Funds Insider

OCTOBER 2021

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Contents

Foreword

We are delighted to introduce the third edition of Funds Insider, our quarterly publication focusing on hot topics across a wide range of practice areas that we believe will be of particular interest to private capital clients.

This edition will cover:

- SPACs in the UK and Europe
- ESG within fund formation
- Loyalty shares under Spanish companies law
- ESG developments for asset managers
- Amendments to Luxembourg Securitisation Law
- Net Zero and Digitalisation

Our offices remained busy over the summer period with everything and everyone back in full force from September. Over the past quarter we have continued to see an increased focus on ESG from all of our clients as we support them through this transition in every way we can. There has also been a continued focus on technology with clients looking for new opportunities in a rapidly changing world. There have also been a number of local regulatory changes across Europe which have impacted our international clients. We are grateful to continue supporting our clients across all jurisdictions in these areas.

We hope you enjoy reading this edition of Funds Insider and please do get in touch if you have any feedback or if there are any topics that you would like us to cover in future editions.

Funds Insider

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Spotlight on SPACs

A brief survey of SPACs in the UK and Europe

By Jeffrey Johnson

SPACs have been one of the most significant trends in global equity and M&A markets over the past two years, with record numbers of SPACs listing and creating a vast war chest of funds for M&A activity. Although historically more prevalent in the US, they are increasingly making a mark in the UK and Europe as well. Read on to get up to speed on the latest developments.

What is a SPAC?

A "SPAC" is a "special purpose acquisition company". As the name suggests, it is a newly formed shell company, formed for the specific purpose of raising capital through an IPO in order to fund an (as yet unidentified) acquisition within a specified timeframe post-IPO. This will often be done by way of merger, with the target then effectively becoming the listed business. Usually a SPAC will complete one main business combination, which is one of the things that differentiates a SPAC from a traditional investment fund. A SPAC listing will typically be spearheaded by well-connected founders (or "sponsors") who have industry or private equity expertise, with IPO investors basically investing in the strength of the founders' reputation and confidence in the founders' ability to consummate an attractive business combination.

Although "shell" or "blank cheque" companies of various types exist in many jurisdictions, when people speak of "SPACs" today they are usually referring to the model that originated in the US. The hallmarks of a US-style SPAC include:

- An acquisition strategy defined by geography, industry and/or financial or other characteristics of target, but no specific target at point of the IPO;
- Proceeds raised at IPO will be held in trust and may only be used to fund acquisition of a target business; if not deployed within a specified timeframe (typically 2 years), the SPAC will be liquidated and funds returned pro rata to investors;
- Shareholders typically entitled to vote on the business combination once identified;
- Shareholders entitled to redeem shares for cash at time of business combination; and
- IPO which involves listing of units comprised of shares and warrants to subscribe for further shares, all of which can eventually be separately traded.

It is not unusual for the price of the business combination to significantly exceed the ring-fenced IPO proceeds (sometimes by several multiples). Add to that the cost of redeeming a portion of the shares at the time of the business combination pursuant to shareholders' redemption rights, and the SPAC will typically need additional funds beyond the IPO proceeds in order to complete a business combination. This is often accomplished by way of a "PIPE" ("private investment in public equity") transaction, whereby certain wall-crossed investors commit (concurrently with entry by the SPAC into a merger/acquisition agreement, and conditional upon completion of the business combination) to purchase new shares in the SPAC.

SPAC resurgence in the US and emergence in Europe and the UK

SPACs have been around for decades, but have experienced a marked resurgence in recent years, fuelled by unprecedented levels of SPAC listings in the US. According to Refinitiv data, there were over 240 SPAC listings in the US in 2020, raising more than $80 million (more than traditional IPOs that year). This record was surpassed within just the first few months of 2021, and as at the end of June 2021 there had been more than 360 US SPACs raising more than $106 million.

The numbers for the US dwarf those in Europe and the UK, which together saw just 3 SPAC listings in 2020 (raising $500 million). Nevertheless, while momentum in the US appears to be slowing down since the first few months of the year, there has been increasing interest in Europe as a result of the recent US SPAC boom, with multiple European stock exchanges actively promoting themselves as destinations for SPAC listings. European SPAC activity has already increased significantly in 2021 compared with the year before, with the prior year with 27 SPAC listings raising more than $6 billion as at 23 July, (according to Bloomberg), and further SPAC deals are reportedly in the pipeline in markets including London, Amsterdam, Frankfurt and Paris.

Among the high profile European SPAC deals recently launched are:

- Pegasus Europe SPAC (the largest European SPAC to date, listed in Amsterdam, with a focus on the financial services industry; raised €500 million in April IPO);
- Hedosophia European Growth (listed in Amsterdam with a focus on European technology companies; raised €400 million in May IPO);
- I2PO (listed in Paris with a focus on the entertainment and leisure sector; raised €275 million in July IPO); and

- VAM Investments SPAC BV (Italian-sponsored SPAC listed in Amsterdam with a focus on consumer products and services in Europe; raised €225 million in July IPO).

Most of the SPACs launched in Europe this year have very much been based on the US model, incorporating most of the features of US SPACs described above. The ability to successfully implement this model in the European context depends on a number of factors, including local corporate law requirements in the SPAC's jurisdiction of incorporation (which may be different from the jurisdiction of the listing venue), as well as stock exchange and listing requirements, and engagement with these issues early in an IPO process is vital.

SPACs in London

Turning our attention to the UK in particular, although investment funds and other types of "blank cheque" companies have always been common in the UK, until recently launching a US-style SPAC in London involved significant roadblocks as a result of certain features of the UK listing regime. The chief barrier was the presumption in the UK Listing Rules that an issuer will be suspended from trading when it announces a potential acquisition until detailed information about the proposed target is provided to the market – effectively locking up investors for a significant period of time post-announcement of a business combination.

In light of the increased interest in SPACs internationally and a desire to ensure London did not miss out on potential SPAC listing opportunities, the UK Government ordered a review of the UK listing process which culminated in a recommendation to amend the UK Listing Rules to become more amenable to SPAC listings. The FCA's final rule changes in response to these recommendations were published on 27 July 2021 and became effective on 10 August 2021. Under the revised rules, SPACs listed in London are not subject to the presumption of suspension as long as they (i) raise at least £100 million from public investors and (ii) include certain investor safeguards in their structure. These required safeguards include:

- A "redemption" option allowing investors to exit a SPAC prior to any business combination being completed;
- Ensuring money raised from public shareholders is ring-fenced;
- Requiring shareholder approval for any proposed business combination, with SPAC founders, sponsors and directors being prevented from voting; and
- A time limit on a SPAC's operating period if no business combination is completed (typically 2 years, or 3 years with shareholder approval, with the possibility to extend the period by a further 6 months without shareholder approval if a business combination has been agreed but not completed within the original time limit).

