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AIMA

# Responsible Investment Primer

May 2020

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**Max Budra**  
Associate, AIMA  
mbudra@aima.org

**Lucian Firth**  
Partner, Simmons & Simmons  
lucian.firth@simmons-simmons.com

**Sarah Crabb**  
Managing Associate, Simmons & Simmons  
sarah.crabb@simmons-simmons.com

# Introduction

Responsible investment is one of the most significant and fast-growing trends in the hedge fund industry today.

Certain aspects of responsible investment (RI) are not new. Hedge fund managers (referred to in this primer as 'managers') have always taken a broad view of risk, which has often meant accounting for what we would now call environmental, social, and governance ('ESG') risks. Some institutional investors, meanwhile, have historically demanded investment products that exclude certain assets, such as the manufacturers of cluster munitions.

However, RI has clearly never been as important to managers and their investors as it is today. In his January 2020 'Letter to CEOs,' Larry Fink, Chairman and CEO of BlackRock, stated that "[o]ur investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors. And with the impact of sustainability on investment returns increasing, we believe that sustainable investing is the strongest foundation for client portfolios going forward."

This growing interest is set against a backdrop of global change. The 2015 Paris Agreement, for example, gave new international impetus to combatting climate change, and this has been followed by a raft of regulatory initiatives in the European Union (EU)—summarised below—and other jurisdictions. Recent events such as the Australian bushfires of 2019-2020 have further spurred conversations about environmental risks in the investment management industry. Investors are increasingly asking their managers about their RI policies and practices, and many will expect to see evidence that their managers have thought through the potential ESG risks to their investments.

RI is a broad term that encompasses a range of approaches. At one end of the spectrum, a manager could practice RI simply by screening a handful of securities out of a portfolio. At the other end, the manager could decide to run a fund entirely dedicated to investing in assets that generate environmental or social goods.

The form of RI a manager chooses will be determined by the reasons why it chose to implement RI in the first place. Broadly, those reasons can be divided into two categories: some may adopt RI primarily for ethical reasons, others as a means of controlling risk or generating outperformance. While one manager, for example, may elect not to invest in tobacco manufacturers on moral grounds, another might abstain from investing in those same manufacturers out of a concern that the social risks they bear may make them unprofitable.

Many questions, however, still surround RI. For some hedge fund strategies, it may have little relevance—trading interest rate futures, for instance, may offer little scope to implement RI. Moreover, managers have traditionally been wary of anything that might restrict what investments they can make. As such, some managers may face challenges when investors question them on their RI practices, while others may be unsure whether they can implement RI in a cost-efficient manner, given challenges such as the difficulty in obtaining the necessary ESG data.

This primer provides a high-level overview of RI, and outlines some of the more common RI approaches adopted by managers. It also seeks to answer some frequently asked questions about RI in the context of hedge funds, outlines a series of AIMA principles for effective regulation in this space, and provides an overview of the proposed EU sustainability regulations.

RI is a dynamic field and the terms used can vary from region to region. While the content of this primer represents the best efforts of AIMA and Simmons & Simmons, the views expressed and the information provided are not necessarily those of all AIMA member firms and may evolve through time.

We hope that this primer will help investors understand RI and its applicability and relevance to hedge funds, assist regulators with the key issues currently faced by managers as they develop regulation in this area, and provide some clarity around the language of RI, to facilitate meaningful conversations between managers, investors, and other stakeholders.

# Key Concepts

## Screening

Screening (sometimes referred to as ‘socially responsible investment’ or ‘SRI’) is a process in which certain assets are excluded from an investment portfolio. Screening is one of the simpler forms of RI, and has been practiced by managers for some time—generally in response to demands from large institutional investors linked to religious, public, or charitable organisations. By way of example, a manager may invest in accordance with a screening policy which prohibits it from investing in tobacco companies, or arms manufacturers. Managers often offer screened versions of existing strategies.

While screening is relatively straightforward, it comes with several potential challenges. The first is that investors may have different views as to what assets are acceptable in a screened product, making it difficult to offer a single comingled screened fund. Some investors, for instance, may not want their capital invested in companies that produce alcoholic beverages, while others may only be concerned with ensuring that their capital is not invested in arms manufacturers. This problem is generally overcome through the use of separately managed accounts.

