

Luxembourg, 11 September 2023

## Position Paper

### **Calibration of the depositary duties as regards the monitoring of ESG investments**

#### **Introduction**

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

#### **Important**

This document was prepared by ALFI's Depositary Bank Forum Steering Committee in association with ALFI's ad hoc working group covering ESG investment limits. These working group comprise of representatives of asset managers, depositary banks, securities services firms, audit firms and law firms.

The position paper presents the working groups' interpretation and understanding of the duties of the depositary as regards the monitoring of ESG investments.

The ALFI position paper regarding the calibration of the depositary duties as regards the monitoring of ESG investments has not been validated by any regulator. It does not diminish the responsibility of each stake-holder using it to comply with the applicable rules on investment monitoring. This document must not be relied upon as advice and is provided without any warranty of any kind and neither ALFI nor its members who contributed to this document accept any liability whatsoever for any action taken in reliance upon it.

This document is drafted on the basis of rules in force at the time of publication.

Generally, this document may be amended without prior notice to incorporate new material and to amend previously published material where the working group considers it appropriate. ALFI strives to update this document to the best of its endeavours but is not legally bound to do so.

ALFI members are welcome to submit a question. Please send your questions to [info@alfi.lu](mailto:info@alfi.lu).

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## I. Background information

### 1. Glossary

Please kindly refer to the glossary in Annex.

### 2. ESMA's supervisory briefing

- a. On 31 May 2022, ESMA published a supervisory briefing<sup>1</sup>. The content of this briefing aims to provide guidance to NCAs regarding the supervision of sustainability-related disclosures and integration of sustainability risks.
- b. §46 states the following:  
“NCAs should further ensure, through appropriate actions, that **all relevant information and data** are provided by the UCITS management companies and AIFMs to the appointed depositary to enable it to perform effectively the relevant depositary functions. In particular, **depositories should include all ESG-related investment restrictions in the monitoring of the compliance of the instructions coming from the management company or the investment manager.**”
- c. Points of discussions stemming from the supervisory briefing:
  - i. Such provisions could be interpreted in a way that the entirety of the ESG-related limits checks is the responsibility of the depositary, while there is no legal requirement. Indeed, no provision is known per se in the law, as regards ESG-related investments specifically. The ESMA briefing does not describe what the controls should be.
  - ii. One of the purposes of the ESMA briefing is to further enhance convergence among NCAs<sup>2</sup>. Therefore, unlevelled supervisory practices between NCAs should be avoided.

### 3. Scope of the document

The present document covers the depositary duties only. The IFM duties are not covered.

## II. Regular duties of the depositary

1. The directives preclude the depositary to be involved in the investment management function.

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<sup>1</sup> ESMA Supervisory Briefing on EU convergence in the supervision of investment funds with sustainability features (ESMA34-45-1427), 31 May 2022.

<sup>2</sup> ‘by addressing the potential issues arising from the supervision of sustainability-related disclosures as well as the integration of sustainability risks by fund managers and the design of common supervisory practices’, ESMA Supervisory Briefing (Op.cit.) §16.

2. General oversight requirements<sup>3</sup> are to be considered when determining how to execute periodical checks on investment restrictions. Specifically, according to the investment restrictions within the meaning of AIFMR and UCITSR<sup>4</sup>, the depositary is expected to perform risk assessment on IFM's internal control robustness, notably by way of due diligences, in order to determine scope, frequency and methodologies to be applied for the execution of periodical investment portfolio compliance checks (ex-post), with respect to the investment policy and restrictions.
3. The depositary is performing its oversight duties on investment restrictions already in scope, in particular, as regards the carrying out of the AIFM's/Manco's instructions within the meaning of AIFMR and UCITSR. Whether an asset qualifies as an ESG related investment<sup>5</sup> or as a sustainable investment<sup>6</sup>, should not per se be triggering specific duties other than those that already apply.
4. The monitoring of the sustainability risks and factors relating to a given fund is part of the duties of its IFM<sup>7</sup>.

