1. Introduction: ESG and Euro CLOs

The rise of environmental, social and governance ("ESG") financing in Europe in recent years has been nothing short of remarkable as investors increasingly seek to prioritise investment in sustainable assets. This global trend towards sustainable investment has filtered into the European collateralised loan obligations ("Euro CLO") market with most new issue or reset Euro CLO transactions incorporating ESG investment criteria in some shape or form.

At the same time, regulators are focusing on shifting capital flows towards a more sustainable economy. One way that they have sought to do this is by targeting "greenwashing" of financial products by prescribing and harmonising ESG disclosure in Europe via the Sustainable Finance Disclosure Regulation ("SFDR").

The impact of SFDR on Euro CLOs was a notable theme of 2021, as Euro CLO investors subject to SFDR sought to invest in Euro CLOs subject to certain ESG diligence, investment and disclosure standards (in part to satisfy their own obligations under SFDR or other applicable ESG regimes).

As the impact of ESG investment and regulatory considerations on the Euro CLO market become ever more significant, this Client Alert focuses on how ESG has impacted Euro CLOs and what ESG developments we can expect to see in 2022 and beyond.

2. What is SFDR and how does it impact Euro CLOs?

SFDR aims to reduce informational asymmetries applicable to European investors with regard to ESG information, thereby allowing those investors better to take into account ESG factors in their investment decisions. In particular, SFDR permits funds to be badged as “promoting environmental or social

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1 Morningstar reported that, in the third quarter of 2021, sustainable funds attracted all-time high net inflows of $134 billion, with 270 new sustainable funds launched in the third quarter of 2021. https://www.morningstar.co.uk/uk/news/216474/sustainable-assets-are-teetering-on-the-%244-trillion-mark.aspx.
3 SFDR forms part of a broader legislative package under the European Commission’s Sustainable Finance Action launched in March 2018 and sets out harmonised rules applicable to certain financial institutions on transparency with regard to the integration of sustainability risks, the consideration of adverse sustainability impacts in their investment decisions.
ESG and Euro CLOs: The Past, Present and Future

characteristics” (“Article 8 / Light Green Funds”) or “having sustainable investment as its objective” (“Article 9 / Dark Green Funds”). Whilst such Article 8 / Light Green Funds and Article 9 / Dark Green Funds have increased disclosure requirements (including in offering documents, in annual reports and on websites for in-scope financial entities and products), they will be granted a European Union (“EU”) endorsement for ESG compliance and are attractive to investors seeking to invest in ESG friendly assets.

SFDR applies to certain “financial market participants” located in the EU (including MiFID investment firms and credit institutions providing portfolio management services, AIFMs and UCITS managers) when making available a “financial product”. SFDR is not directly applicable to a Euro CLO because (i) a CLO issuer, incorporated as an Irish DAC, does not fall within the definition of “financial market participant”; and (ii) Euro CLO notes, as debt instruments, do not constitute “financial products” within the meaning of SFDR. CLO managers based in the United Kingdom (“UK”) and the United States (“US”) are outside of the scope of SFDR as they are not EU MiFID authorised investment firms and, in the case of UK-based CLO managers, the operative provisions of SFDR were not on-shored into UK legislation prior to the UK's withdrawal from the EU. EU-based CLO managers that are investment firms or credit institutions, on the other hand, are likely to be subject to SFDR by their provision of portfolio management services to clients (e.g. CLO issuers).

Notwithstanding that SFDR is generally not directly applicable to Euro CLOs, we are seeing European investors in Euro CLOs request transaction disclosure in accordance with reporting requirements under SFDR (principally requests for “Principal Adverse Sustainability Impacts Statements” pursuant to Article 4 of SFDR). There are also signs that Euro CLOs are beginning to be aligned with the requirements of Article 8 / Light Green Funds (i.e. the CLO manager agrees with the CLO issuer to manage the portfolio, and provide disclosures to Euro CLO investors, consistent with Article 8 of SFDR) (an “Article 8 Aligned CLO”) in order to accommodate investor demand for such products. We will explore these developments further below.