Most of these safeguards reflect the usual practice for US-style SPACs, with the exception of excluding SPAC founders and sponsors from voting on the acquisition.

The rule changes generally bring the London market more in line with other jurisdictions in terms of the way SPAC deals are structured. The extent to which US-style SPACs will feature more prominently in the London market following the rule changes remains to be seen, and will be influenced by broader market factors, but the rule changes represent a major development and show there is significant interest from a variety of parties in seeing SPACs become a part of the UK equity landscape.

De-SPAC transactions

Even if you do not participate in a SPAC IPO (either by listing one or investing in one), you may well come across a SPAC in the context of the M&A market. The SPAC boom of the past couple of years means that there is a vast amount of money sitting in these listed cash vehicles looking for M&A targets (most of which need to complete a business combination, or "de-SPAC" transaction, within 2 years or else face winding up and returning funds to shareholders). European businesses are the subject of interest from both the increasing number of European SPACs and many US SPACs – particularly as the US market is very crowded, leading to SPACs looking further afield for acquisition opportunities. De-SPAC transactions with European targets have increased exponentially in 2021, with aggregate deal values in the tens of billions. Technology-driven, innovative and start-up companies, as well as companies with an ESG focus, have been of particular interest to SPACs. Among recent de-SPAC transactions involving US SPACs acquiring European or UK targets (effectively taking them public in the US) are the SPAC business combinations of the UK electric vehicle maker Arrival and the Italian luxury clothing brand Ermenegildo Zegna.

A de-SPAC transaction can be an attractive option for many companies, allowing them a faster route to the public markets and a more controlled price discovery process. Nevertheless, a number of considerations need to be taken into account in connection with any potential business combination with a SPAC, and detailed advice will be required from lawyers and accountants regarding the technical legal and regulatory requirements (which will vary by jurisdiction) and tax aspects of the business combination process, particularly where a US SPAC is acquiring a European business. In addition to completing an M&A transaction, the target is essentially transitioning into a listed business, and will need to prepare for this as well.

The outlook for European SPACs

With support from stock exchanges and regulators, and a variety of high profile market players keen to utilise the SPAC model, SPACs are well-placed to deepen their footprint in Europe and the UK over the remainder of 2021 and beyond. A big factor that will affect overall market sentiment and investor appetite will be the performance of the recent vintage European SPACs launched in 2021 to date, the performance of their shares in the market, their success in completing attractive business combinations and their performance post-combination. This is currently against the backdrop of a very active M&A market overall, including US SPACs looking for European targets, so there will be intense competition for strong targets. But the SPAC market has proven to be a dynamic one and, although doubtless the SPAC market, like all markets, will experience ebbs and flows, SPACs are likely to remain a significant part of the equity markets and M&A landscape for some time to come.

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Ready or not, ESG is coming

What sponsors should expect from investors regarding ESG considerations in fundraising

By Hadrian Beckett, Peter Mallon and Catherine Gokah

"ESG" has been a long-running buzzword in the funds industry. The growing spotlight on environmental crises has spurred investors and sponsors to reflect on their business practices and their sustainability credentials. Pitchbook's 2020 survey ("ESG and the Private Markets, Navigating the application of ESG in the private markets") indicated that general partners are increasingly feeling pressure from limited partners to consider sustainability within their investment decisions.

With ESG's growing prominence in the industry, addressing investors' ESG demands can be a minefield for sponsors. In this article we look at some of these demands and examine the pitfalls that sponsors should avoid when negotiating ESG terms with investors.

By Your Side [Letter]

Investors usually first discuss their ESG needs with sponsors during their due diligence of the fund, with requests and terms later being documented in their side letters. Each investor is unique, and so ESG demands can be bespoke to reflect the investor's profile. From a sponsor's perspective, adhering to subtle nuances of investor demands can be an administrative headache.

Historically, investor demands typically included requests that sponsors consider ESG factors when evaluating prospective investments; investors have also asked that sponsors ensure that their investment practices take into account or adhere to certain ESG principle frameworks, such as the United Nations' Principles of Responsible Investing (UNPRI).

In recent fundraisings however, some investors have sought more substantial evidence of sponsors embedding ESG principles. Examples include bespoke annual ESG risk reporting on the underlying investments and ESG-related incidents. Some investors have requested that sponsors complete ESG questionnaires. Other investors have requested that sponsors engage in good faith discussions on their compliance with investment restrictions set out in the underlying limited partnership agreement.

The two most important things to bear in mind with these requests are consistency and future proofing. First, sponsors may wish to maintain a standard ESG approach for their investors and so avoid becoming over-burdened by tailored ESG requirements for each investor. Second, sponsors should be mindful of agreeing to standards that may change over time. ESG compliance is only going in one direction – and sponsors need to avoid agreeing to a shifting set of goalposts.

Excuses, Excuses

Investors such as sovereign wealth funds and development banks may have more onerous ESG terms than other institutional investors. For example, they may be restricted from investing in certain categories of industries or have a mandate to only invest in funds that can make a positive ESG impact on the companies in which they invest.

Such requirements can be problematic for sponsors whose funds are not set up in such a restrictive way – agreeing to such investor demands may in turn vary the investment policy of the fund for all investors. To avoid such situations, sponsors should ensure that their fund documents contain a well drafted excusal provision, which allows certain investors to sit out investments that would breach their internal requirements. In return, that investor may request more transparency and prior communication on portfolio investments from the sponsor to determine whether they would need to exercise such excusal right.

Fix Up, Look Sharp

With the above in mind, it is important for sponsors to consider and develop their ESG policy. Sponsors should weigh up the operational demands of complying with investor ESG considerations against the impact on investor relations if they do not do so. Some investors may not be willing to back sponsors who do not show ESG capabilities (or appetite). What's more, for certain investors, these reporting and due diligence demands are hard and fast. If they cannot be met, the investor cannot invest.

To address this, many sponsors are building their capabilities to meet these demands. For example, sponsors have dedicated ESG task groups to identify and monitor ESG issues relating to particular regions and industries and to track the evolution of ESG policies and regulations. Some sponsors are now incorporating ESG principles into their traditional analysis of portfolio investments by leveraging ESG research into the investment process, for example by obtaining third-party reports, commissioning investment companies to produce reports or having internal teams perform research into the industry. Other sponsors use positive screening, which focuses on companies which exhibit positive ESG characteristics or which are taking steps to improve their ESG profile, either in comparison to other companies or on a country, regional, sector or industry basis.

