Climate-related risks and ESG

A strategic guide for fund managers on ESG investing and navigating regulatory requirements

Grow | Protect | Operate | Finance

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The opportunity for fund managers

Financial markets need clear, comprehensive, high-quality information on the impacts of climate change risks and opportunities. Many of the largest asset owners and asset managers globally have been leading the way on sustainable investments. In recent years, public opinion and pressure from institutional and increasingly retail clients, as well as evolving government policies are driving a significant shift in the investment industry. Stakeholder expectations and the introduction of regulatory requirements for managing and disclosing climate-related risks across the board have raised the stakes for investment managers.

Fund managers now have a crucial opportunity to future-proof their organization's resilience, meet these growing expectations and position themselves ahead of the curve not just on climate issues, but more broadly on how they are considering other ESG risks and opportunities. The implementation of requirements and processes will require in-depth thought and a careful review of the organization's investment strategy, processes and capabilities. By doing so, strengths, weaknesses and opportunities on the critical subject of climate-related risks can be identified.

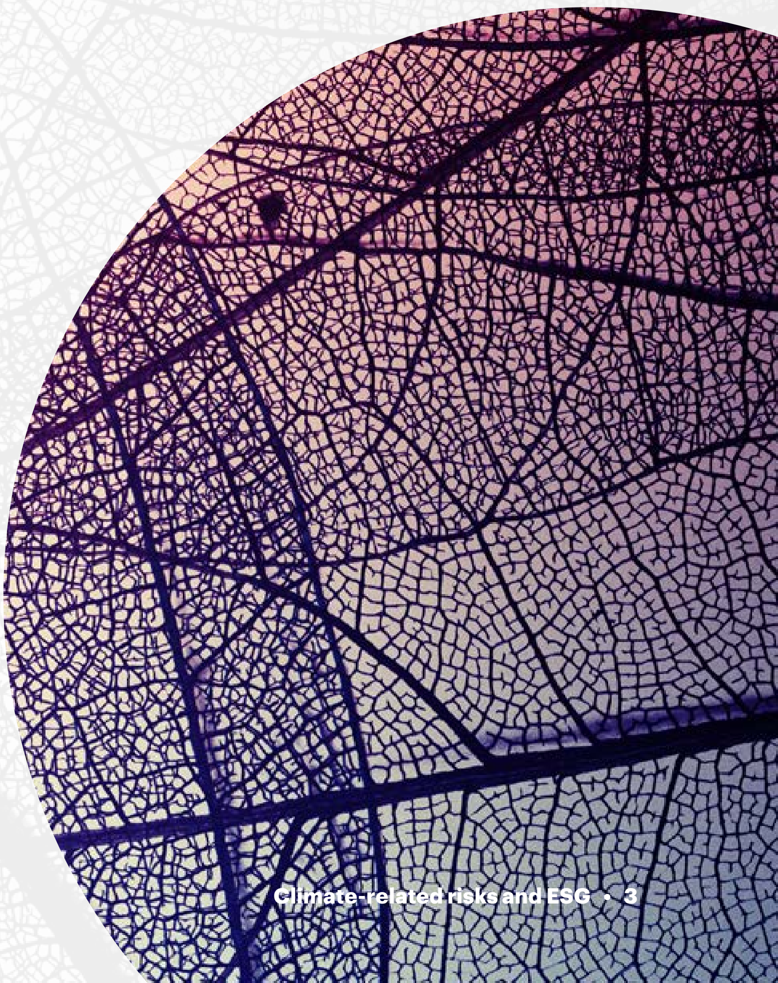
Requirements for fund managers in relation to disclosure of climate-related risks in investment portfolios, and ESG risks more broadly, are changing rapidly. The tendency may be to treat these requirements as a compliance exercise. However, the implications of climate change are far-reaching and taking a 'tick-box' approach may affect the resilience of portfolio companies and ultimately translate into financial risks. Fund managers need to act now to maintain credibility and the trust of investors while achieving positive climate outcomes as part of an ethos of responsible investment. If no action is taken, fund managers may fail to meet the expectations of their investors or even be regarded as missing climate-related opportunities from climate mitigation, adaptation or transition to a low carbon economy. Ultimately fund managers may quickly fall short against domestic or global peers if they are not addressing climate-related risks.

Looking at the global context, the agenda is a pressing one as we saw at the COP26 Climate Summit in Glasgow, Scotland in November 2021. As a legally binding international treaty on climate change, the Paris Agreement sets out ambitious goals to achieve net-zero by 2040 and limit global warming to 1.5C. It recognises that the world needs to enhance adaptive capacity, strengthen resilience and reduce vulnerability to climate change. For example, some national and regional regulations, such as the EU Green Deal and Action Plan for Sustainable Finance are based on these goals and serve as a 'tool kit' for appropriate implementation.