Another challenge is that screening may inadvertently increase the profits to be gained from investing in excluded securities, a market effect which has been noted by several prominent figures in the financial services sector.<sup>1</sup> To illustrate this, take a (fictitious) company, Nicotine Inc. As more investors adopt screening policies which forbid investment in tobacco companies, the demand for Nicotine Inc.’s stock will decrease. To remain attractive to investment, Nicotine Inc. may need to add a premium to its stock, making holding it more profitable and thus rewarding those who still invest in the company. The corollary of this, however, is that the cost of Nicotine Inc.’s capital would increase.

Many managers have informal conventions around the securities in which they invest, such as an unwritten rule not to invest in landmine

manufacturers. However, a manager is only practicing screening when those conventions are codified in a formal policy. As such, many firms may be able to practice screening simply by formalising the principles by which they already abide.

## Environmental, social, and governance factors

The use of environmental, social, and governance factors when investing—a process generally referred to as ‘ESG integration’—is an increasingly common form of RI. Simply put, ESG integration involves accounting for environmental, social, and governance factors when making an investment or risk management decision.

ESG integration is generally practiced for the purpose of limiting undesired risk; it can be done at both the asset and the portfolio level. At the asset level, a manager may examine the ESG attributes of a company before investing in it. For instance, it may investigate the company’s sensitivity to climate change, or its workplace safety practices. At the portfolio level, a manager would monitor aggregate ESG attributes. They may, for instance, monitor the total aggregate carbon emissions of every investment in a portfolio, in order to gauge that portfolio’s overall exposure to the risk of a carbon tax.

ESG integration can also be practiced to generate increased performance. This is clearly related to the question of risk mitigation: a company with a poor safety record, for instance, will be more exposed to legal claims or regulatory penalties that could jeopardise its profits. Some have suggested, however, that companies with high ESG scores may simply be more adaptable in general, and better poised to capitalise from economic transitions. While the notion that a well-run company tends, on balance, to deliver better financial performance than one which is run poorly is relatively uncontroversial, the performance effects of ESG integration have not yet been

<sup>1</sup> See, for instance, the comments of Cliff Asness, CEO, AQR, on this topic: <https://www.aqr.com/cliffs-perspective/virtue-is-its-own-reward-or-one-mans-ceiling-is-another-mans-floor>

determined. It should also be noted that, as the use of mainstream ESG factors becomes more popular, any outperformance that they may provide could be eroded.

Crucially, one of the greatest challenges managers face when implementing ESG is gaining the necessary data. Issuers are generally not required to disclose information on their performance on most ESG factors; such data is even more difficult to source for private assets. Third-party ESG data, meanwhile, can be expensive, limited, and inconsistent. As such it can often be difficult to gather the data necessary to reliably integrate ESG into investment and risk management decisions.

For more information on how a firm can implement ESG integration, please see AIMA's guide [Responsible Investment Policies for Hedge Fund Firms](#).

## Impact investing

Impact investing is the most rigorous, and least common, form of RI: it calls for deliberately investing capital in order to create measurable social or environmental goods. In many ways impact investing bridges the gap between traditional investing and philanthropy, by deliberately creating public goods while also generating profits. Impact investing is closely linked to the phenomenon of social entrepreneurship, in which for-profit companies work to solve social and environmental problems.

At present, impact investing is relatively uncommon in the hedge fund industry; it is seen more typically in the private equity and private credit sectors, where closed-ended funds may invest in infrastructure such as hospitals and schools. Hedge funds prioritise their ability to protect and grow the capital of their investors, and some argue that impact investing is simply too restrictive to be able to meet that goal. In addition, the implementation

of impact investing may require a retooling of expertise within a firm, as many managers lack the in-house talent needed to measure long-term social and environmental impact. As such, impact investing tends to be offered by smaller firms which have opted to specialise in this type of investing.

## Responsible behaviour outside of the investment mandate

Many managers are beginning to consider how they can improve their ESG profiles as businesses, beyond their investment mandates. This is manifesting itself by managers considering factors such as the gender balance and diversity of their own staff (particularly within their portfolio management teams), the wellbeing and mental health of their staff, their governance in internal decision making, and their environmental footprint. Some managers are also considering ESG factors when creating fund structures, such as by seeking to diversify the composition of the directors on their fund boards.