This practice is becoming the norm, not the exception - 71% of sponsors surveyed by Preqin in November 2020 have indicated that they require portfolio companies to report on their ESG metrics.[1]

Conclusion

The rise of ESG has brought about opportunities for sponsors and investors alike to reshape the funds landscape and the companies in which they invest. Sponsors have the power to change the business of their portfolio companies in response to growing ESG investor demands and, as the saying goes, with great power comes great responsibility.

Sponsors, whether ready or not, are at the forefront of this movement. This is a fantastic chance for them to engage in thought leadership and to develop new opportunities and relationships with investors and portfolio companies.

Members of the Ashurst funds practice are more than happy to advise on ESG considerations for fundraisings from sponsors' and investors' perspectives. More widely, Ashurst can also provide innovative and tailored advice to ensure clients comply with ongoing ESG disclosures and regulatory requirements, including through our ESG Ready digital toolkit.

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Loyalty shares under Spanish companies law

An overview of the law which came into force on 3 May 2021

By Francisco Vázquez Oteo and Jorge Vázquez

Law 5/2021, which came into force on 3 May 2021, has introduced the concept of loyalty shares for Spanish listed companies.

Law 5/2021 transposes into Spanish law Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017, aimed at incentivising long-term investments in listed companies. However, loyalty shares were ultimately excluded from such Directive as a consequence of the amendments approved by the European Parliament. In this regard, the introduction of loyalty shares for Spanish listed companies follows a similar path to other European continental countries (France's *Loi Florange*, Italy's *Decreto de Competitivitá*, Belgium and the Netherlands).

Loyalty shares must be expressly recognised in the relevant by-laws (otherwise no loyalty shares would exist for such listed companies) and refer to shares held without interruption by the same shareholder for at least two years.

Loyalty shares carry a double vote (i.e. double the number of votes compared with their nominal value), so this new legal concept applicable to listed companies implies a dissociation of capital and voting rights and constitutes an alteration of the rule of "one share, one vote".

As expressly stated in the explanatory statement of Law 5/2021, loyalty shares are being introduced in Spanish legislation as a way of incentivising long-term investments and reducing short-term pressures on the management of listed companies, given that long-term investments are supposed to encourage greater involvement of shareholders in corporate governance, which is deemed to be in the best interest of a company. Thus, the Spanish legislator understands that short-term investments are not in the best interest of listed companies and add pressure on the management of listed companies, resulting in a negative impact on stock market sustainability and volatility. As we will see at the end of this article, some legal authors and market experts do not entirely agree with this analysis.

Brief review of the legal regime for loyalty shares

Requirements for the recognition of loyalty shares

There are certain requirements for a share of a listed company to be deemed a loyalty share:

- The concept of loyalty shares must be expressly stated in the by-laws of the relevant listed company. Reinforced majorities are required for the amendment of by-laws in this regard (60 per cent or 75 per cent of the share capital, depending on the quorum of the GSM). Therefore, the recognition of loyalty shares is an option, and not an obligation, for listed companies.
- The continuance of the loyalty share regime in the by-laws must be confirmed by the GSM once five years have elapsed from the initial approval of the regime. On the other hand, the loyalty share scheme can be terminated at any time by the GSM (by an absolute or two-thirds majority depending on the quorum).
- The relevant share must be held without interruption by the same shareholder for at least two consecutive years from the registration of such share in the special registry book for double-voting shares.
  In this regard:
  - The two-year term can be increased in the by-laws, but not reduced.
  - The two-year period (or longer if so stated in the by-laws) starts to run from the registration of the relevant shares in the special registry book for double-voting shares created by new Law 5/2021. Therefore, the loyalty share regime has no retroactive effect (except for private companies deciding to go public), so that shares owned by a shareholder opting for loyalty shares need to be registered in the special registry book and need to be held without interruption by that same shareholder for at least two consecutive years from such registration.
  - The relevant shareholder has the right, but not the obligation, to request its registration in the special registry book as owner of the relevant shares. Any transfer of such shares must be notified to the company.

Other relevant legal aspects of loyalty shares

Other relevant aspects of the regulation on loyalty shares are as follows:

- Loyalty shares are not treated differently to other shares in that the transfer of loyalty shares entails that such shares are no longer deemed loyalty shares and, therefore, do not grant a double vote to the new owner (there are some exceptions to this rule, for example, in the case of intra-group or mortis causa transfers).
- Double votes of loyalty shares are taken into account in calculating the quorum at the GSM and for the purposes of voting majorities. On the other hand, any limitations stated in the by-laws on the maximum number of votes to be issued by a shareholder are also applicable to loyalty shares.
- Information on loyalty shares:
  - The relevant company shall provide the information recorded in the special registry book for double-voting shares to any shareholder who requests it.
  - Information on double-voting shares existing at any given time, and any registered shares pending compliance with the loyalty period, shall be included on the listed company's website. Such information shall also be shared with the Spanish securities market regulator (*CNMV*).
- Double-voting rights of loyalty shares will be taken into account in relation to the takeover bids regime (and also regarding the obligation to notify significant stakes in listed companies according to Spanish Securities Market Law). Thus, it could be the case that a potential acquirer of listed shares does not reach the 30 per cent threshold of share capital, but, through prior holding of loyalty shares (and, if applicable, regular shares) and the potential new acquisition of shares, it reaches 30 per cent of the voting rights (the threshold required to launch a takeover bid). Nevertheless, such takeover bid will not be necessary if:
  - The 30 per cent threshold is reached exclusively due to the change in the total number of voting rights of the company resulting from the existence of shares with loyalty voting rights; and
  - Within three months of the date on which the 30 per cent threshold for voting rights has been exceeded, either the relevant shareholder sells the number of shares necessary to reduce the excess of voting rights to below 30 per cent, or the loyalty voting rights exceeding 30 per cent of the voting rights of the company are waived.

Impact of loyalty shares in Spanish listed companies

As highlighted above, the main purpose of the introduction of loyalty shares for Spanish listed companies is to encourage long-term investments and the involvement of long-term shareholders in the management of the company.

Nevertheless, some scholars and economists have been highly critical of the introduction of loyalty shares in the Spanish market given that, in their view, (i) there is no evidence that long-term investments are either more beneficial to the interest of the company in the long term or imply a greater involvement in the management of the company; and (ii) the majority of stakes in Spanish listed companies are already held by a few long-term investors (and not dispersed as in, for instance, US-listed companies). On top of this, given the current shareholding structure of most Spanish listed companies, the loyalty share regime could in fact help to increase the power of the current long-term majority shareholders of such companies.