The US Securities and Exchange Commission (**SEC**) has proposed new rules for climate-related corporate disclosures by public and listed companies, which is a key step in the availability of corporate data for investment analysis. More recently the SEC has proposed new requirements specifically directed at ESG disclosure and reporting requirements for fund managers and funds. Canada's proposed Climate-Aligned Finance Act covers “federal financial institutions” – banks, deposit institutions and pension funds. In this guide, we take a deep-dive into current or forthcoming regulations on fund managers in the EU, Hong Kong, the UK and the US. We look at the similarities and differences we are seeing across these geographies. We examine what this means for fund managers when it comes to meeting their regulatory compliance obligations while also exploring the specific opportunities this presents to their organizations.

An additional challenge for investment managers today is how to respond to the need for more transparency in relation to ESG without running the risk of "greenwashing". Market regulators around the world – including the UK Financial Conduct Authority (**FCA**) and the SEC – have recently set out their commitment to tackling misleading disclosures in relation to ESG. Firms need to be aware of this risk in relation to their external communications and ensure that what they say matches what they do.

Our experience in supporting clients with their ESG requirements spans a wide range of financial organizations, global markets and industry sectors. Wherever you are on your ESG journey as a fund manager, we can help. We look forward to discussing how your organization can best navigate the changing regulatory environment, set the right ESG strategy for your firm and leverage the available opportunities.



Regulatory change spotlight

Hong Kong

For fund managers licensed by the Securities & Futures Commission (**SFC**), the deadline is fast approaching to comply with new requirements on the management and disclosure of climate-related risks under the Fund Manager Code of Conduct (**FMCC**).

TCFD framework gaining widespread acceptance

Since their introduction, the Recommendations of the Taskforce for Climate-related Financial Disclosures (**TCFD**) of the Financial Stability Board is gaining widespread acceptance. This framework has gained the support of many investors as being the most useful for addressing climate-related risks.

In line with the TCFD's core pillars of governance, strategy, risk management, metrics and targets, Hong Kong requirements cover governance, investment management, risk management and disclosure. Hong Kong SFC issued a circular (**Climate-related Risks Circular**) setting out the expected standards for Hong Kong fund managers complying with the new FMCC requirements, which helpfully clarifies and adapts TCFD to the business and specifics of fund management.

Fund managers will need to conduct an internal review and assessment of their existing governance structures, investment fund strategies, investment management processes and risk management framework and available investment tools and data. The process and outcome can be quite different for fund managers of varying sizes, and with different investment strategies and fund structures.

The FMCC rules apply to Hong Kong licensed fund managers of retail funds as well as private funds, and across asset classes, including private equity and alternatives. Having said that, each manager will need to determine the relevance and materiality of climate-related risks to its funds under management, as well as engage in a process to work out the exact scope and extent of the new requirements and expected standards under the Climate-related Risks Circular.

This is an opportunity for fund managers, not just a risk

The Hong Kong rules also require fund managers who are responsible for the overall operation of a fund to provide disclosures that enable investors to make informed decisions about their investment in the fund and how the fund manager takes climate-related risks into account in its investment management processes and risk management processes. This includes where climate-related risks have been assessed to be irrelevant to the investment strategy, or where climate-related risks have been assessed to be relevant but "immaterial".

Further, a fund manager is required to define the role of its board of directors or any board committee in the oversight of incorporating climate-related considerations into its investment and risk management processes. There should be assignment of roles and responsibilities to management-level positions or management committees to manage climate-related risks, as well as established structures for monitoring and regularly informing management on the status and progress of managing climate-related risks.

Fund managers should set goals and develop action plans to address and manage climate-related risks where relevant and material, or to review and record assessments of relevance and materiality. This will involve identifying relevant and material physical and transition climate-related risks, liability risks from physical or transition risks, and other potential financial risks from climate-related risks, within the fund managers' investment research, analysis, investment decisions and risk management processes including, where appropriate, applying tools and metrics to assess and quantify climate-related risks.

"To comply, Hong Kong fund managers will need to conduct an internal review and assessment of their existing governance structures, investment fund strategies, investment management processes and risk management framework and available investment tools and data."