### III. Calibration of the depositary duties as regards ESG-related limits(specifically)

Key principles applicable (summary):

- i. Depositaries are not in scope of SFDR, as they are not "financial market participants"<sup>8</sup>,
- ii. The Depositary should perform the oversight on simple limits, and then if applicable, apply the procedure for complex limits when they are considered as non-simple, as described below.
- iii. Where taxonomy or sustainable investment data are not available to allow quantitative ESG-related limits checks by the Depositary, the Depositary should receive appropriate data or all relevant information from the IFM,
- iv. Depositaries should include ESG-related limits monitoring as part of their due diligence on IFMs,
- v. Depositaries are not responsible for challenging classification of funds as Article 6, 8 or 9 under SFDR.

As per the standard depositary oversight duties, the depositary should perform investment portfolio compliance checks (ex-post), with respect to the investment policy. These checks should be performed according to the two following scenarios<sup>9</sup>.

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<sup>3</sup> as set out under art. 3 of CDR 2016/438, art. 92 CDR 231/2013.

<sup>4</sup> pursuant to Article 95 CDR 231/2013 and Article 6 CDR 2016/438.

<sup>5</sup> The acronym "ESG" stands for financial product that promotes among other characteristics environmental, or social characteristics within the meaning of article 8 SFDR.

<sup>6</sup> i.e. a financial product having a sustainable investment as its objective, within the meaning of Article 9 SFDR.

<sup>7</sup> in line with ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD (ESMA34-45-688), 30 April 2019.

<sup>8</sup> pursuant to Article 2(1) SFDR.

<sup>9</sup> the concept of simple/complex limits introduced here applies only to the depositaries.

1. Investment policy with ESG-related **simple limits**. These limits are most of the time quantitative, and are easily observable or measurable (e.g. percentage in target companies/industrial sectors, or an exclusion filter as regards companies/industrial sectors).
  - i. Quantitative driven limits mentioned in the investment policy in relation to ESG investments<sup>10</sup> should be considered by the depositary as ESG-related limits and thus covered by the regular controls.
  - ii. Regular controls can either be based on output from IFM's control (subject to satisfactory risk assessment), or performed independently by depositaries.
2. Investment policy with ESG-related **complex limits**<sup>11</sup>, where these limits are not easily observable nor measurable<sup>12</sup> (e.g. percentage of alignment with the taxonomy, or sustainable investments).
  - i. Similar to other specific topics such as Liquidity risk monitoring, review of independent valuer, the Depositary should not be required to assess the adequacy nor to replicate or challenge the process in place at the IFM for determining the compliance of the investment portfolio with the relevant ESG eligibility criteria. No specific analysis, nor qualitative eligibility controls should be performed by the depositary on underlying investments. Depositary's obligations should indeed be limited to ensuring that the IFM has documented procedures in place and carried out in that regard, in line with the fund's investment policy (see iv.).
  - ii. A number of the qualitative ESG-related limits cannot be monitored on a continuous basis, simply because the underlying KPIs from the investee companies will not be published on a continuous basis.
  - iii. The outcome of the risk assessment<sup>13</sup> should help the depositary to determine whether the IFM's information suffice, or if an independent source is needed to perform the periodical controls.
  - iv. In practice, when it comes to verifying compliance to complex limits, and under circumstances where depositary independent controls may prove challenging (notably due to lack of data publicly available), depositary monitoring can be based off output of IFM's controls in line with aforementioned general oversight requirements. This methodology rests on preliminary risk assessments on IFM's investment restriction monitoring organization to be conducted for the purpose of ensuring that the IFM's process in place for monitoring ESG-related

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<sup>10</sup> e.g. an investment policy containing an investment percentage on a listed stock benefiting from a satisfying ESG rating.

<sup>11</sup> 'complex' should be understood as the opposite of 'simple'. The complex limit test should be performed only if the simple limit test has failed.

<sup>12</sup> This issue is subject to a request for clarification, as per the ESAs letter to the EU Commission of 9 Sept. 2022 (JC 2022 47).

<sup>13</sup> in the meaning of section II.2.

limits as referred to under the funds' investment policy are in place and operate effectively.

Similarly to the logic to be applied for other oversight duties (such as those applicable to valuation of illiquid assets using internal valuation model vs use of external valuer), this could result in the following approaches when it comes to risk assessment/due diligence over IFM's monitoring process of ESG related limits on the following possible IFM's organizations:

-Option 1: IFM's internal screening process: depositary to verify existence and consistency of methodologies and criteria with rules and process as described under the funds' offering documents;

-Option 2: IFM's use of external data provider: depositary to ensure the external sources are effectively in use as part of IFM's monitoring process.