In any case, given this new concept of loyalty shares, when investing in a listed company, the investor should carefully check the company's by-laws in order to verify whether the existence of loyalty shares is expressly provided for therein. In this respect:

- If loyalty shares are provided for in the by-laws, it is advisable:
  - To review the information on loyalty shares included on the company's website and, if possible, request a copy of the special registry book of loyalty shares; and
  - When the prospective investment is a long-term investment, to request registration in the special registry book of loyalty shares so that the two-year term (or longer term, if applicable) starts to run.
- If loyalty shares are not provided for in the by-laws, the shareholding structure of the company together with the required majorities to approve the loyalty share regime should be analysed in order to advance any potential change in the voting structure.

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Top 10 ESG developments for asset managers

An overview of the key factors impacting the industry

By Lorraine Johnston and Bisola Williams

The growing importance of ESG matters has meant considerable changes for asset managers. At EU level, the European Sustainable Finance Disclosure Regulation (SFDR) has applied since March 2021. SFDR requires the disclosure of how asset managers integrate sustainability risks and factors into the investment process.

SFDR goes hand in hand with the EU Taxonomy, which is another recent European regulation, this time aiming to create a system by which economic activities can be classified as "environmentally sustainable".

At UK level, we are also seeing an indication of the outline of the post-Brexit ESG framework for UK asset managers.

We set out the top 10 2021 regulatory developments for asset managers under the following categories: SFDR preparation and organisational requirements for EU asset managers; UK post-Brexit ESG framework; and ESG data quality and greenwashing.

This will likely become increasingly important for the asset management industry, particularly in the run-up to COP26, which is being held in Glasgow in November.

SFDR preparation and organisational requirements

1) SFDR templates published

In February 2021, the ESAs issued a report containing guidance on the format of disclosures under SFDR. This includes a standardised format for entity-level reporting under article 4 of SFDR, generally known as the Principal Adverse Sustainability Impacts Statement; and a mandatory disclosure template for pre-contractual disclosures and for periodic reports of funds promoting environmental or social characteristics (article 8 "light green funds") and funds that have sustainable investment as their objective (article 9 "dark green funds"). In March 2021, the ESAs published a joint consultation paper on the proposed changes to existing RTS and the format of disclosures to be made by asset managers under the SFDR, as well as RTS, under the Taxonomy Regulation.

The aim is for these templates to provide standardised disclosures which can be easily understood and compared against each other for article 8 (funds which promote environmental or social characteristics) and article 9 funds (funds which have sustainable investment as their objective). These templates will need to be used by in-scope asset managers where funds are either EU funds or marketed to EU investors.

While the templates are not yet finalised, in-scope asset managers should use best efforts to provide the type of information set out in the publications until such time as the RTS enter into force (they have already been delayed (see point 4 below)).

2) ESA letter to the European Commission calling for clarification on the SFDR

In July 2021, the European Commission published an internal Commission Decision an annex in response to a letter from the ESAs asking for clarity in relation to aspects of the SFDR. These include: whether non-EU AIFMs would need to comply with SFDR by virtue of article 4(1)(b) of AIFMD (which captures non-EU AIFMs); the application of the 500-employee threshold for principal adverse impact reporting on parent undertakings of a large group; what will and will not constitute an article 9 product; and the meaning of "promotion" in the context of article 8 products promoting environmental or social characteristics.

The European Commission's response is helpful in some, but not all, areas and further questions remain.

3) ESAs' supervisory statement in relation to the SFDR

In February 2021, the ESAs published a supervisory statement providing that asset managers and national competent authorities should "refer" to the draft RTS of the final report submitted to the European Commission in February 2021 for the purposes of applying the provisions of articles 2a, 4, 8, 9 and 10 of the SFDR in the period between 10 March 2021 and the application date for the RTS (which have not yet been adopted by the European Commission). The statement also includes an annex containing specific guidance on the application of timelines of some specific provisions of the SFDR (e.g. the application timeline for entity-level principal adverse impact disclosures and for financial products periodic reporting) and a summary table of application dates, which asset managers may find helpful.

4) European Commission confirms delay to application date of EU SFDR RTS

In July 2021, the European Commission published a letter, confirming that delegated regulations under the EU SFDR (described at point 1 above) on ESG disclosures for asset managers will be condensed into one delegated regulation containing all relevant RTS. It also confirmed that some rules that were due to apply from 1 January 2022 will be postponed until 1 July 2022.

This gives firms additional time to make preparations to ensure that they can comply with SFDR disclosure templates.

5) ESG delegated acts amending AIFMD, UCITS and MiFID II finalised

In August 2021, a number of ESG delegated acts amending MIFID II, UCITS and AIFMD were published in the EU Official Journal. These cross-refer to the SFDR and impose additional requirements on asset managers.

Under the delegated regulation amending AIFMD, AIFMs will need to take into account sustainability risks when complying with general requirements; ensure that senior management is responsible for the integration of sustainability risks into investment processes; consider the types of conflicts of interest arising in relation to the integration of sustainability risks and factors (e.g. greenwashing, mis-selling and misrepresentation of investment strategies); and, in addition to existing requirements relating to due diligence, consider sustainability risks when selecting and monitoring investments, designing written policies and procedures on due diligence, and implementing effective arrangements.

The delegated act amending AIFMD applies from August 2022. While this may feel like a long way off, some considerable work is required in order to ensure compliance with the delegated regulation before then.

UK Post-Brexit ESG Framework

6) FCA consultation on extending climate-related disclosure requirements to asset managers

In June 2021, the FCA issued a consultation paper setting out proposed rules in relation to disclosures required to be made by some UK asset managers in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). UK asset managers would need to make an annual sustainability disclosure report in respect of an entity's sustainability profile covering governance, strategy and risk management; scenario analysis; and metrics and targets. At product level, a UK asset manager would be required to make an annual sustainability disclosure report in respect of its products/portfolios.

A policy statement on these proposed rules should be published shortly. Although, since many larger UK asset managers already provide TCFD reports, the new rules may not be overly burdensome.

7) UK Taxonomy: Green Technical Advisory Group

In June 2021, the UK Government provided further confirmation that the UK would be developing its own framework for determining whether investments can be defined as environmentally sustainable. The UK announced that it had set up the Green Technical Advisory Group (GTAG), which will oversee the Government's delivery of the UK's "Green Taxonomy". The UK had previously indicated that it would establish its own UK Taxonomy by the end of 2022 and this publication represents a significant step towards that goal.

8) FCA guiding principles on ESG and sustainable investment funds

In July 2021, the FCA published a Dear Chair letter addressed to the chairs of authorised fund managers (AFMs) on improving the quality and clarity of authorised ESG and sustainable investment funds. The letter was issued as a response to FCA concerns about poorly drafted and substandard applications for authorisation of investment funds with an ESG or sustainability focus.