3. How has ESG impacted Euro CLOs to date?

ESG related provisions began to be incorporated into Euro CLOs in 2019 and, until recently, have focused on “negative screening” of ESG matters.

Early ESG investment restrictions were incorporated into Euro CLOs, via the eligibility criteria, by certain exclusions in investing in the financial instruments of obligors whose business related to “excluded industries”, such as the production or marketing of controversial weapons (e.g. antipersonnel landmines, cluster weapons and biological weapons), development or production of nuclear weapons and thermal coal production. ESG investment restrictions encountered some early resistance from CLO managers, some of whom expressed concerns at incremental creep of investment restrictions into comparatively “anodyne” industries (e.g. gambling or chemicals), and increased correlation risk and reduced diversity scores by excluding a broad universe of loans. However, as ESG became a higher priority for investors in Euro CLOs, CLO managers embraced such restrictions and the typical list of excluded ESG industries has expanded to include, among other things: (i) the extraction of oil, gas or thermal coal, or the generation of electricity using coal; and (ii) trading in hazardous chemicals, pesticides and wastes, ozone-depleting substances, endangered or protected wildlife or wildlife products, palm oil, pornography or prostitution; tobacco or tobacco-related products; predatory or payday lending activities; or weapons or firearms.
By the start of 2021, ESG investment restrictions in some shape or form had become a standard feature of newly issued, or resets of, Euro CLOs. Over the course of the year, those ESG investment restrictions, in the round, continued to tighten as Euro CLO investors demanded (and CLO managers accommodated) further ESG negative screening. In more recent transactions, we have seen CLO managers seek to demonstrate their commitment to ESG by incorporating ever stricter investment criteria such as (i) additional excluded industries (e.g. narcotics or, in some cases, gambling); (ii) revenue carve-outs assessed at a consolidated group level and lower permitted revenue carve-outs for excluded industries; and (iii) ESG investment decisions assessed by reference to international global treaties (e.g. the United Nations Principles for Responsible Investment) setting out objective parameters to what can be considered “ESG friendly” assets.9

Whilst the historic approach of Euro CLOs and ESG has focused on “negative screening”, it is evident the Euro CLO investors and CLO managers are considering positive screening10 and thematic investment11 with respect to Euro CLO portfolios in order to satisfy investor requirements for sustainable investment and to align their Euro CLOs with the requirements of Article 8 / Light Green Funds or even, eventually, Article 9 / Dark Green Funds.12

4. How does SFDR impact Euro CLO investors?

Euro CLO investors are increasingly focused on the ESG due diligence and investment procedures implemented by CLO managers as part of their investment processes. This is, in large part, driven by SFDR requirements imposed on in-scope investors. SFDR requires “financial market participants” to, among other things:

1. at an entity level, disclose on their website:
   a. information on their policies to integrate sustainability risks13 in their investment decision-making processes;14
   b. information on whether they take into account the principal adverse impacts of their investment decisions on sustainability factors15 (and, where they do, to provide a statement on due diligence with respect to those policies and certain other prescribed information);16

2. at financial product level, disclose:
   a. in their pre-contractual disclosures, information on whether they integrate sustainability risks into their investment decisions and, where they do, the likely impacts of sustainability risks on the returns of the applicable financial product;17

9 For example, in Neuberger Berman Loan Advisers Euro CLO 2 managed by Neuberger Berman Europe Limited, the eligibility criteria exclude obligors that undertake directly or indirectly “ESG Norm-based exclusions”, which include (i) activities that are United Nations Global Compact (UNGC) violations; or (ii) obligors that have been identified as having corporate involvement in the manufacture of biological and chemical weapons, anti-personnel land mines, or cluster munitions as defined in the Biological and Toxin Weapons Convention of 1972, the Chemical Weapons Convention of 1993, the Anti-personnel Landmines Convention of 1997, and/or the Convention on Cluster Munitions of 2010.
10 Positive screening means investment in the most sustainable products within each asset class.
11 Thematic investment means investment in products which give exposure to specific sustainability themes.
12 See Section 6 of this Client Alert.
13 See Article 2(22), SFDR. SFDR defines “sustainability risk” as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.”
14 See Article 3(1), SFDR.
15 See Article 2(24), SFDR. SFDR defines “sustainability factors” as “environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.”
16 See Articles 4(1) and 4(2), SFDR.
17 See Article 6(1), SFDR.
In order to comply SFDR’s disclosure requirements, and to satisfy their investment guidelines for ESG focused capital, it is now common for Euro CLO investors to require CLO managers to demonstrate a commitment to ESG at an organisational level, and to agree to provide ESG-related disclosure.