-Option 3: combination of both review of IFM controls output and depositary separate control based on common or separate ESG data feeds.

In all cases, while the Depositary is not necessarily expected to challenge the IFM's internal ESG screening model per se or the actual data from external ESG service provider, depositary verifications must provide assurance<sup>14</sup> on the existence and consistency of IFM's methodologies, criteria and controls with disclosures to investors from funds' offering documents.

- v. On 2 December 2022, the CSSF published a Q&A in relation to SFDR<sup>15</sup>. The response the question 4<sup>16</sup> is referring to the oversight duties general requirements for the depositary to consistently perform risk assessments and verifications of processes under the responsibility of the IFM's, the outcome of which determine how the ongoing monitoring and periodical controls will be executed as part of oversight procedures (i.e, either separate depositary control, review of IFM's controls or combination of both). This principle applies for all oversight duties including investment restrictions monitoring and regardless of rules' complexity. With this in mind, the reference to "*depositary being in charge of the independent monitoring*" under the Q&A quoted above, has to be understood as the second level control provided by the depositary when it comes to oversight duties (the IFM's internal control framework considered in this context as first level control). In other words, the reference to "*independent monitoring*" relate to the nature of the depositary function as

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<sup>14</sup> within the meaning of ALFI guidelines on oversight duties and cash monitoring, in particular Section IV.3. on *Duties regarding the carrying out of the fund's instructions*.

<sup>15</sup> CSSF, FAQ Sustainable Finance Disclosure Regulation (SFDR), 2 December 2022.

<sup>16</sup> *The IFMs must ensure ongoing compliance with all the rules laid down in the prospectus/issuing document of the funds they manage, with the depositary being in charge of the independent monitoring of the compliance of investment restrictions as per applicable legal provisions related to obligations of depositary oversight.*

described here and not to a methodology mandating depositaries to necessarily reperform separate IFM's processes or controls in all instances.

#### IV. Availability of the information (applicable to investment policies with complex limits)

1. Along the lines of CSSF Circular 18/697<sup>17</sup> as regards ownership verification, the depositary and the IFM should agree, on a written procedure specifying the type of transactions to be anticipated and the nature of information (and the frequency) to be provided by the IFM to the depositary to fulfil its supervision duties.
2. Due diligence on the IFM could foresee the provision of information to the depositary:
  - i. An enhanced due diligence process on the IFM should foresee the provision of ESG inclusion/exclusion criteria. The depositary due diligence will in the first-place leverage on the assessment performed by the IFM, including but not limited to IFM expertise and experience, specific risk associated to the asset class, and risk assessment of the ecosystem in the asset class service.
  - ii. Opportunity to have a standard due diligence questionnaire to delineate two cases: provision or no provision of suitable data.
3. Such information channel would solve the case where the IFM is not able to share its ESG strategy (proprietary and confidential) with its depositary. As regards the potential alternative of public information (when available), a golden source should be privileged, for consistency purposes.

#### V. Calibration of the depositary liability as regards ESG-related limits (specifically)

1. The depositary is not a "financial market participant"<sup>18</sup> under SFDR.
2. The IFM remains fully responsible for ensuring compliance with fund offering documentation. Similarly to other regulatory streams, the depositary's role is limited to ensuring that the IFM has implemented a dedicated process, e.g. for
  - i. Liquidity stress testing, in line with CSSF Circular 20/752,
  - ii. Management of collateral, in line with CSSF Circulars 14/592 and 16/644.
3. It is not part of the depositary duties to check the SFDR classification of a fund at issue (e.g. consistency of the investments with an Article 6, 8, or 9 classification, as part of the SFDR pre-contractual disclosures regime).
4. The depositary must however be notified by the IFM of any breaches identified and the resolution of these.

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<sup>17</sup> §105 in particular.

<sup>18</sup> pursuant to Article 2(1) SFDR.

## VI. Annex – Glossary

AIFM	Alternative Investment Fund Manager
CDR	Commission Delegated Regulation
CSSF	Commission de Surveillance du Secteur Financier
ESG	Environmental, Social and Governance factors
ESMA	European Securities Markets Authorities
IFM	Investment Fund Manager
NCA	National Competent Authority
SFDR	Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related pre-contractual disclosures in the financial services sector
UCITS	Undertaking for Collective Investment in Transferable Securities