The annex to the letter sets out guiding principles for consideration when an authorised investment fund pursues a responsible or sustainable investment strategy and claims to pursue ESG or sustainability characteristics, themes or outcomes. The letter provides action points for AFMs such as in relation to the names and investment strategies of ESG-focused funds; documentation and periodic reports in respect of ESG-focused funds; and existing arrangements for sourcing and using ESG data.

There are a number of similarities between the letter and the SFDR, even though the UK has not onshored the SFDR, and the letter arguably implements parts of SFDR with regard to UK authorised funds. The letter probably gives an indication of what's to come in the UK in relation to the SFDR and will be of interest to both authorised and unauthorised fund managers.

ESG data quality and Greenwashing

9) ESMA letter on ESG ratings and ESG data providers

In January 2021, ESMA issued a letter regarding ESG data providers. This is particularly relevant to asset managers who need to demonstrate how they take ESG factors into account in investment processes and risk management processes. There has been concern in the industry about the quality of ESG data provided by service providers. The letter calls for a common legal definition for ESG ratings so that all existing product assessments regarding the ESG profile of an issuer/security are subject to safeguards, and states that ESG rating providers should be subject to stringent measures to ensure that ESG ratings and assessments are based on up-to-date, reliable and transparent data sources, and that methodologies are transparent.

This is an area to watch and is likely to develop in the same way for ESG rating providers as we have seen for credit rating agencies.

10) Renewed sustainable finance strategy

Finally, in July 2021, the European Commission published the renewed sustainable finance strategy. Although the proposals are a long way from being concrete requirements, they give an indication as to the critical next steps in EU ESG legislation and contain important proposals that will be of interest to asset managers. Proposals include: looking at ways to boost the existing supervisory and enforcement powers of competent authorities to address greenwashing; a general framework for labels for financial instruments; minimum sustainability criteria for financial products that promote environmental or social characteristics under the SFDR; a proposal for a Corporate Social Responsibility Directive to require large listed EU companies to disclose "meaningful, comparable and forward-looking sustainability data across the finance value chain"; and action by the European Commission to strengthen the reliability and comparability of ESG ratings by Q1 2023.

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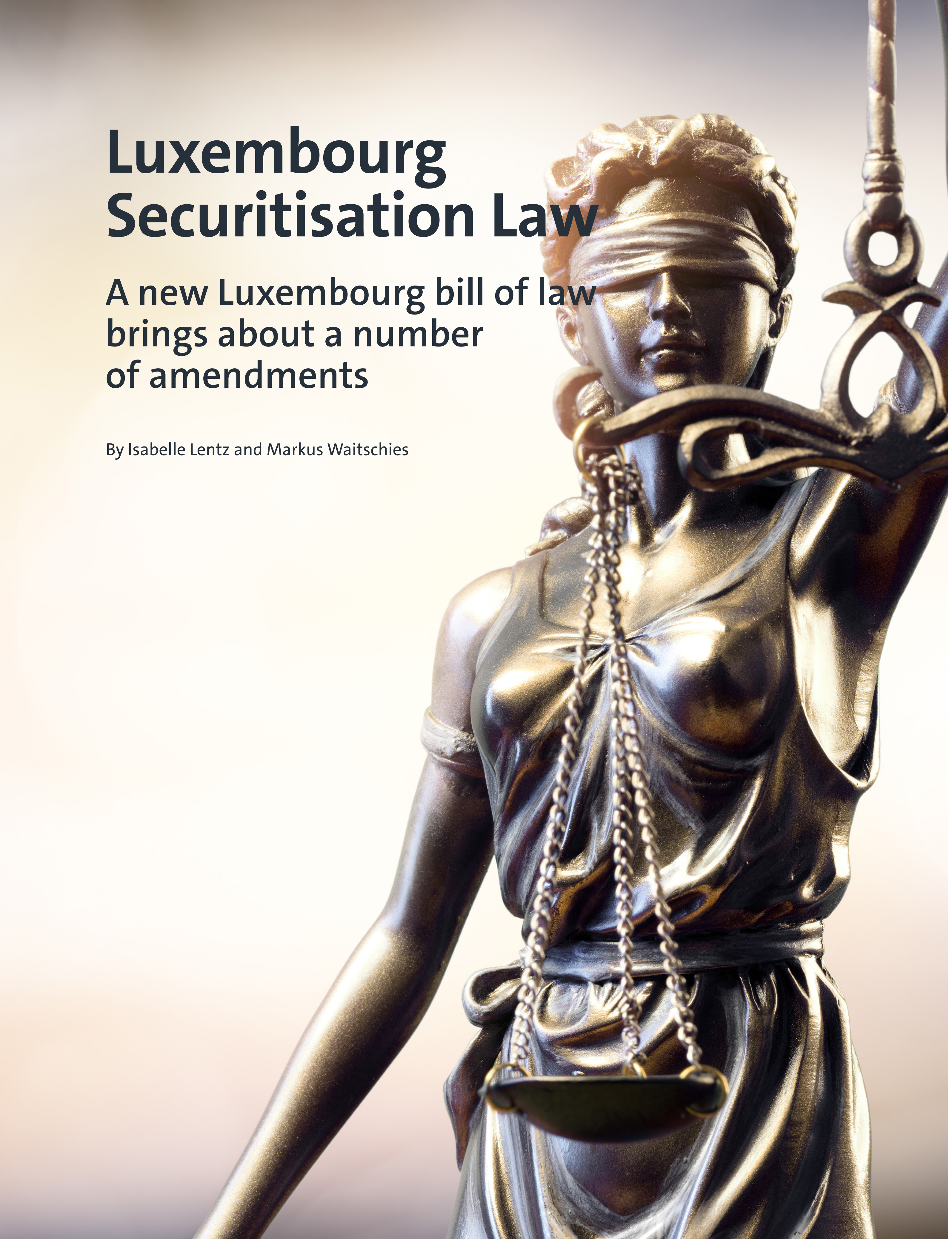

Luxembourg Securitisation Law

A new Luxembourg bill of law brings about a number of amendments

By Isabelle Lentz and Markus Waitschies

On 21 May 2021 a new bill of law (N° 7825) was submitted to the Luxembourg Chamber of Deputies (Chambre des Députés) with the purpose of amending the Luxembourg law of 22 March 2004 on securitisation (the “Bill of Law” and the “Luxembourg Securitisation Law”, respectively).

