financial statements under Art. 8 of the Taxonomy Regulation, or the qualification of products under Art. 8 and Art. 9 SFDR. Irrespective of the asset manager's

[53] See European Commission, Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds, Brussels, 25.11.2021, COM(2021) 721 final 2021/0376 (COD).

[54] See Zetzsche, D., & Anker-Sørensen, L. (2022). Regulating Sustainable Finance in the Dark. *European Business Organization Law Review*, 1-39.

ambitions on environmental sustainability, the taxonomy alignment of the underlying investments will be rather low at least until 2023.

Furthermore, the dearth of data necessarily impacts on the efficiency of any quantified investment and risk management approach and thus undermines the new rules implemented through the April package.

The situation is even worse with regard to third-country target investments that either do not report sustainability data or report data under different reporting standards.

To show the scale of the problem, if only one datapoint on the 12/14 sustainability factors listed in the SFDR L2 annexes is missing, the target investment of the investment fund may not be classified as taxonomy-aligned. This would be the case regardless of whether that very datapoint is related to the business of the target investment or not. If, for instance, the target investment does not report the data since it has nothing to do with a given sustainability factor, the investment is nevertheless not aligned. In turn, fund managers would need to report that they cannot fully consider sustainability risks nor sustainability factors in their investment and risk approaches related to that asset and fund.

One of the solutions discussed in the fund industry is the use of estimates. Yet, the Commission has stated that this would not be permissible as part of the mandatory reporting used for calculating the taxonomy alignment under Art. 8 Taxonomy Regulation.[55] As a consequence, many fund managers will report a low Green Investment Ratio in Art. 8 reports, and need to understate their sustainability-related activities in financial reports pursuant to Art. 11 SFDR, thereby discouraging sustainable investment strategies in the first place.

b) Policy Proposal

We suggest tackling the sequencing issue with a dual approach.

[55] See European Commission, FAQs on reporting of Taxonomy-eligible economic activities and assets in accordance with the Taxonomy Regulation Article 8 Delegated Act, available at https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-article-8-report-eligible-activities-assets-faq_en.pdf, where question 12 reads: 'Can financial undertakings use estimates for Taxonomy-eligibility, when information is not available from the reporting firm in 2022?' and the Commission pointed that 'Eligibility-related disclosures of financial undertakings shall be based on actual information, provided by the financial or non-financial undertaking, per Article 8(4) of the Disclosures Delegated Act. In the case where an underlying undertaking has not yet disclosed its taxonomy-eligibility, a financial undertaking may choose to estimate the proportion of eligibility of economic activities as part of their voluntary disclosure. Such estimated values may only be reported on a voluntary basis and must not form part of the mandatory disclosures'.

On the one hand, we propose making sustainability data accessible as fast as possible by way of the Single European Access Point Action Plan.[56] This way, the joint financial supervisors assist in making data that are available accessible to financial intermediaries.

On the other hand, until sufficient data are made available through the Single European Access Point, we suggest a phasing-in approach that would temporarily allow the use of estimates under conditions that prevent circumvention and greenwashing: the ESMA, or the Joint Supervisory Committee of the ESAs, as the case may be, by way of guidelines, should permit the use of estimates for the application of both the Taxonomy Regulation and SFDR, under the condition that the reporting entity can explain why it cannot use bottom-up data, and further lays out the basis on which the respective data were estimated. The ESMA may also put forward restrictions on the use of own estimates if official estimates are available. This would allow, for instance, reliance on official estimates given by public bodies, including environmental ministries, for any given sector or country.

To support this step, the ESMA, or the Joint Supervisory Committee of the ESAs, as the case may be, should also further the use of simple assumptions. For instance, in the absence of any reporting to the contrary, it may be permissible to assume that any firm in the European Economic Area complies with the social and governance factors being considered as part of the sustainable investment test under Art. 3 and Art. 18 Taxonomy Regulation and Art. 2 (17) SFDR.