5. What ESG trends are we seeing in the Euro CLO market?

A. ESG Due Diligence and Investment Procedures

CLO managers have made significant investment into the development of ESG policies and strategies, and dedicated ESG research teams and personnel, in each case, to be utilised in their investment decisions and due diligence with respect to the impact of an obligor’s business on ESG matters. The majority of CLO managers have implemented investment guidelines and procedures that take into account ESG considerations. For example, prior to investing in an obligor, a CLO manager might expect the obligor to have policies in place to reduce greenhouse gas emissions and/or to conduct biodiversity impact assessments of their operations and supply chains, and/or to achieve net zero deforestation objectives within clear timeframes. Information on a CLO manager’s policies, strategies and research terms is frequently disclosed in the offering circular and marketing materials for Euro CLO transactions (and, in certain instances, on the websites of CLO managers).

CLO managers are also going further and agreeing contractually to comply with initial and ongoing “ESG due diligence procedures” in respect of each investment, and to take into account “ESG best practices” for each Euro CLO investment. This approach was first taken in the “North Westerly CLO VI” transaction managed by NIBC Bank N.V. and has since been adopted by a number of other CLO managers in the market. The application of ESG due diligence procedures and best practices to investments, as a contractual matter or otherwise, is to be welcomed. However, such procedures and practices by CLO managers have historically been undermined by an absence of publicly available information on the ESG impact of obligor activities (or, where access to obligor management is available, a reluctance on the part of obligor management teams to disclose such information). This has presented difficulties for CLO managers seeking to effect ESG due diligence or to report ESG portfolio data to Euro CLO investors.

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18 See Article 7(1), SFDR.
19 See Articles 8 and 9, SFDR. Certain disclosure requirements also apply to Article 8 / Light Green Funds and Article 9 / Dark Green Funds under the Taxonomy Regulation (as defined below). See Section 6 of this Client Alert.
20 By way of example, the Sustainable Investing Policy of FIL Investments International is available at https://fidelityinternational.com/sustainable-investing-policy/
21 For example, a CLO manager using commercially reasonable efforts, among other things, (a) prior to the purchase of a collateral obligation, to (i) review due diligence materials reasonably available; (ii) attend investor presentations and/or conduct management meetings; (iii) review publicly available third party information; and (iv) conduct relevant internal research from ESG focused teams; and (b) once a collateral obligation is purchased, periodically to (i) attend management meetings, conference calls or other events relating to the obligor, and (ii) monitor on an ongoing basis the industry and sector trends relating to that obligor.
22 This may include standards and methodologies determined by the CLO manager for assessing the ESG impact and profile of an industry or an issuer or financial instruments based on the then prevailing interpretations and practices relating to ESG-compliant investing and lending.
23 For example, see “Blackrock European CLO VII” (as refinanced on 8 March 2021) managed by Blackrock Investment Management (UK) Limited.
Encouragingly, there has been a recent industry-wide push from leveraged finance market participants to solicit ESG data from underlying obligors in a market standard fashion. The Loan Syndications and Trading Association (“LSTA”) has developed an ESG diligence questionnaire for borrowers to complete for review by prospective lenders, and the Loan Market Association (“LMA”) and the European Leverage Finance Association have published the “Guide for Company Advisers to ESG Disclosure in Leverage Finance Transactions”. In addition, in November 2021, it was reported by Creditflux that Findex and more than 30 European CLO managers had formed a working group focused on ESG-based disclosures required by SFDR in order to provide a united and consistent approach to ESG compliance within the Euro CLO market. Such industry-led developments have assisted, and will continue to assist, CLO managers with ESG diligence and investment.

