

# ESG drives growth within Luxembourg's investment funds industry

**Marcel Bartnik** and **Irina Stoliarova** of **GSK Stockmann** discuss Luxembourg's fund industry including the trends driving its growth and the hurdles to overcome

Luxembourg continues to be the leading hub for the establishment of investment funds in Europe. Despite the COVID-19 pandemic, Luxembourg has seen a continued growth of the assets under management (AUM), increasing to the staggering amount of €5,248.971 billion as at the end of March 2021, which shows a continuous and stable growth and development in the market.

One of the current trends driving growth and development in the Luxembourg fund industry is sustainable finance.

In February 2021, the credit rating agency Moody's acknowledged this trend by certifying Luxembourg's good environmental, social and governance (ESG) performance with a triple-A rating, for the first time ever. The positive ESG credit impact score given to the Grand Duchy reflects low exposure to environmental and social risks, top-performing governance as well as a very high capacity to respond to market disruptions and, of course, continued efforts in this area by the government and the market players.

In the context of a global shift towards sustainable finance, driven not least by an ambitious regulatory agenda in the EU, Luxembourg has taken and continues to take the leading position in the development of new products and services. It can be argued that we are now at the start of a new era of complete reshaping of finance and redirection of private capital towards greener and more sustainable environmental objectives and investments.

The main drivers towards the ESG liquidity flows redirection are: (i) investor demand, based on a changing 'mindset' towards sustainability in general; (ii) political and regulatory pressure; and (iii) reputational considerations.

This trend is expected to continue and accelerate in the near future. This is, however, not without some challenges.



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risks, the consideration of adverse sustainability impacts and the provision of sustainability-related information.

The set of disclosure requirements introduced by the SFDR concern two different levels: entity level (i.e. applicable at the level of the managers such as AIFMs), and product level (i.e. applicable at the level of AIFs, UCITS, separate accounts).

Since March 10 2021, the SFDR-related disclosures have to be complied with by financial market participants. In particular, financial market participants need to publish the following on their websites:

- How they integrate sustainability risks into investment decision-making processes;
- Whether or not they consider principal adverse impacts that their investment decisions may have on sustainability factors;
- How remuneration policies take sustainability risks into account; and
- ESG information about the investment funds themselves, such as disclosures in offering documents and prospectuses.

Moreover, for the first time ever, different categories of financial products are defined depending on the level of ESG compliance, and which are subject to additional disclosure requirements: There is the so-called 'Light Green Product' or 'Article 8 Product' – which only promotes environmental or social characteristics (or a combination of those characteristics).

There is also the so-called 'Dark Green Product' or 'Article 9 Product', that has sustainable investment as their principal objective. Those types of products have to comply with additional product level disclosures in comparison to so-called 'neutral products', sometimes referred to as 'Article 6 Products' and that do not take any ESG aspects into account.

It is important to highlight that as of now, mandatory transparency disclosures have to be complied with by financial market participants only on a best effort basis, given that the level 2 measures – so-called Regulatory Technical Standards (RTS) that were expected to provide detailed formal and technical guidelines on how to implement the above requirements in practice – are not yet applicable.

In February, only a few weeks before the March 10 2021 SFDR application

## What is the SFDR?

The EU Sustainable Finance Disclosure Regulation, 2019/2088 (SFDR), was adopted at the end of 2019 and amended by the EU Taxonomy Regulation, 2020/852 (Taxonomy Regulation) in 2020. The implementation process of the SFDR has completed its first step of its long-time journey, consisting in the

mandatory application of high-level principle-based requirements under the SFDR as of March 10 2021.

The SFDR requires investment fund managers such as AIFMs, UCITS management companies and investment firms (financial market participants), to comply with harmonised rules on transparency with regard to sustainability

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deadline, the final report including the latest draft RTS was published. The draft RTS, however, has not yet endorsed by the EU Commission. It is now expected to apply as of January 1 2022, considering that the European Parliament or the Council may still object to the content, meaning that the final RTS may still be slightly different from the current draft.

This situation created challenges for the financial market participants: While they were obliged to apply the SFDR disclosure rules, in the absence of finalised RTS it was not clear which level of detail to disclose, or for example which sustainability factors should be considered.

It is also worth mentioning that the interpretation of the SFDR itself raised a number of questions and uncertainties. Some of these were even raised by the European Supervisory Authorities (ESAs) in a letter from January 2021 to the EU Commission, where five main issues related to the interpretation of the SFDR were identified. At present such letter remains unanswered.

At the end of February 2021, the ESAs issued a statement on the application of the SFDR during the interim period from March 10 2021 to the application date of the final RTS.

The ESAs recommended that the financial market participants should use the February RTS as a starting point, and encouraged them to use that interim

period to prepare for the application of the RTS. The *Commission de Surveillance du Secteur Financier* (CSSF), responsible for financial regulation in Luxembourg, followed such recommendation in a communication to the Luxembourg fund industry.