We further note a contradiction where there is a prohibition on using estimates for mandatory reporting, while relying on index investing is permissible, and perhaps even encouraged, by EU law. This contradiction stems from the fact that, to a large extent, index providers fill gaps by relying on more or less substantiated estimates. This may explain why the European Commission fell pressed to allow the use of own assessments and estimates in exceptional cases where financial market participants cannot reasonably obtain the information needed to reliably determine the alignment of their investments with the technical screening criteria defined in the Delegated Regulation on climate change.[57] Such cases relate to economic activities carried out by undertakings that are not subject to the Taxonomy Regulation and its Delegated Act on climate change.[58] Yet the

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[56] See European Commission, Targeted consultation on the establishment of a European single access point (ESAP) for financial and non-financial information publicly disclosed by companies, available at https://ec.europa.eu/info/consultations/finance-2021-european-single-access-point_en.

[57] European Commission, Questions related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR), May 2022, available at https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf.

[58] European Commission, Questions related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures

exception is granted only exceptionally and for those economic activities, using complementary assessments and estimates on the basis of information from other sources.[59] These strict conditions hardly meet the need to allow for estimates until most investee companies disclose data on Taxonomy alignment.

We thus propose that the use of estimates shall be allowed if the estimate is provided by entities seen as reliable for index provision by EU financial regulation (i.e. the benchmark administrators regulated under the Benchmark Regulation).

Once the FSAs of the Member States find that sufficient data are available, for any or all data points, the ESMA, or the Joint Supervisory Committee of the ESAs, as the case may be, may revise its policy and restrict the use of estimates for all or any specific sustainability factor(s).

2. Lack of Models on Double Materiality

a) The Issue

Around the world, regulators so far have focused on integrating what EU law calls 'sustainability risks' into financial regulation. The EU SFAP's double materiality standard is more innovative: to our knowledge, no other financial regulation worldwide had previously required disclosures on mere externalities from issuers and product originators as Arts. 4, 6, 8, and 9 SFDR and the fiduciary duty rules of the UCITSD and AIFMD L2 of the April package require.[60]

However, such degree of legislative innovation also creates many challenges. Professional investment entails the allocation of financial resources according to well-reasoned models and processes. Integrating externalities requires modelling, empirical testing, and adopting sound processes on how to integrate these externalities into investment and risk policies.

Beyond mere exclusionary factors (such as a high listing of a given country on a corruption index), developing models to answer questions like the extent to which some low degree of externalities (e.g. a low degree of

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in the financial services sector (SFDR), May 2022, available at https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf.

[59] European Commission, Questions related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (SFDR), May 2022, available at https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf.

[60] See Zetzsche, Bodellini and Consiglio, The EU Sustainable Finance Framework in Light of International Standards (Working Paper, 2021), www.ssrn.com/abstract=3984511.

greenhouse gas emissions) are permissible when sufficiently compensated by a strong financial performance, will keep investment and risk managers busy for years.[61] The lack of models exacerbates the significant uncertainty surrounding the quantification of impact investing[62] – which is another crucial cornerstone of showing the positive effects of sustainable investments.

b) Policy Proposal

The need to consider externalities is not only a crucial component of the EU SFAP, but also the logical consequence of product manufacturers marketing funds claiming that the implementation of their investment policy would do some good with respect to environmental or social objectives. Yet, we ask for a longer phasing-in period that would allow for the better testing of models prior to their implementation in investment and risk management becoming binding.

The main reason behind the introduction of this phasing-in period is that all current models could not be tested with data on externalities provided by the target companies, simply because these target companies have not yet had to disclose these data in the first place (see supra, IV.1.). In turn, all models – which under the existing legislation will be applicable from 1 August 2022 – are untested under real data conditions. Accordingly, their formal implementation and disclosures thereon (as part of Articles 4, 6, 8, or 9 SFDR) are either absurdly risky or misleading in that fund managers and portfolio managers will need to revise their models several times over the next few years as more data become available for backward testing.

Instead, we would ask financial supervisors to encourage fund managers and portfolio managers to perform experiments with models and describe, in lieu of binding disclosures, the nature and scale of their experiments, including insights and limitations. The same approach must be pursued when FSAs ask external auditors to review compliance with the April package rules.