B. ESG Reporting

One of the more recent ESG-related developments in the Euro CLO market is Euro CLO investor requests for CLO managers to agree to provide them with “Principal Adverse Sustainability Impact Statements” consistent with Article 4 of SFDR. Although not directly applicable to non-EU regulated CLO managers, increasing numbers of “third country” CLO managers (i.e. UK and US CLO managers) are voluntarily complying with Article 4 of SFDR on a reasonable discretion and reasonable efforts basis to assist Euro CLO investors with their own Article 4 reporting requirements.

Article 4 of SFDR requires in-scope financial market participants to provide information on whether they take into account the principal adverse impacts of their investment decisions on sustainability factors (and, where they do, provide a statement on due diligence with respect to those policies and include certain prescribed information), taking into account the size, nature and scale of their activities and the types of financial product that they make available. On 4 February 2021, the European Supervisory Authorities published their final report on the draft regulatory technical standards to apply with respect to Article 4 of SFDR (the “Draft PASIS RTS”) and the Draft PASIS RTS are expected to apply from 1 January 2023.

The Draft PASIS RTS set out a prescribed (and reasonably onerous) template that any “Principal Adverse Sustainability Impact Statement” will need to comply with. This template requires: (i) quantitative disclosures including quantitative data on 14 key indicators (nine relating to the environment and five relating to social factors) for assessing adverse sustainability impacts across a range of ESG factors; and (ii) qualitative disclosures, including (a) information about policies on the identification and prioritisation of principal

The most recent iteration of the LSTA’s “Due Diligence Questionnaire – Borrower” was published in May 2021 and is available at https://www.lsta.org/content/esg-diligence-questionnaire-borrower/.

This document is intended to be practical tool for company advisers to use in support of their efforts to provide ESG discourse in high yield bond and leverage loan offering materials and financial reports. It is available at https://www.lma.eu.com/application/files/8816/1105/1620/Guide_for_Company_Advisers_to_ESG_Disclosure_in_Lev eraged_Finance_Transactions.pdf.


CLO managers that have agreed to undertake ESG due diligence procedures and best practices have generally done so on a “commercially reasonable endeavours” and “sole discretion” basis in light of the difficulties in soliciting ESG data in respect of obligors, and because no clearly-defined description (legal, regulatory or otherwise) or market consensus has developed as to what constitutes best practice in assessing the ESG impact and profile of an industry or an obligor.

See, for example, “Tikehau CLO VI” managed by Tikehau Capital Europe Limited.

See also Article 4(2), SFDR.

The European Supervisory Authorities are the European Securities and Markets Authority, the European Banking Authority and the European Insurance and Occupational Pensions Authority (together, the “European Supervisory Authorities”).

See the Final Report on draft Regulatory Technical Standards with regard to the content, methodologies and presentation of disclosures pursuant to Article 2a(3), Article 4(6) and (7), Article 8(3), Article 9(5), Article 10(2) and Article 11(4) of Regulation (EU) 2019/2088, available at https://www.esma.europa.eu/sites/default/files/library/jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf.


See Articles 4 to 6, Draft PASIS RTS.
adverse sustainability impacts and indicators;34 (b) information on engagement policies and policies relating to reducing principal adverse impacts;35 and (c) reference to adherence to responsible business conduct codes and internationally recognised standards for due diligence and reporting.36

The stated intention of the European Commission is that clients and investors will use such disclosures to identify firms that do more on “sustainability factors” and favour products or services from such firms. It is also hoped by the European Commission that this approach will influence obligors and product providers to adopt “ESG norms” to assist with global efforts towards tackling climate change, diversity and anti-bribery. In many respects, these goals are coming to fruition in the Euro CLO market, as Euro CLO participants adopt voluntary compliance with SFDR’s Article 4 reporting regime at a contractual level.