This is, at least partially, driven by demands from investors, who are increasingly evaluating the managers to which they allocate against ESG factors. For more information on these considerations please see AIMA's guide, [Policy and Practice: ESG Considerations at Alternative Investment Management Firms](#).

# Regulatory Principles

The regulatory environment surrounding RI is nascent. At present, one of the most high-profile initiatives in this area comes from the European Commission, which has adopted an action plan to increase capital flows to 'sustainable' investments. This plan has formed the foundation of recent and proposed EU regulations, further details of which are set out below (see the section entitled "EU Developments"). At the same time, there has been a significant regulatory push around RI elsewhere, such as in the People's Republic of China, where the China Securities Regulatory Commission has announced plans to require issuers to disclose the environmental risks associated with their operations in 2020.

Given the dynamism of this topic it is vital that regulation does not end up stifling innovation. In conjunction with our members, AIMA has formulated the following key principles to help inform the debate on effective RI regulation.

## Investor-led

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Managers exist to serve the needs of their investors. Any regulation on RI must take into account the fiduciary duty managers owe their investors; ultimately managers are the agents of their investors and are beholden to their demands. As such, the implementation of RI should be a product of investor demand. Managers are best positioned to know what their investors want from an RI product, and indeed whether their investors want such a product at all. It may therefore be unwise to require all investment managers to adopt RI principles.

## Principles-based

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RI is still a nascent phenomenon and is evolving rapidly. Any RI regulation must allow the field to develop naturally and sustainably, and not unduly stifle or constrain it. Accordingly, AIMA recommends that any RI regulation should be high-level and principles-based. Managers need flexibility to adapt their strategies and asset allocations in response to the evolution of RI. For instance, biomass wood chips were once seen as 'sustainable' products, but they are now avoided because of their high carbon emissions. RI regulation must permit managers the flexibility to adapt and respond to such changes.

## Proportionate

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Regulators should be mindful that RI may simply not be applicable to certain investment strategies, such as those based on short-term sovereign bonds. Rather, regulators should take into account the diversity of strategies used by managers. Failure to do so would increase the risk of 'greenwashing' and make it more difficult for investors to determine which managers were practicing RI in a meaningful way.

## Non-duplicative

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Regulation that seeks to embed RI practices into various aspects of investment management, such as risk management, may end up being redundant or self-defeating. Managers take their role as guardians of the capital of their investors seriously, and exercise thorough risk management and asset selection processes. These often already take into account sustainability risks, where they are material. As such, regulation requiring managers to account for such issues may be redundant. There is also the danger that regulation might create a situation where RI processes are regarded as separate from more 'traditional' aspects of investment management, thereby preventing RI from becoming an everyday part of investment management.

## Consistent

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RI is a broad term that can mean different things to different people. It is therefore imperative that regulators ensure consistency in the terms they use across different pieces of regulation. This is likely to require cooperation between market participants, policymakers, and regulators to create a common vocabulary which has an appropriate level of flexibility.

## Practical

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Regulators should be aware that the data necessary to implement many forms of RI can be expensive, inconsistent, or simply unobtainable. Compelling managers to use certain forms of data could create an artificial market in which the managers are forced buyers. As such regulators should avoid requiring managers to use specific types of data. Further, regulators should be mindful that mandating the use of a specific form of data can risk distorting the concept of RI by artificially defining its parameters.

## Broad-based

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Regulating managers alone is unlikely to achieve the goal of any RI regulation. To be effective, a regulatory framework must be broad-based and must encompass the behaviour of issuers. This is related to the problem of data scarcity. In many jurisdictions, issuers have few obligations when it comes to disclosing ESG data, and a strong incentive not to do so voluntarily. Any RI regulation should ensure a proper foundation of data is available before mandating specific action on the part of managers.

# EU Developments

The EU has set in motion an ambitious legislative programme to make ESG concerns a central plank of regulation in the financial services industry. The EU's initiative is particularly relevant to managers which have an express ESG or sustainability focus. However, key aspects of the new rules will apply to all managers—even those without such a focus. The first set of rules of particular relevance to most managers is scheduled to come into force in Q1 2021, so firms will need to prioritise the ESG initiatives as a key project in 2020.