Why fund managers need to act now

"Large Fund Managers" are additionally required under the FMCC to assess the relevance and utility of scenario analysis to evaluate the resilience of investment strategies to climate-related risks under different pathways. Further, enhanced standards involve disclosing the engagement policy at the entity level and implementation, as well as the fund level portfolio carbon footprints of the Scope 1 and Scope 2 Greenhouse Gas (**GHG**) emissions associated with the funds' underlying investments, the calculation methodology, underlying assumptions and limitations, and the proportion of investments which are assessed or covered. Fund managers are encouraged to also include portfolio Scope 3 GHG emissions if data is available.

Compliance deadline

"Large Fund Managers" must comply with the baseline requirements by August 2022 and with enhanced standards by November 2022. Smaller fund managers need to comply with the baseline by the later date of November 2022.

	Funds under management	Deadline for compliance with baseline requirements	Deadline for compliance with enhanced standards
Large fund managers	> HK$8 billion	August 2022	November 2022
Smaller fund managers	< HK$8 billion	November 2022	n/a

Example Hong Kong Fund Manager Requirements

- Conduct an internal review and assessment of existing governance structures, investment fund strategies, investment management processes and risk management framework, and available investment tools and data.
- Provide disclosures that enable investors to make informed decisions about their investment in the fund and how the fund manager takes climate-related risks into account in its investment management processes and risk management processes.
- Define the role of the board of directors or any board committee in the oversight of incorporating climate-related considerations into its investment and risk management processes.
- Set goals and develop action plans to address and manage climate-related risks where relevant and material, or to review and record assessments of relevance and materiality.

Regulatory change spotlight

UK

FCA focused on ensuring high quality climate and sustainability reporting

Following the conclusion of the COP26 Climate Summit in Glasgow, the FCA has also introduced TCFD-aligned new rules on climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers with an aim to develop market leading ESG practices and regulations. The FCA's 2022/23 Business Plan, published in early April, sets out its intention to promote high quality climate and sustainability related disclosures and to develop metrics to assess both the quality and the quantity of disclosures by regulated firms. More broadly, the FCA will integrate ESG considerations into how it authorizes firms and individuals and focus on ensuring that claims about the ESG credentials of products can be backed up with evidence.

"In light of a COP26 background and related investment community UN and Net-Zero Asset Manager initiatives, fund managers can no longer bury their heads in the sand on addressing carbon footprints in their investment portfolio. This is increasingly necessary to keep up with the industry and client expectations in the future."

This is an opportunity for fund managers, not just a risk

Under the FCA rules, eligible firms are required to produce an annual TCFD entity report. The report must be posted on a prominent place on the firm's website. Firms can cross-refer to disclosures made in other reports that cover the relevant content. Typically, an entity report must include climate-related financial disclosures regarding the overall assets managed or administered by the firm in relation to its TCFD in-scope business. This will include an explanation of how the firm's approach to the TCFD recommendations has informed its ESG strategy. Qualitative examples must be provided regarding how the firm applies climate-related scenario analysis in their risk and investment decisions. Where a firm has set a climate-related target, it needs to describe the target, including the key performance indicators (**KPIs**) it uses to measure progress. Alternatively, if a firm has not set climate-related targets, it must explain why in its TCFD entity report.

Why fund managers need to act now

COP26 in November 2021 demonstrated the commitment of governments around the world as well as the private sector to meeting the goals of the 2015 Paris Agreement to limit global temperature rising. Within the investment community, members of initiatives such as the UN-convened Net-Zero Asset Owner Alliance and the Net-Zero Asset Managers Alliance have pledged to cut carbon emissions, so fund managers can no longer bury their heads in the sand on addressing carbon footprints in their investment portfolios. This is increasingly necessary to keep up with the industry and to meet client expectations in the future.

Compliance deadline

FCA ESG disclosure requirements came into effect on 1 January 2022 for firms managing more than £50 billion in assets (or £25 billion assets under administration for asset owners). Other firms, with assets greater than £5 billion, will be subject to the new rules from 1 January 2023.

Funds under management	Deadline for reporting
> £50 billion / £25 billion assets under administration for asset owners	30 June 2023
< £50 billion	30 June 2024

Example UK fund manager requirements

- Annual TCFD report published on website
- Climate-related financial disclosures
- Qualitative examples of how the firm applies climate-related scenario analysis in risk and investment decisions
- Climate-related targets including KPIs or an explanation as to why targets are not set

Regulatory change spotlight

USA

The SEC focus on consistent, comparable and reliable information for investors on incorporation of ESG factors by investment advisers and funds

In March 2022, the SEC proposed disclosure requirements for public companies, acknowledging that investors require information on climate-related risks reasonably likely to have a material impact on the business or financial statements, necessary for investment decisions. The proposals reflect the TCFD framework.