While this approach might sound surprising, it is a mere consequence of the current 'state of ignorance' in which we find ourselves.[63] Regulators and fund managers need to acknowledge that they know very little about how to integrate externalities into their models, and

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[61] See Zetzsche, D., & Anker-Sørensen, L. (2022). Regulating Sustainable Finance in the Dark. *European Business Organization Law Review*, 1-39.
[62] Some proposals have been lately advanced, see Andrew W. Lo and Ruixun Zhang, Quantifying the Impact of Impact Investing, Working Paper, October 2021, available at SSRN: https://ssrn.com/abstract=3944367 or http://dx.doi.org/10.2139/ssrn.3944367.
[63] See Zetzsche, D., & Anker-Sørensen, L. (2022). Regulating Sustainable Finance in the Dark. *European Business Organization Law Review*, 1-39.

developing good models takes time and requires good data if the models are truly to guide the investment and risk approaches of the industry.

3. Human Resources

a) The Issue

Another difficulty fund managers face today is the availability of human resources that have sufficient sustainability expertise. This is particularly true for small- and medium-sized fund managers that cannot compete with the salary levels of global investment firms. This challenge stands at odds with the terms of the April Package that requires a fast building-up of expertise and resources in the field.

b) Policy Proposal

We propose applying the proportionality principle, with specific respect to the business model of any given fund manager. From that perspective, showing resources somewhere in the investment chain for any given function may temporarily suffice to meet the requirements of the April Package.

For instance, if a fund manager focuses on risk management and delegates portfolio management to an investment firm inside the EU, both the fund manager and the investment firm are subject to the same requirements for the same functions (i.e. portfolio management and risk management). This amplifies the need to build resources at a time where resources are scarce and the financial industry struggles with the implementing costs imposed by the sustainability agenda.

In sum, we propose asking fund managers to show that, for any given function, the resources required by the April Package are in place and operational somewhere in the investment chain. This would require the fund manager to focus on resources in the field of risk management, while the investment firm could focus on portfolio and investment management.

Again, this approach should be limited in terms of time and reassessed once all steps regarding sustainability transformation are in place.

As an alternative, or cumulatively, some would prefer more lenient outsourcing arrangements to deal with organizational requirements. This may be permissible for small firms and a few medium-sized firms with little sustainability exposure. However, in principle, we hold that the core functions of any fund management firm should be represented and fulfilled by in-house staff.

4. Costs and gaps of the Taxonomy approach: the matter of compensation

a) The Issue

Another widely recognized issue is that the handling of the Environmental Taxonomy is costly in many respects. In particular, the Taxonomy is extremely granular and lacks a sensible approach that allows for a cost-efficient application. For instance, the Taxonomy asks, as part of its do-no-significant-harm conditions, for the calculation of water use for any given toilet, shower, and other water-using devices,[64] rather than setting an average use of water per capita or square meter. Again, stepping over the limit for any given toilet and shower renders the whole project unsustainable (*rectius* non-taxonomy aligned), even if the property overall uses less water than would be the case if any specific standard was adhered to.

This granular approach in regulation is anti-innovative and increases costs to the extent that it does not allow for cost-efficient compensation measures. In times of sky-rocketing building costs, rising interest rates, and increasing inflation, any cost-enhancing measure that does not truly further sustainability objectives is beyond comprehension. If complying with sustainability standards is overly costly, the real economy will look for ways of financing that are less Taxonomy-sensitive, which will gradually render the Taxonomy obsolete in favor of other sustainability benchmarks. The framework is made even more complicated by the overlaps as to the concept of sustainable investment between the Taxonomy Regulation and the SFDR.[65]

b) Policy Proposal: Facilitating Compensation Measures

We propose that EU legislators state clearly, by way of legislation, that compensation measures are permissible and do not lead to the disqualification of any investment as Taxonomy-unsustainable. Moreover, we encourage the development, through the EU Sustainable Finance Platform, of frameworks in which such compensation may take place. For instance, if the water limit set for toilets, urinals and showers together leads to a set use of water per capita per annum, under sensible criteria the publication of such data would further advance the efficiency of compensation measures.