Three pieces of Level 1 legislation which form part of the EU's Action Plan on Financing Sustainable Growth are of particular importance to managers, together with changes to several existing Level 2 measures.

## Level 1

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### Framework (or Taxonomy) Regulation

This creates a common taxonomy for determining how far an economic activity can be described as being 'environmentally sustainable,' in turn allowing managers and investors to establish how environmentally sustainable a given investment is.

The Framework Regulation will, in large part, be relevant only to managers which make available a financial product which either has an objective of environmentally sustainable investment, or promotes environmental characteristics, although all managers will need to make a negative disclosure to confirm that all out-of-scope financial products are out of scope.

The contents of the Framework Regulation have been agreed and are now awaiting formal adoption by the European Parliament before being published in the Official Journal (OJ). The development of Level 2 measures will then follow, though the exact timing of these will depend on how far the EU's attention continues to be taken by fighting the COVID-19 pandemic.

### Disclosures Regulation

This sets out a series of sustainability-related disclosures, which must be made (a) in the documentation for a fund or managed account and (b) on a manager's website.

Many aspects of the Disclosures Regulation will apply to all managers, including those which have no express ESG or sustainability focus (although some aspects will be relevant only to those financial products which have a specific ESG focus).

The Disclosures Regulation was published in the OJ in December 2019. Although the large majority of its provisions will not come into effect until 10 March 2021, in-scope managers will need to have to make significant business and policy decisions in relation to how sustainability impacts on their investment processes and would be well advised to prioritise this work in order to comply with the Regulation's requirements on time.

## **Low Carbon Benchmarks Regulation**

The Low Carbon Benchmark Regulation amends the Benchmarks Regulation by introducing appropriate and objective low-carbon indices that could be used as a reference index and sets out the key requirements applicable to the methodology for the new benchmarks.

The Low Carbon Benchmark Regulation was published in the OJ on 9 December 2019, coming into force the next day. Level 2 measures which were expected to be ready in Q2 2020 have now been delayed as a result of the COVID-19 pandemic and are currently expected in Q3.

## **Level 2**

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### **Suitability Delegated Regulation**

In January 2019, the Commission published a draft delegated regulation under MiFID 2. This would amend an existing delegated regulation to clarify that investment firms providing financial advice and portfolio management must take clients' ESG considerations and preferences into account in the investment and advisory process as part of the firm's 'suitability' assessment.

Firms would also have to furnish clients with information on the ESG factors of financial products before being able to provide investment advice or portfolio management services and prepare a report to the client explaining how the firm's recommendation meets the client's investment objectives, risk profile, capacity for loss bearing and ESG preferences.

### **Integrating sustainability into a firm's systems and controls**

Finally, the Commission is considering ESMA's technical advice on amending Level 2 delegated acts under the AIFMD, the UCITS Directive and MiFID 2, to ensure that sustainability risks and sustainability factors are integrated within a manager's organisational, operating and risk management processes.

# FAQ

## Is responsible investment compatible with the concept of a hedge fund?

Yes. Hedge fund managers are, by definition, unconstrained and active investors. As such some have argued that RI represents a constraint that is antithetical to the premise of hedge funds. However, as explained in this primer, not all forms of RI are based on constraints. In many cases, RI is simply a means of using data to make more informed investment and risk management decisions.

Further, hedge fund managers (and active managers more broadly) may actually be more capable of implementing RI than their passive counterparts. Passive, indexed funds are compelled to own certain securities in order to avoid tracking errors, and thus do not usually have the ability to selectively exclude securities from their portfolios. Further, passive managers often do not engage with the companies in which they invest. Many hedge fund managers, on the other hand, have a long history of engaging with the management of the companies in which they invest.

## How can investors be sure that a manager is really performing responsible investment?

There is always the risk of so-called 'greenwashing,' in which a manager will label a product as environmentally sustainable in order to attract business, without actually implementing RI in any substantive way.

At present, the onus is on investors to properly research managers and their products. However, in the future, national regulators may regulate the use of such terms as 'ESG' and 'sustainable' more strictly. Once fully effective, the EU developments set out in the previous section should serve to inform investors to a much greater degree of the

extent to which a manager is performing RI. Further, verifications performed by third party labelling agencies can provide some comfort to investors as to the nature of the products in which they are investing.