It is important to note that where CLO managers agree to comply voluntarily with Article 4 of SFDR, they are not, in our experience, also opting to comply with the required firm-level website disclosure requirements prescribed by Article 4 of SFDR – the requirement is limited to producing reports in accordance with the template requirements under the Draft PASIS RTS. The Findox working group discussed above was established to assist CLO managers to implement SFDR’s Article 4 reporting standards into monthly trustee reports, by collecting the required data from underlying obligors. As the Euro CLO market develops ESG reporting capability (including with respect to the Draft PASIS RTS), we expect to see Article 4 SFDR reporting becoming “market standard” within the Euro CLO market.

It is also worth highlighting that a number of CLO managers are seeking to demonstrate their green credentials by providing additional monthly or quarterly ESG reporting. In the recent “Neuberger Berman Loan Advisers Euro CLO 2” transaction, Neuberger Berman Europe Limited as CLO manager agreed to prepare a quarterly ESG report including (a) the average “ESG Score” (i.e. a score assigned by Neuberger Berman Europe Limited reflecting the underlying obligor’s overall adherence to ESG factors in accordance with its policies and procedures) of the portfolio from time to time; (b) commentary and description of the obligors added or removed from the portfolio as a result of material ESG factors; and (c) if applicable, details of any “ESG Obligors” (i.e. obligors that satisfy certain “objective” third party standards). In respect of limb (c), “ESG Obligors” were identified by reference to industry and global standards, introducing a degree of objectivity and transparency to this determination.37 Whilst such reporting has, to date, largely been offered at the discretion of certain CLO managers, our expectation is that as the ESG market develops, it will become the norm for CLO managers to seek to provide some form of periodic ESG reporting to investors based on objective industry and global standards.

C. ESG Portfolio Profile Tests

In addition to a focus on ESG due diligence and investment procedures and ESG reporting, the Euro CLO market has seen tentative steps taken towards thematic investment in ESG assets via the Euro CLO’s portfolio profile tests. This approach has been taken in certain limited circumstances to satisfy investor

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34 See Article 7, Draft PASIS RTS.
35 See Article 8, Draft PASIS RTS
36 See Article 9, Draft PASIS RTS.
37 The term ESG Obligors includes (1) “ESG Rated Obligors” who are obligors rated with a sufficient ESG rating from an ESG Rating Agency to be eligible for favourable regulatory treatment by a competent authority or for such obligor to be eligible for a G10 central bank asset purchase or liquidity program; (2) “Green Obligors”, who satisfy LMA’s Green Loan Principles (available at https://www.lma.eu.com/application/files/9115/4452/5458/741_LM_Green Loan_Principles_Booklet_V8.pdf) or ICMA’s Green & Social Bond Principles (available at https://www.icmagroup.org/News/news-in-brief/green-and-social-bond-principles-2021-edition-issued/); and (3) “Sustainability-linked Obligors” (A) who satisfy the LMA’s Sustainability Linked Loan Principles (available at https://www.lma.eu.com/application/files/8416/2210/4806/Sustainability_Linked_Loan_Principles.pdf), (B) who satisfy ICMA’s Sustainability-linked Bond Principles (available at https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/sustainability-linked-bond-principles-slbp/), (C) whose loan or bond includes covenants in respect of the UN Sustainable Development Goals; or (iv) whose financial instruments are eligible for a G10 central bank asset purchase or liquidity program.
preferences and in order for Euro CLOs be structured as Article 8 Aligned CLOs (notwithstanding that a Euro CLO would not be “in scope” for the purposes of Article 8 of SFDR).