The Bill of Law, once fully approved by the Luxembourg Parliament, will bring about considerable changes to the Luxembourg Securitisation Law rendering the securitisation regime more flexible with respect to different types of securitisation structures and the specific requirements securitisation market participants might have in particular cases.

In this respect, the Bill of Law’s main purpose is twofold: (a) to explicitly set out and clarify current market practices in the law such as the criteria to be taken into account when assessing the authorisation requirement with respect to securitisation undertakings which offer securities to the public on a continuous basis while introducing legal definitions in relation to the treatment of different types of securities with respect to their legal subordination; and (b) the lifting/easing of particular restrictions securitisation undertakings have to comply with under the current regime such as the constraints regarding borrowing structures and portfolio management, etc.

There are five main aspects in the Bill of Law worth focusing upon of particular interest to market participants.

1. Issuance of loans in addition to the usual issuance of securities (*valeurs mobilières*)

Under the current Luxembourg securitisation regime a securitisation undertaking is foremost an issuance vehicle and therefore the entry into borrowing structures by taking out loans to investors should only be done on an ancillary basis.

In other words the securitisation undertaking is usually financed by the issuance of securities whose value or yield depends on the risks assumed by the securitisation undertaking pursuant to article 1 (1) of the Luxembourg Securitisation Law. In specific instances it is however acceptable that a securitisation undertaking may use borrowing or intra-group financing on a temporary basis in order to pre-finance the acquisition of the risks to be securitised while it proceeds to the issuance of securities to investors at a later stage (warehousing).

However, it is also acceptable that borrowing can be done on a lasting but limited basis. In this respect, it is important to note that such borrowing can only be done on an ancillary basis while the main and determining purpose of the transaction must always be securitisation, i.e. the economic transformation of risks into securities. In other words, borrowing is considered acceptable if the transaction as a whole also entails the issuance of securities for a proportionately substantial amount. This current practice is reflected in question 9 of the CSSF Frequently Asked Questions on Securitisation, October 2013 (the “CSSF FAQs on Securitisation”).

This restriction is now intended to be lifted given that the Bill of Law foresees changes which would allow a securitisation undertaking to enter into all types of borrowing structures providing a much more flexible framework as well as allowing certain investors, whose investments might be restricted for internal reasons to specific loan products, to also participate in Luxembourg securitisation structures.

The yield or principal repayment of such loans would also depend on the underlying securitised assets, as is the case with usual debt securities issued by a securitisation undertaking which are linked to a specific compartment or pool of underlying. This approach would also be in line with (EU) Regulation 2017/2402 of 12 December 2017 creating a general framework for securitisation (the “EU Securitisation Regulation”) given that the EU Securitisation Regulation does not require a securitisation vehicle to issue securities in order to fall under its scope.

2. Active management of risk portfolio

Furthermore, the limitation that active management is generally not permitted, and portfolio management restricted to a prudent person's passive management, is expected to be eased as well.

In this respect it is worth recalling that the CSSF is of the opinion that the management of the underlying securitised portfolio must first of all be passive in character, irrespective of whether or not the actual management is delegated to a professional acting on behalf of the securitisation undertaking.

However, in particular cases the CSSF accepts structures where the management of the securitised assets includes for instance the renegotiation of any schedules of repayments or any of the credit terms in a situation in which the relevant debtor is facing financial difficulties. Under no circumstances however is it permitted for a securitisation vehicle to manage its underlying assets in such a way that short-term market fluctuations of market prices are taken advantage of, such management resulting in ongoing claim acquisitions and assignments.[1]

The reason for this restriction has always been seen in the fact that in traditional securitisation structures the securitised risk of specific underlying assets should predominantly depend on the nature and characteristics embedded in such assets and should not hinge on the competence of a portfolio manager and his/her ability to restructure the underlying portfolio in light of market developments and price fluctuations at a short notice.

Once the Bill of Law has been passed in this respect it should be possible to manage risk portfolios even in accordance with short-term market fluctuations and price developments. However, in order for such active management to be permitted it is important to note that the risk portfolio to be actively managed would need to be composed of debt securities, financial debt instruments or receivables as per the current structure of the Bill of Law. Furthermore, active management would only be allowed in structures in which the securitisation undertaking did not offer securities to the public (ie restriction to private placement structures).[2]

3. Granting of collateral by a Luxembourg securitisation undertaking

The granting of collateral by a Luxembourg securitisation vehicle over its assets is currently limited to situations in which it is done for the benefit of the vehicle's investors (i.e. the subscribers of the securities issued) or if the granting of collateral is carried out with a purpose of assuring the securitisation of the underlying in question (i.e. whenever the granting of collateral is necessary in order for the vehicle to be able to acquire and securitise the assets).

In this respect, the relevant article 61 (3) of the Luxembourg Securitisation Law explicitly stipulates that the creation of security interests over the securitisation undertaking's assets can only be done in order to *secure the obligations the securitisation undertaking has assumed for their securitisation or in favour of its investors, their fiduciary-representative or the issuing vehicle participating in the securitisation*. Any security interests and guarantees which have been created in breach of this rule are considered void by direct application of the Luxembourg Securitisation Law.[3]

However, the Bill of Law now foresees the introduction of a much wider scope which would already allow a Luxembourg securitisation undertaking to provide collateral to any third party provided the granting of collateral were linked to the securitisation structure as a whole (*relatifs à l'opération de titrisation*).[4]

4. Authorisation requirement for a Luxembourg securitisation undertaking

Furthermore, the Bill of Law contains an explicit definition regarding the question of when a securitisation undertaking is to be considered to be issuing securities to the public on a continuous basis requiring it to be authorised by the CSSF. The answer to this question is currently still based on the CSSF FAQs on Securitisation which provide that issuances are made to the public on a continuous basis if more than three issuances are made to the public per calendar year and on an all compartment basis.

In this respect, the current rule that private placements are not considered offers to the public will still be applicable.

However, certainty will in particular be obtained in relation to the required per unit minimum denomination securities need to have in order for them not to be deemed to be issued to the public, which the CSSF FAQs on Securitisation currently seem to suggest should at least be EUR 125,000.

The threshold of EUR 125,000, however, is not entirely in line with the legal situation under Regulation (EU) 2017/1129 of 14 June 2017 on the prospectus to be published when securities are

1 Question 7 of the CSSF FAQs on Securitisation, last paragraph

2 Article 14 of the Bill of Law

3 Article 61 (3), last sentence of the Luxembourg Securitisation Law

4 Article 13 (2) of the Bill of Law

offered to the public or admitted to trading on a regulated market (the "Prospectus Regulation") given that article 1 (4) (c) of the Prospectus Regulation sets out that an offer of securities to the public, the per unit denomination of which is at least EUR 100,000, does not require the prior publication of a prospectus.