As to the overlaps between the Taxonomy Regulation and the SFDR with regard to the concept of sustainable investment, we have somewhere else discussed the introduction of a scorecard system which could help fix

[64] See Annex 1 to Climate Delegated Act on construction of new houses.
[65] See EUROSIF, EU Sustainable Finance & SFDR: making the framework fit for purpose - Eurosif Policy Recommendations for Article 8 & 9 product labels, June 2022, at 3.

the inconsistencies between these two legislative acts, while tackling the risk that economic activities (and investments thereof) that do not meet the strict requirements of the taxonomy but still provide a positive contribution to social or environmental objective are properly recognized.[66]

5. Legal Uncertainty

a) The Issue

The current sustainability framework suffers from legal uncertainty in many regards. For instance, the distinction between funds that qualify under Article 8 SFDR and funds that do not qualify for that purpose is uncertain. The initial idea was that the art. 8 product category would include a relatively large number of funds with a host of different investment strategies, while these products were meant to foster the transition to a more sustainable business model and to re-direct flows of investment to sustainable activities. Yet the texts of both L1 and L2 legislation have been interpreted differently by the interested stakeholders, namely asset managers, investment firms, legal consultants, auditors and to a certain extent NCAs. The ESMA in its sustainable finance roadmap 2022 – 2024 has identified the main uncertainties in this regard and announced that it will look into this issue as such uncertainties could facilitate greenwashing.[67]

In our view, the following are the most critical points. Specifically, does it suffice for funds to exclude certain assets in their investment policy to qualify under Art. 8 SFDR? Regulatory guidance has suggested that this is indeed the case,[68] and the L2 SFDR standards seem to be similarly designed if the exclusion is integrated into the fund's investment policy.[69]

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[66] See Zetzsche, Bodellini and Consiglio, Towards a European Social Taxonomy: a Scorecard Approach, (Working Paper, 2022).

[67] ESMA, Sustainable Finance Roadmap 2022-25, 10 February 2022, ESMA30-379-1051.

[68] See European Commission, Question related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Sustainable Finance Disclosure Regulation 2019/2088), at 7-8, available at https://www.esma.europa.eu/sites/default/files/library/sfdr_ec_qa_1313978.pdf, where it is underlined that 'nothing prevents financial products subject to Article 8 of Regulation (EU) 2019/2088 not to continue applying various current market practises, tools and strategies and a combination thereof such as screening, exclusion strategies, best-in-class/universe, thematic investing, certain redistribution of profits or fees'.

[69] Recital (11) of the European Commission Delegated Regulation of 6 April 2022, discussing product categorisation and disclosures under SFDR, states 'Financial market participants should therefore only disclose those criteria for the selection of underlying assets that are binding on the investment decision-making process, and not criteria that they may ignore or override at their discretion.'.

On a different note, the supplement of the MiFID implementing rules as part of the April package requires the provision of certain sustainability information by product manufacturers to product-distributing investment firms. Yet, many investment funds, in particular special funds, are not distributed, but rather set up for a given group of institutional investors. Do the fund managers then have to provide distribution-related information (in particular by making the European ESG Template available)?

Here, as in other respects, the authors of the official guidance should be careful regarding the practical consequences of the suggested legal position in light of market practice. For instance, concerning the exclusion of ESG factors, we are not aware of any investment fund manager that does not exclude certain investments for social and governance reasons. As an example, no EU fund manager will find itself ready to invest in countries or companies that, with certainty, exploit child labor. As an effect, several, if not all, investment funds would qualify under Art. 8 SFDR.[70] This effect is surprising in light of the fact that Art. 8 SFDR does not require to list assets in which funds cannot invest for ESG reasons, but rather qualifies a fund as 'Art. 8 fund' if ESG factors are used for "promotional purposes". At the same time, the strict interpretation of Art. 8 SFDR that treats any exclusion sufficient to qualify a fund as Art. 8 fund exposes product manufacturers to the sort of greenwashing accusations currently hotly debated (and partially enforced) in a number of Member States. [71] Moreover, the current focus of EU legislators on avoiding circumventions runs the risk of pouring the baby out with the bathwater as no differentiation or market signal could be achieved by qualifying all (or most) funds as Art. 8 SFDR funds. Interestingly in this regard it has been observed that a significant number of