As discussed above, Article 8 / Light Green Funds are financial products that seek to promote environmental or social characteristics (or a combination thereof). There is little guidance on what investment criteria are required for Article 8 / Light Green Funds, but the prevailing view is that Euro CLO investors in an Article 8 Aligned CLO will require (in addition to various disclosure requirements) a portfolio profile test and/or collateral quality test requiring a certain level of investment in ESG assets to be maintained at all times (or if not maintained, improved through trading). One example of this is the recent “Fidelity Grand Harbour CLO 2021-1” transaction managed by FIL Investments International, which requires that not less than 50 per cent. of the aggregate collateral balance of the portfolio consist of “Sustainable Obligations”. Sustainable Obligations, for this purpose, are collateral obligations with an “ESG Score” of “C” (or the numerical equivalent based on external third party ESG ratings) or higher.

As CLO managers and Euro CLO investors look at the possibility of marketing Article 8 Aligned CLOs, we expect to see more CLO managers incorporating ESG portfolio profile tests into Euro CLO transactions that they manage.

6. How will an Article 8 Aligned CLO be structured?

SFDR permits a significant amount of discretion with respect to the extent that an Article 8 Aligned CLO would need to promote “environmental or social characteristics”. This opens up the possibility of Article 8 Aligned CLOs of a varying degree of green, particularly as the European Supervisory Authorities have advised that, at the lowest end of the scale, negative screening only may be sufficient to qualify a financial product as “Article 8 compliant”.

In the event that a CLO manager chose to market a transaction as an Article 8 Aligned CLO, we would expect to see the CLO manager agree, in the collateral management agreement of the Euro CLO, to manage the portfolio and provide disclosure to Euro CLO investors in a manner consistent with Article 8 of SFDR. For this purpose, and notwithstanding the European Supervisory Authorities guidance with respect to negative screening discussed above, we expect Euro CLO investors and managers to want to undertake to effect some level of thematic investment effected via portfolio profile or collateral quality tests in order to “promote environmental or social characteristics (or a combination thereof)” for Article 8 Aligned CLOs, although it remains to be seen how the market will develop on this point.

The disclosure requirements for Article 8 / Light Green Funds are quite prescriptive, and, in particular, an Article 8 / Light Green Fund must disclose:

1. in its pre-contractual disclosures:

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38 See, for example, “Fidelity Grand Harbour CLO 2021-1” managed by FIL Investments International.
39 See section 6 of this Client Alert for further details.
40 This “ESG Score” is a score assigned by FIL Investment International reflecting the underlying obligor’s overall adherence to ESG factors in accordance with its Sustainable Investment Policy (available at https://fidelityinternational.com/sustainable-investing-policy/ (as may be updated from time to time).
41 Collateral obligations that are not assessed as having an ESG Score of between A and C remain eligible for inclusion in the portfolio, subject to meeting the applicable eligibility criteria, provided they are able to demonstrate that they are maintaining or improving trajectory with respect to their sustainable characteristics.
42 Recital 18 of the Draft PASIS RTS provides that “Financial products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics (environmental or social characteristics) cover various investment approaches and strategies, from best-in-class to specific sectoral exclusions.”
43 Not all obligations in the portfolio will need to promote environmental or social characteristics to qualify as an Article 8 Aligned CLO. Recital 21 of the Draft PASIS RTS provides that “Financial products that promote environmental or social characteristics can invest in a wide range of underlying assets, some of which may not themselves qualify as sustainable investments or contribute to the specific environmental or social characteristics promoted by the financial product”.

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a. information on how applicable environmental or social characteristics are met;\textsuperscript{44}

b. if an index has been designated as a reference benchmark:
   i. information on whether and how this index is consistent with those characteristics;\textsuperscript{45}
   ii. where the methodology used for the calculation of the index is to be found;\textsuperscript{46}
   iii. information on the environmental objective or objectives listed under the Regulation (EU) 2020/852 (the “Taxonomy Regulation”)\textsuperscript{47} to which the underlying investment contributes;\textsuperscript{48} and
   iv. a description of how and to what extent the underlying investments qualify as “environmentally sustainable” for the purposes of the Taxonomy Regulation, and also the proportion of investments that are environmentally sustainable;\textsuperscript{49}