### What is next?

The March 10 2021 deadline is just the first step of a long-term sustainable finance journey, and of the SFDR implementation.

One important next step is obviously the finalisation of the RTS. These provide detailed rules on the content, methodologies and presentation of disclosures under the SFDR. That includes, for example, rules on how the statement relating to potential adverse impacts on sustainability factors should be published on an entity’s website; or how disclosures for Article 8 and 9 Products should look like in the offering documents and prospectuses. They also contain mandatory templates to be used by financial market participants in order to meet the disclosure obligations required under the SFDR.

Compliance with those RTS, once finalised, will be the next hurdle for the industry. The new disclosure rules will require huge amounts of ESG data which is currently not available. For example, the data necessary to disclose information

about each mandatory sustainability factor set out in the current draft RTS would need to be collected about every portfolio item of an investment fund.

For big parts of entire asset classes this data simply does not exist, and will be difficult to obtain in particular if the investment targets are not located in the EU. In time, this can be expected to change, but in the meantime the critical lack of data is something that has to be dealt with.

Another challenge is the timing of when periodic reports about ESG information have to be made available. Currently, these reports have to be made available in January 2022 for the year 2021. The problem with that timing is that the RTS are supposed to define mandatory templates to be used for such reports.

In the absence of a final version of the RTS, the financial market participants will have to use the current versions for the year 2021, knowing these may still be subject to changes. Also, the ESG reporting obligation only applies as of March 2021, and it is unclear how the time before the entering into force of the SFDR should be dealt with.

The more pragmatic approach would be to only start these reporting duties in 2022, and while this is likely to be adopted in the final RTS, there can be no guarantee for this. Therefore, it seems like

## *“There are multiple challenges for investment funds, their managers and initiators linked to compliance with ESG related rules.”*

a good idea to use the current interim time to identify (and try to collect) the required data for the reporting, and to put in place workflows and teams to deal with this.

Another aspect that should not be overlooked in this context is that, depending on the location of the fund initiators and managers, it might be necessary for them to comply with several regulatory standards for ESG disclosures at the same time, and which are not identical. An example would be an investment fund that is based in the EU but also distributed in the UK, US or Asia, as it can be expected that all those regions will develop their own ESG disclosure requirements applicable to financial products.

### **Impact of the Taxonomy Regulation on the SFDR**

Finally, another impact on the SFDR is linked to additional sustainability-related disclosures introduced by the Taxonomy Regulation in pre-contractual and reporting documents in relation to Article 8 and 9 Products. The Taxonomy Regulation is, in principle, a set of rules that is independent from the SFDR. However, for the definition of the environmental aspect (the ‘E’ of ‘ESG’ in this context), the SFDR refers to the Taxonomy Regulation.

In addition, the Taxonomy Regulation provides for disclosure obligations in relation to ecological aspects for the aforementioned two new ESG fund categories. By way of example, it defines for Article 9 Products what could be considered as an environmental objective that such product could contribute to; for Article 8 Products, the Taxonomy Regulation obliges them to publish a disclaimer in the sense that the ‘do not significantly harm’ principle applies only to investments that comply with EU criteria for environmentally sustainable economic activities.

These disclosure requirements resulting from the Taxonomy Regulation will apply as of January 1 2022 with regard to the first two environmental objectives (climate change mitigation and adaptation), and as of January 1 2023 for the other environmental objectives.

These additional deadlines and compliance requirements from different regulatory texts add complexity for fund managers and initiators. As a reaction thereto, a consultation process on consolidated regulatory technical standards for disclosures based on both the Taxonomy Regulation and the SFDR has been started at EU level. It is expected that these consolidated RTS should be endorsed soon in order to be applicable as from January 1 2022.

### **Outlook**

There are multiple challenges for investment funds, their managers and initiators linked to compliance with ESG related rules. Uncertainty of interpretation, lack of finalised guidelines, multiplication of only partially coordinated legislative texts, various deadlines that have to be complied with and lack of available data that is necessary to comply with the disclosure requirements are not to be taken lightly.

One can add to this the general tendency over the last years to significantly increase the granularity and level of detail in applicable rules, resulting in regulations and RTS that are extremely voluminous and often difficult and time consuming to absorb and monitor. Last, but not least, staff with expertise in this sector have to be identified, hired or trained.

On the other hand, it is clear that these rules are here to stay, and that sustainable finance is a long-term trend with significant opportunities for the fund industry. Mitigating the above challenges should therefore be the strategy, by getting familiar with the new rules and taking steps to implement them as far as possible. Those that are able to do so in a cost-efficient manner are likely to be those that can benefit from the opportunities in terms of performance, growth of assets under management and reputation that sustainable finance products can bring.