## Is responsible investment compatible with the practice of short selling?

Yes. Short selling is, in most circumstances, neither irresponsible nor unethical, and it can form a critical tool in RI. For instance, a manager could short a company with poor environmental practices that were hidden from the public and which the market had failed to price in. However, managers should be clear with their investors on whether they short assets that have been screened from the long side of their portfolios. For more information please see [Responsible Investment Policies for Hedge Fund Firms](#).

## Can responsible investment considerations go beyond the portfolio investments?

Yes. At the level of the fund, the effectiveness and the quality of governance provided by the fund's board of directors can be an RI concern. Prospective investors in a fund may raise a variety of issues: is the board comprised exclusively of independent directors? What is the board's gender balance? What do its members bring in terms of diversity of backgrounds, skills and experience?

At the level of the manager, similar consideration may be given to the composition of the investment team and senior management. Investors may also examine the degree to which certain functions within the manager, such as compliance and risk, are independent from the investment decision makers.

## Is responsible investment compatible with the use of offshore fund structures?

Yes. Investment funds use offshore fund structures to meet the challenges of accommodating investors and investments located in multiple jurisdictions. Offshore jurisdictions provide expertise and a concentration of fund servicing businesses in a cost-efficient manner. A wide range of international initiatives, including the OECD's Base Erosion and Profit Shifting (BEPS) project, seek to address deficiencies in the international taxation system and create a fair tax system. These measures, combined with the expertise offered by offshore jurisdictions, promote responsible and ethical investments across the globe. In spite of this, certain investors—such as Northern European investors, who have historically been very significant allocators to ESG strategies—may prefer onshore structures.

## Is responsible investment compatible with a public pension mandate?

In some jurisdictions, pension plan trustees or other investing fiduciaries may not use plan assets to promote social, environmental or other public policy causes at the expense of the financial interests of the plan's participants and beneficiaries. A fiduciary may not accept lower expected returns, or take on greater risk, in order to secure collateral benefits. Since every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals. However, when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as 'tie-breakers' for an investment choice.

## How does responsible investment affect fund performance?

This is a difficult question, as the answer depends on what form of RI is being considered. Modern portfolio theory would suggest that, all else being equal, narrowing the range of securities held in a portfolio will increase that portfolio's volatility and risk. However, RI screening generally does not drastically limit the range of assets in which a manager can invest—most screens are focussed on assets such as tobacco, controversial munitions, and the like.

Determining the performance effects of ESG integration is also complicated. As mentioned above, most managers already account for the risks posed by sustainability factors on their potential investments, meaning that the actions of a manager formally practicing ESG integration may not substantially differ from those of other managers. Further, a company with good governance ('G') may also perform well on various financial metrics, which may be caught by more traditional factors. This makes attributing performance difficult, especially at the portfolio level, where benefits may be offset by the cost of ESG integration.

Perhaps the simplest answer is that many investors seem to believe that RI is important for fund performance, and are increasingly asking their external managers about their RI policies and practices.

## Is divestment the answer?

There are currently a number of high-profile divestment campaigns, such as one targeting fossil fuels which is supported by many academic institutions.

The counterargument, however, is that divestment means the loss of a voice or voting rights. As such, it can be argued that it is more responsible to maintain an investment and engage with the relevant issuer's governing bodies in order to encourage them to improve their ESG practices.

By way of example, the Church of England is widely credited with having pressured Royal Dutch Shell to make firm commitments to cut its carbon footprint. Investor expectations around divestment and engagement vary and managers should ensure that they adequately disclose which approach or approaches they may use.

### **How are managers dealing with investor demands to demonstrate responsible investment?**

Many managers are reporting an increase in questions from investors about their RI practices. Managers who may not have considered RI may find that, through becoming an engaged asset owner, they are able to demonstrate positive practices without the need to significantly change their investment approach. This usually involves, at a minimum, systematically exercising voting rights, but may extend to interactions between the manager and the governing bodies of issuers within the manager's portfolio. Through ownership of a small percentage of a listed company's equity, a manager may be able to demand the attention of the company's governing bodies and pressure them to improve their ESG practices.