2. in periodic reports to investors:
   a. a description of the extent to which applicable environmental and social characteristics are met,\textsuperscript{50} with such disclosure to be given in the form required by Annex IV of the Draft PASIS RTS once it comes into effect;\textsuperscript{51} and
   b. where an Article 8 / Light Green Fund promotes one of the six environmental characteristics set out in the Taxonomy Regulation:
      i. information on the environmental objective or objectives to which the underlying investment contributes; and
      ii. a description of how and to what extent the underlying investments qualify as “environmentally sustainable” for the purposes of the taxonomy, and also the proportion of investments that are environmentally sustainable.\textsuperscript{52}

3. on the website of the relevant manager:
   a. description of the applicable environmental or social characteristics;
   b. information on the methodologies used to assess, measure and monitor the applicable environmental or social characteristics;
   c. information on how those characteristics are met; and
   d. if an index has been designated, information on whether and how this index is consistent with those characteristics.\textsuperscript{53}

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\textsuperscript{44} See Article 8(1), SFDR and Articles 13 to 19 of the Draft PASIS RTS. Note that The Draft PASIS RTS requires such disclosures to follow the template to be set out in Annex II thereto.

\textsuperscript{45} See Article 8(1), SFDR.

\textsuperscript{46} See Article 8(2), SFDR.

\textsuperscript{47} The Taxonomy Regulation also forms part of the European Commission’s Sustainable Finance Action Plan and is intended to provide a common language for firms and investors to identify which economic activities are “environmentally sustainable”. The Taxonomy Regulation sets out criteria for determining whether an activity is environmentally sustainable.

\textsuperscript{48} See Article 8(2a), SFDR.

\textsuperscript{49} See Article 8(2a), SFDR.

\textsuperscript{50} See Article 11(1)(a), SFDR.

\textsuperscript{51} See Article 58 to 63, Draft PASIS RTS.

\textsuperscript{52} See Article 11(1)(d), SFDR and Article 6, Taxonomy Regulation.

\textsuperscript{53} Article 10(1), SFDR. See also Articles 32 to 44 of the Draft PASIS RTS, which, among other things, requires disclosures to be set out in a section of the relevant manager’s website titled “Sustainability-related disclosures” and in the same part of the website as the other information relation to the fund, including marketing communications.
It is clear, therefore, that CLO managers will need to invest time and money in understanding and complying with SFDR’s prescriptive disclosure requirements for Article 8 / Light Green Funds if they are to market an Article 8 Aligned CLO. It is our expectation, however, that CLO managers will be able to develop policies and procedures to comply with the Article 8 disclosure requirements reasonably quickly (perhaps utilising third party providers) and that the process will become relatively standardised as the market develops. Ultimately the time and money spent developing policies and procedures to market Article 8 Aligned CLOs is likely to pay dividends for CLO managers as Euro CLO investors demand ESG-friendly assets and global standards migrate towards SFDR’s Article 8 standards. Increasing CLO investor demand for ESG friendly assets is, in due course, likely to result in improved pricing for Article 8 Aligned CLOs.

7. **Will we see an Article 9 Aligned CLO in the future?**

In the future we expect CLO managers to seek to structure Euro CLOs aligned with the requirements of Article 9 of SFDR (“Article 9 Aligned CLOs”). Article 9 Aligned CLOs will need to have a sustainable investment objective that, at a high level, requires the relevant Euro CLO to invest in economic activities that contribute to an environmental objective (as measured by certain indicators) and/or a social objective. The sustainable investment objective required for Article 9 Aligned CLOs is naturally going to be a difficult threshold for Euro CLOs to meet (in particular as the pool of leverage loans satisfying such criteria will be limited). Further discussion on the requirements of Article 9 Aligned CLOs is outside the scope of this Client Alert.

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54 For CLO managers that are “out of scope” of SFDR, any reporting obligations would be as a contractual matter for the particular Euro CLO as opposed to firm-level requirements (and so marketing an Article 8 Aligned CLO would not necessitate a CLO manager making similar disclosures for other funds that do not have a similar investment focus).

55 See Article 2(17), SFDR.