[70] As of 31st March 2022, 31,5% of funds available in the EU (excluding money market funds, funds of funds and feeder funds) were classified as either Article 8 SFDR funds (27,9%) or Article 9 SFDR funds (3,6%). In terms of assets under management, the two groups accounted for an even larger share of the EU market, amounting to 45,6% of the total assets under management. Article 8 SFDR products alone accounted for 40,7% of total assets under management, while Article 9 SFDR products accounted for 4,9% total assets under management. In terms of monetary value, the combined assets under management of Article 8 SFDR funds and Article 9 SFDR funds amounted to EUR 4,18 trillion, see Morningstar Direct. Data as of 31 March 2022 - Based on SFDR data collected from prospectuses on 96% of funds available for sale in the EU, excluding money market funds, funds of funds, and feeder funds.

[71] See EUROSIF, EU Sustainable Finance & SFDR: making the framework fit for purpose - Eurosif Policy Recommendations for Article 8 & 9 product labels, June 2022, at 3, where on these grounds it is observed that a clearer differentiation between product categories, namely art. 8 fund and art. 9 funds, is required to ensure that financial markets participants can classify their investment products appropriately and in a manner that properly explains the characteristics of the products concerned. Accordingly, minimum requirements should be set for products complying with Article 8 and 9 SFDR.

products qualified as Art. 8 or 9 SFDR funds still have relatively high and increasing exposures to activities related to fossil fuels.[72]

In a similar vein, what purpose does distribution-oriented sustainability information serve if a given fund is not distributed? In these and other cases, a purpose-based interpretation that limits distribution-related or promotion-related information to funds that are promoted and distributed (in contrast to set-up upon demand by a given institutional investor) would reduce costs without limiting the sustainability impact of the rules in question: we can safely assume that any information necessary for the said institutional investor will find its way to that investor, due to contracting between the fund manager and said investor.

b) Policy Proposal

Legal uncertainty is inherent in any newly-adopted piece of legislation, and the efforts made by EU regulators to provide legal certainty are laudable. Yet, EU lawmakers could distinguish more clearly between 'binding' and 'non-binding' opinions to give the market more room for experimentation. This could be achieved by discussing the pros and cons more clearly in a given statement, and by laying out the options for supervisors and supervised entities, thus assuring them that various interpretations are permissible for now. Again, after a period of experimentation and re-assessment, the number of permissible options may be reduced. While this step would be uncommon for top-down financial supervision, it would reflect the innovative nature of the EU's sustainable finance strategy and the fact that no blueprint guides EU regulators in integrating a 'double materiality standard' for the whole EU financial industry.

6. National Fragmentation

a) The Issue

Several EU Member States have issued 'clarifications' on their own interpretations of sustainability-oriented EU financial rules. For instance, the German BaFin has issued statements on sustainability risk management and is consulting on an ordinance relating to sustainability-oriented investment funds.[73] Furthermore, between March and July 2020, the French Autorité des Marchés Financiers (AMF) published a Recommendation on

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[72] EUROSIF, EU Sustainable Finance & SFDR: making the framework fit for purpose - Eurosif Policy Recommendations for Article 8 & 9 product labels, June 2022, at 9.

[73] BaFin, BaFin starts consultation on its Guidelines on sustainable investment funds, Press Release, 2 August 2021, https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/2021/pm_210722_Nachhaltigkeitsleitlinien_en.html.

the 'Information to be provided by collective investment schemes incorporating non-financial approaches.' This Recommendation, which applies to all French AIFs and UCITS as well as non-French UCITS authorized to be marketed to French retail investors, is aimed at preventing greenwashing by requiring that information provided to investors regarding a given fund's consideration of non-financial characteristics (e.g. ESG criteria such as responsible, sustainable, ethical, or low-carbon investing) is proportionate to the actual consideration of these factors.[74]

These statements may be understood as gold-plating in the sense that they add extra perspectives of the Member States' regulators to European requirements and provisions.