This has led to uncertainty in cases where the per unit minimum denomination of securities offered by a securitisation undertaking only amounts to EUR 100,000 and not to EUR 125,000. The legal consequence is clear under the Prospectus Regulation as no prospectus needs to be approved for such offers under prospectus rules. However, under the current structure this does not automatically make the offer a private placement under the Luxembourg Securitisation Law.

In fact, in this respect the CSSF FAQs on Securitisation are to some extent ambiguous given that on the one hand they clearly state that an offer of securities, where the per unit denomination is at least EUR 125,000, need not be taken into account in the context of the assessment when a securitisation undertaking is offering securities to the public on a continuous basis. On the other hand, however, it also says in the CSSF FAQs on Securitisation that issues distributed as private placements irrespective of their denomination are not considered issues to the public.

The Bill of Law in this respect intends to clarify that an offer of securities could only be deemed to be made to the public if the securities in question had a per unit denomination of less than EUR 100,000. In addition to this in order for a public offer scenario to arise the securities would also not need to be addressed to professional investors as defined in the Luxembourg law of 5 April 1993 on the banking sector and not be made under the form of a private placement. All three criteria are cumulative.

5. Issuance of tranched securities

Finally, the Bill of Law also intends to clarify certain aspects regarding the issuance of tranched securities. In this respect it is worth remembering that only structures in which a securitisation undertaking engages in tranching fall under the scope of the EU Securitisation Regulation.

In light of these differences a Luxembourg securitisation transaction can primarily be structured in two possible ways:

- **Securitisation which is only subject to the Luxembourg Securitisation Law**

  It is still possible to structure a Luxembourg securitisation transaction in a manner that such structure is only required to be compliant with the Luxembourg Securitisation Law and does not fall under the scope of the EU Securitisation Regulation. This can generally be achieved by either securitising a risk other than a credit risk (the EU Securitisation Regulation only focuses on the securitisation of credit risk) or by not tranching the securities to be issued.

- **Securitisation under the EU Securitisation Regulation**

- Securitisation transactions which securitise credit risk and issue tranched securities, i.e. securities which contain different segments, e.g. senior and subordinated segments, will usually be subject to both the Luxembourg Securitisation Law and the EU Securitisation Regulation as mentioned above.

In other words, this usually means that the requirements with respect to risk retention, transparency and due diligence as required by the EU Securitisation Regulation, need to be complied with by the securitisation undertaking in addition to the application of the general framework of the Luxembourg Securitisation Law. Consequently, the provisions set out in both the Luxembourg Securitisation Law and the EU Securitisation Regulation will have to be respected by a Luxembourg incorporated securitisation vehicle in such a case.

The Bill of Law foresees the introduction of explicit rules regarding the legal subordination between different types of securities, unless contractually agreed otherwise.

For instance units/shares issued by a securitisation undertaking relating to the same underlying assets other debt instruments or loans are also linked to will have to be considered to be tranched by way of law, such equity instruments being legally subordinated to debt instruments issued or loans taken out by the securitisation undertaking. Furthermore, debt instruments having a variable yield will also per se be deemed to be subordinated to debt instruments which contain a fixed-yield rate.

However, the Bill of Law contains the possibility for the securitisation undertaking to derogate from these subordination rules in its articles of association, its management regulations or any other agreement entered into by the securitisation undertaking by explicitly establishing different subordination rules with respect to particular issuances.

Summary

The new Luxembourg Securitisation Law, should the Bill of Law be approved in substantially the present format, will entail, as described above, a series of rather considerable amendments to the current market practice.

The three main modifications which are likely to have the biggest impact on Luxembourg law governed securitisation structures are the following ones (all provided the Bill of Law is indeed adopted on the basis of document N° 7825 dated 20 May 2021):

- *Securitisation vehicles will be allowed to engage in all types of borrowing in addition to issuing financial instruments.*
- *Active management of the underlying securitised assets will be possible for risk portfolios consisting of debt securities, financial debt instruments and receivables. However, such active management will be restricted to situations in which the relevant financial instruments which were issued to finance the acquisition of the assets are not offered to the public.*
- *Securitisation vehicles will furthermore be allowed to grant collateral over their assets, even to third parties or other group companies, provided a link to the securitisation has been established. This means that the provision of collateral will also be possible whenever such collateral is not being granted with the aim to secure the obligations the securitisation undertaking has assumed in view of their securitisation. This will allow the granting of collateral in scenarios in which the focus and benefit of such collateral provision is predominately linked to the third party's interests as beneficiary of the collateral rather than on the perspective of the securitisation undertaking securing its own obligations arisen in the context of the acquisition of the underlying assets.*

The legislative process has not yet officially been concluded and the Bill of Law is still being discussed in the Commission des Finances et du Budget which was provided with it for further discussions and possible amendment suggestions on 3 June 2021.

However, on 20 September 2021 the official feedback on the Bill of Law provided by the Luxembourg Chamber of Commerce was published. The Luxembourg Chamber of Commerce is in favour of the proposed amendments and in particular of the proposed lifting of the above described restrictions in order to render the securitisation regime more flexible. It however states that it would have preferred to see the obligation that authorised securitisation undertakings must entrust their liquid assets and securities with a credit institution established or having its registered office in Luxembourg as set out in article 22 of the Luxembourg Securitisation Law amended as well.

In this respect, the Chamber of Commerce is of the opinion that in order to obtain more flexibility for the market the use of credit institutions which are registered in another EEA Member State or, of a credit institution which is registered in another European country but the use of which has been specifically authorised by the CSSF, should be allowed as well. Furthermore, the Luxembourg Chamber of Commerce regrets that the Bill of Law does not contain any clarifications with respect the requirements established by the CSSF as regards loan origination done directly by the securitisation vehicle (direct lending).

It can therefore not be excluded that further amendments, and in particular modification suggestions with respect to the points discussed above, will be made.

Furthermore, it is difficult to predict when the legislative procedure will conclude and the new Luxembourg Securitisation Law will enter into force.

However, as depicted it is likely that the changes proposed will have a significant impact on current and future securitisation structures in Luxembourg.

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Net Zero and Digitalisation

Key issues when investing in energy technologies

By Adam Eskdale and Christopher Bates

Data-focused business models and a “digital first” approach are now recognised by the UK Government, regulators and market participants alike as the key to coordinating, modernising and decarbonising an evermore complex energy system.

As a result, investment in the underlying digital solutions and smart infrastructure is not just increasingly attractive: it is imperative. The UK Government’s energy digitalisation strategy stresses that every part of the energy system still needs to be digitalised – demand, supply, markets and networks – to create investment opportunities at every step of the energy life cycle.