Further, the adoption of a firmwide prohibited securities screening list may be a relatively straightforward way by which to formalise a firm's existing informal RI practices. Many managers, for instance, may already not invest in so-called 'uncontroversial controversies,' such as manufacturers of cluster munitions. As such, creating a formal policy and a prohibited asset list to that effect can be a relatively straightforward way of demonstrating some degree of RI practice.

# Glossary

**Best-in-class:** Assets or investments that are the best performers amongst their peers in terms of environmental, social, and/or governance factors.

**Engagement:** The practice of seeking to influence the behaviour of a company in which a fund is invested in order to improve their environmental, social, and governance practices. For instance, engaging with a company's board in order to improve that company's labour practices.

**Environmental, social, governance (ESG) factors:** Identifying traits of a security that may not have been taken into account by that security's price, but which may affect its desirability from both a non-financial and a financial point of view. For example, accounting for a company's carbon footprint when deciding whether to invest in that company.

**Ethical investment:** Using one's ethical principles as the main filter for securities selection. Ethical investing depends on an investor's views: some may choose to eliminate certain industries entirely or to over-allocate to industries that meet that individual's ethical guidelines.

**Green investment:** Investment activities that focus on companies or projects that are committed to the conservation of natural resources, the production and discovery of alternative energy sources, the implementation of clean air and water projects, or other environmentally conscious business practices.

**Impact investing:** Investments made in order to deliberately create social goods. For instance, investing in a for-profit company which makes affordable water purifiers for the developing world.

**Responsible investment (RI):** An umbrella term describing the formal integration of ethical, social, or sustainability considerations into investment decisions.

**Screening:** A process which excludes certain securities from a portfolio based on perceptions of their moral worth, their environmental impact, or other non-financial considerations. For example, the exclusion of cluster munition manufacturers from an investment portfolio.

**Sustainable investment:** An investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management.

**Sustainability risks:** Risks to the value of an asset occasioned by environmental, social, or governance issues. For instance, the price of an equity declining due to fines levelled against the issuer for environmental damages.

**United Nations Principles for Responsible Investment (UN PRI):** An agency that promotes responsible investment through a set of six investment principles that offer actions for integrating responsible investment into investment decisions.

# Additional Resources

For more information about responsible investment and the hedge fund industry, please see the following sources:

- AIMA: [Due Diligence Questionnaire for Responsible Investment](#)
  - A DDQ on responsible investment in the hedge fund space produced in conjunction with the UN PRI
- AIMA: [AIMA Responsible Investment Policies for Hedge Fund Firms](#)
  - A guide on how hedge fund firms can create responsible investment policies, and the structure they will need to do so.
- AIMA: [AIMA Policy and Practice: ESG Considerations at Alternative Investment Management Firms](#)
  - A guide on how hedge fund firms can improve the ESG characteristics of their management companies, and how they can differentiate themselves through doing so.
- AIMA: [Responses to ESMA Consultation Papers on the Integration of Sustainability Risks and Factors in MiFID II; the UCITS Directive and AIFMD](#)
  - [AIMA's responses to ESMA's consultations](#) on how responsible investment precepts might be integrated in MiFID II, the UCITS Directive, and AIFMD.
- AIMA: [Letter to IOSCO on Issuer Disclosure of ESG Factors](#)
  - A letter written by AIMA to IOSCO in support of its call for issuers to disclose materially relevant ESG factors.
- AIMA: [Responsible investment webpage](#)
  - Webpage containing AIMA's guidance and regulatory submissions on responsible investment, as well as useful third-party research.
- Simmons & Simmons: [Sustainable Financing and ESG Investment microsite](#)
  - A microsite covering the key regulatory obligations for asset managers stemming from the European Commission's Action Plan on Financing Sustainable Growth.
- Simmons & Simmons: [Top Ten Things Asset Managers Need to Know About the EU ESG Initiative](#)
- Simmons & Simmons Guide: [The EU Disclosures Regulation – Key Requirements for Asset Managers](#)
  - An examination of the key themes in the Disclosures Regulation of relevance to asset management firms, looking at the rules which apply:
    - at the level of the asset management firm
    - to all financial products made available by an asset management firm
    - whether or not the product has an express ESG focus; and
    - only to financial products which have an express ESG focus.



#### Disclaimer

The contents of this primer are not intended as legal advice. Due to this dynamism of this field the meaning of some key concepts may change over time.

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