While these additional national rules and requirements apply to fund managers or investment funds, respectively, residing in the given Member State only, they also erect a barrier to the cross-border provision of services in three respects. Firstly, if the investment fund is located in a Member State different than that of the fund manager, the product rules of the investment fund's Member State also apply. If one set of rules diverges from the other, this imposes additional costs on the cross-border provision of services. This is particularly true in light of the fact that some Member States (e.g. Germany) apply a very broad view as to which rules in the AIF domain belong to the product and which belong to manager regulation. Secondly, investors are facing a fragmented set of disclosures and manager rules and must invest in understanding such differences at a time where all resources should be devoted to the proper implementation of the SFAP framework. Thirdly, under Art. 43 AIFMD, Member States are entitled to impose product rules for retail AIFs. If fund managers want to distribute retail funds across borders, they need to meet all of the relevant local rules on top of the EU regulations.

b) Policy Proposal

We propose addressing the issue in two ways. On the one hand, we encourage a stronger role being played by the ESMA and the ESA Joint Committee in harmonizing EU law requirements through guidelines and supervisory releases where necessary to ensure investor protection. This may result in a new retail fund regulation (or an ESMA guideline to the extent that concerns interpretation of EU law) on 'sustainable AIFs.'

On the other hand, where the views of the Member States' FSAs diverge on any sustainability-related topic, we favor taking the same approach that we have proposed above for statements made by the European Commission and other legislative bodies: we encourage the ESMA, or

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[74] The document consists of eight 'positions' (five of which relate directly to nonFrench UCITS) and 10 recommendations to define the clear, accurate and non-misleading nature of information to be disclosed.

ESAs as the case may be, to ensure that there is transparency on the various interpretations, paired with a statement that, for a phasing-in period, several interpretations are permissible and seen as compliant. These matters may be assessed and streamlined at a later point in time, acknowledging for the time being that 'now' is not the best time to adopt rigid rules.

7. Loan-originating Funds

Although no specific provision as to sustainability has been included in the AIFMD II Review Proposal, a sustainability-related issue relating to loan-originating funds has been spotted by some large impact-investing firms in a joint paper titled 'The European Commission's Proposal Amending Directive 2011/61/EU Alternative Investment Fund Managers.'[75]

a) The Issue

The issue relates to Article 16(2a) of the Proposal, which requires that AIFMs shall ensure that the AIFs they manage be closed-ended funds if the notional value of their originated loans exceeds 60% of their net asset value. Such a provision is expected to directly affect the activities of private-debt-focused impact-investing funds holding a significant portfolio of loans granted to private enterprises in developing economies to promote financial inclusion, the sustainable agri-food value chain, and other sustainable investment objectives. Such funds are often referred to as debt impact investing funds (DIIFs). DIIFs make an important contribution to the achievement of the European Commission's Action Plan on Financing Sustainable Growth[76] and the UN's Sustainable Development Goals.[77]

Most DIIFs are structured as open-ended funds following sophisticated investors' demands and preferences. Should the aforementioned Article 16(2a) of the Proposal become effective, existing open-ended DIIFs would have to (i) change their fund structure (transforming into closed-ended funds), (ii) dilute their loan portfolios to bring it below the threshold of 60% of their NAV, or (iii) cease their activities entirely, as the Proposal does not provide for a grand-fathering

[75] BlueOrchard - Developing World Markets - Finance in Motion - Incofin Investment Management - MicroVest - ResponsAbility Investments - Symbiotics - Triodos Investment Management - Triple Jump, Joint Position Paper re The European Commission's Proposal Amending Directive 2011/61/EU Alternative Investment Fund Managers (Procedure 2021/0376/COD).

[76] EUROPEAN COMMISSION, ACTION PLAN: FINANCING SUSTAINABLE GROWTH (3 Mar. 2018), COM/2018/097 final, https://eur-lex.europa.eu/legalhttps://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097content/EN/TXT/?uri=CELEX:52018DC0097.