Here we set out the key legal issues when investing, and protecting that investment, in two commonly targeted digital solutions – power storage and trading, and smart meters.

The Key Challenge

The top-down model of centralised power production for passive consumers is being rapidly replaced. Energy systems are becoming more disparate, and must balance the ongoing transition to renewable (and intermittent) power inputs with increasingly active and flexible consumers who are discovering the energy-as-a-service industry (and, in particular, their ability to export power back to the grid). Integrating these new models, engaging consumers and achieving the wider electrification of the economy, all in the drive toward net zero, requires something that we currently do not yet have – a fully digitalised energy system.

Power as an asset

‘Data-driven grid flexibility services and the underlying power trading help provide the balance the system requires. Energy storage is an increasingly important part of this.

The primary concerns for storage asset owners are (i) the optimisation of those assets once purchased or constructed, and (ii) maximising the revenue streams that can be established out of the power they hold. In the case of the latter, asset owners often employ digital platform providers to trade the power on wholesale markets using AI-driven algorithms, securing a source of revenue.

When structuring these arrangements with service providers, and in order to maximise their return on investment, asset owners will need to consider the following:

Revenue issues	Different markets offer different cash settlement periods, so any energy trading agreement must include reconciliation mechanisms, clarify when revenue is deemed cash-settled, and clearly structure how the service provider receives commission from the revenue achieved by trading the asset.
Costs	When defining revenue, the parties must clearly allocate liability for trading costs, including costs in respect of transmission, distribution, wholesale taxes, costs to charge the asset, aggregator and intermediary fees, and any collateral cover posted with trading parties.
Asset Sale	Providers often want their trading services to "stick" to the asset, and so may require the novation of the trading services contract to any party which purchases the asset as a condition precedent to the sale. Failure successfully to novate the trading services may result in the owner having to pay an early termination fee.
Performance	As the market for trading services develops, asset owners are increasingly looking to include review provisions, whereby they can benchmark the provider's performance against its competitors, with the ultimate sanction for non-competitive performance being an early withdrawal agreement by the owner.
Other Contracts	Asset owners must align the trading services with their other contractual relationships, such as those dealing with grid connections or asset maintenance, and ensure the service provider's services do not put the owner in breach of these other contracts. Where a service provider offers SVA (supplier volume allocation) only, the asset owner will likely be required to agree to multiple additional terms, flowed down from the relevant supplier, to ensure that the asset owner transfers ownership of the power exported from the asset, and associated benefits, to that supplier.
Maintenance and Operation	Service providers require asset owners to maintain the assets (generally pursuant to O&M contracts), to ensure enough capacity is always available for trading. Asset owners should however set out clear parameters within which the service provider can utilise their assets to trade capacity. This is to ensure providers do not cause the assets to run too “hot”, potentially invalidating the owner’s warranties with asset manufacturers, or limiting the recourse available under the O&M contracts.
Data	The asset performance and trading data is valuable, and so its ownership and permitted use should be made clear between the parties.
Agency	Asset owners may need to delegate certain authorities to service providers which act as trading agents, to allow them to enter trading agreements on behalf of the asset owner. That being the case, a power of attorney is often required between the parties. The asset owner needs to ensure that the terms of that power of attorney are carefully crafted to provide appropriate guard rails around the scope of the service provider’s agency.
SaaS	The above considerations are particularly relevant for a fully managed trading service, however service providers are beginning to offer access to their trading platforms through software-as-a-service business models. Additional consideration should be given to the standard SaaS issues (such as availability and support), together with consideration of the above issues through a SaaS lens, where the provider is not conducting the trading itself.

Smart meters and consumers

Engaging consumers and deploying their collective decarbonising effect is vital to achieving net-zero. The data collected by smart meters allows consumers to visualise and reduce their energy use, allows for smarter grids, and enables new digital offerings through which consumers can interact with the market.

The smart meter rollout programme is more than five years old and was originally due to be completed by 2020. However, delays to the programme and the scale of capital outlay required have meant that rollout is still yet to touch millions of energy consumers in the UK. The investment gap, coupled with the appeal of stable, long-term revenues and low-risk maintenance obligations enjoyed by smart meter owners (known as "meter asset providers", or "MAPs") from meters installed with energy consumers have together meant that the market for ownership of MAP companies has seen refreshed interest from infrastructure funds and private equity over the past couple of years.

When considering investing in MAPs, there are key risks impacting meter portfolios which potential purchasers must investigate carefully through due diligence. In particular:

- **Technical obsolescence**: the pace of technological change will inevitably mean that smart meters become dated, and may no longer communicate or function as intended as we move away from existing technology like 2G and 3G. The potential move from natural gas to hydrogen as a mainstream energy source could also render installed gas smart meters obsolete. It is therefore key to assess the level of protection that a MAP enjoys in respect of potential obsolescence events (and attendant replacement/refreshment obligations). If the MAP's exposure to such risks has been structured appropriately, then rather than a potential impediment to investment, technical obsolescence could represent a substantial revenue opportunity for the MAP.
- **Change in law**: a change in law, including to the standard meter specifications SMETS1 and SMETS2 or the Smart Energy Code, could result in large groups of smart meters becoming non-compliant. Investors should assess where the liability sits for ensuring compliance, as between energy suppliers, MAPs, and meter manufacturers. A change in law can also result in multiple additional costs including the cost of upgrades, removal programmes, additional manufacturer and installation costs, and removal charges. Where a change in law results in a decreased life period for a meter portfolio, it will be important to assess how lost rental payments are accounted for.
- **Warranty protection**: investors should ensure they attain visibility of how warranty coverage is flowed through from manufacturers to energy suppliers, via the MAPs. MAPs are essentially funding middle-men in a smart meter rollout, and as such should attract minimal exposure in respect of the relationship between meter manufacturers and their ultimate customers – the energy suppliers. Often the MAPs do not offer warranties which are backed off with manufacturers, and instead assign their rights to claims and compensation with manufacturers to the energy suppliers, or offer confirmation that manufacturers have given indemnities capable of assignment to the energy suppliers. Investors should track the warranty coverage through to the manufacturers where possible to understand what recourse is available to energy suppliers, what MAPs are required to do to facilitate any claims, and for how long that coverage lasts.

Key takeaway

Opportunities to invest in the growing importance of digital technologies in the UK energy system will continue to emerge. When capitalising on these opportunities, investors need to account for new asset classes and new provider relationships, and take note of the pace of technological change, as well as legislative updates to accommodate them. Deploying strong legal protection is key to protecting such investments in a rapidly changing industry.

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