[77] https://sdgs.un.org/goals.

regime. In the drafters' opinion, transforming open-ended DIIFs into closed-ended funds would be virtually impossible as most investors (in particular retail investors or third parties that distribute such funds to retail investors or act on behalf of retail investors) would likely not be interested in investing in funds with lock-in periods. On the other hand, diluting the loan portfolio by adding other types of asset could make the impact and return proposition unattractive to investors, and potentially could also affect compliance with Article 9 of the SFDR. Furthermore, obviously any future initiative aimed at developing new open-ended AIFs with a loan portfolio exceeding 60% of their NAV would be ruled out.

c) Policy Proposal

Three alternative policy proposals could be considered to tackle such an issue. First, the scope of application of the proposed Article 16(2a) AIFMD could be limited to those AIFs that originate loans with the sole purpose of selling them immediately after the origination on the secondary market. Secondly, an exception to the application of Article 16(2a) AIFMD could be introduced and reserved for financial products falling under the scope of Article 9 of the SFDR. Finally, it could be decided to forego such a rule altogether and instead, tighten the risk management rules applicable to open-ended funds under Article 15 AIFMD and AIFMR.

We find this example insightful to the extent that apparently well-meaning, pro-sustainability-related regulation often has the contradictory effect in light of the particularities of the very market practice to be regulated: disrupting the business model of DIIFs was clearly not intended by the drafters of the AIFMD II, yet an rigid, overly detailed approach may have that very effect. This example again may function as a note of caution that in times of rapidly changing financial and sustainability regulation, the costs of too many details are real, while the risks to be addressed by a given detail of regulation could often be addressed by more broadly drafted, more proportionate and less intrusive means.

V. CONCLUSION: TOWARDS SANDBOX THINKING

The SFAP as well as the Revised Sustainable Finance Strategy of 2021 have created a number of difficulties from the perspective of EU investment fund law and regulation, and impose challenges for the EU investment fund industry as a whole. These difficulties in some respects (like the dearth of data) hinder the proper application of EU investment fund law in its entirety, while in other respects they create unnecessary uncertainty and fragmentation or impose additional excessive costs on the industry. These aspects together create an incentive to apply the new sustainability rules formally, rather than contributing to the EU lawmakers' mission of making the EU financial services sector sustainable.

While there is significant legislative action at EU level, none of the recent activities address the pain points created by the already-existing sustainability-oriented legislation.

The main barrier we have identified herein is an unrealistic assessment of the industry's capability to implement and absorb a plethora of rules which are, in many respects, adopted in haste and which, upon closer inspection, bear many technical deficiencies. Attributable to this sorry state of EU financial law, we have pointed to the fact that politicians have responded to a sustainability crisis when drafting the SFAP and the Revised Sustainable Finance Strategy of 2021 in an overzealous manner. As legal experts have known and warned: 'crises make bad law.'

However, many of the technical deficiencies can be fixed if regulators acknowledge the experimental nature of the SFAP and its follow-up policies. There was no blueprint for the SFAP and its related implementation of a 'double materiality' standard in EU financial law. Much of the legislation is untested, deficient, and incomplete. Lawyers know well that newly-adopted legislative concepts routinely follow a path of 'trial and error.'

In light of this, we encourage EU and national legislators to adopt an approach which we call 'sandbox thinking' which, during a transition period characterized by rapid legal (and technical) innovation, entails mutual learning by regulators and industry alike. Regulators and fund managers should acknowledge they know little about the substance at hand, regulators should apply caution before issuing binding rules or supervisory positions, while at the same time encouraging valuable experiments with different legislative interpretations of EU law as well as gathering data on their effects. In particular, 'sandbox thinking' would allow for (1) the granting of longer phasing-in periods in which multiple legal views are accepted, (2) the use of estimates to supplement hardcore bottom-up data, and (3) a more lenient, objective-focused view on resources and organizational requirements.

All of the former positions may and shall be reassessed at a later point in time, by which the learning curve by regulators and industry has been clearly established and a rigorous data-gathering exercise has been undertaken by financial regulators showing the upsides and challenges of each approach. In the absence of sandbox thinking, we fear that the many deficiencies, the untested effects of the new financial legislation, and the overly ambitious short-term political approaches are likely to hamper, if not altogether stop, the transformation of EU financial services towards greater sustainability. Here, with regard to sustainability, the old adage that *some* progress is better than *none* holds true.