With respect to SEC-registered investment advisers and certain unregistered investment advisers and registered investment companies ("mutual funds" or "funds"), in May 2022, the SEC published proposals to enhance disclosure of ESG strategies in fund prospectuses, annual reports and adviser brochures. The intention of the proposed rule changes is to counter exaggeration of actual consideration of ESG factors by investment advisers and funds.

In addition, the SEC is introducing a "layered" disclosure approach for ESG funds to enable ESG funds to be comparable at a glance by investors. As a general matter, the proposal would require funds that consider ESG factors in their investment process to disclose additional information about their investment strategy. For environmental-focused funds, there are specific proposals for the disclosure of greenhouse gas emissions in the portfolio investments.

Types of ESG funds

The SEC proposal identifies three types of ESG funds:

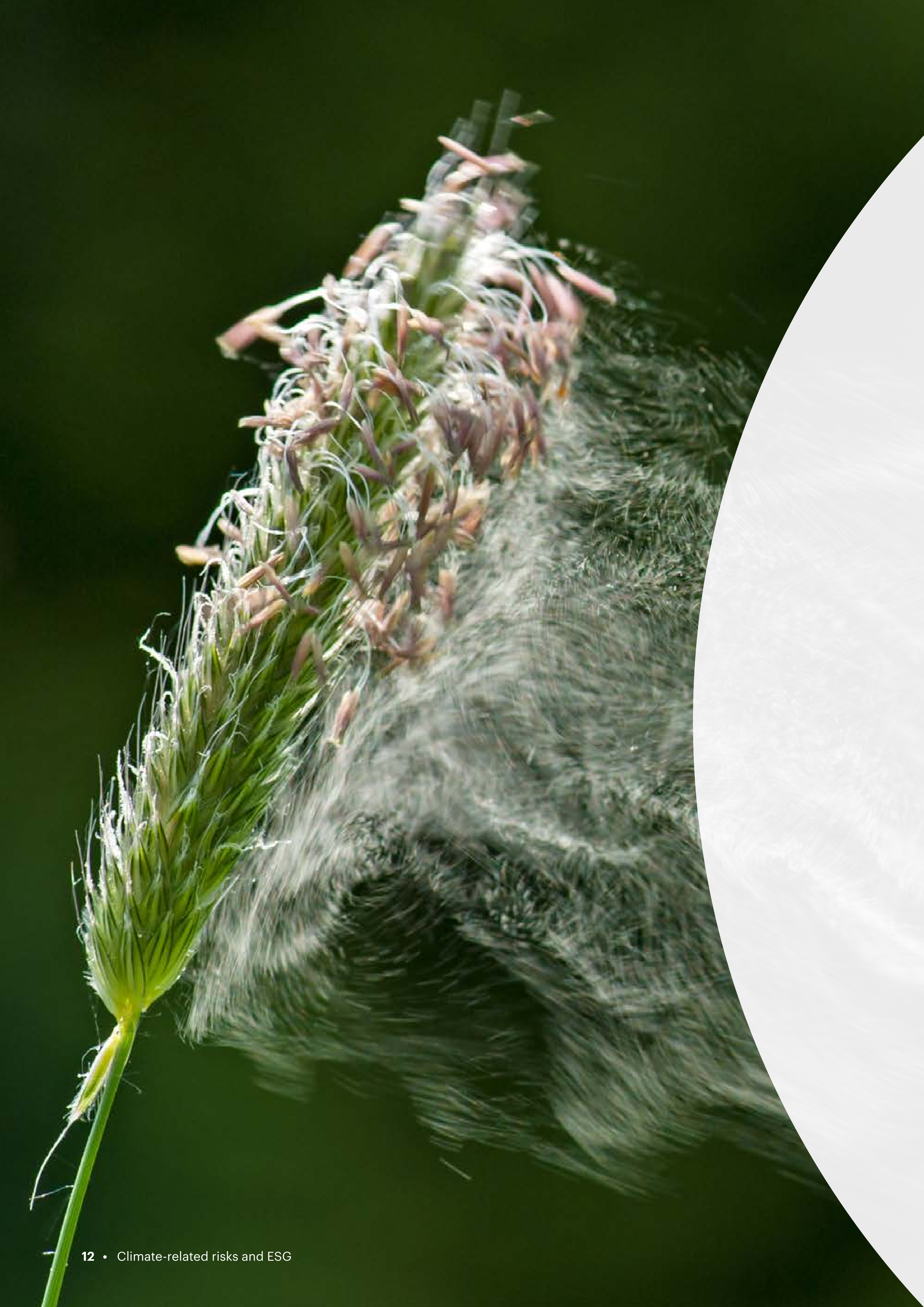
- "ESG Integration" – Funds that integrate ESG factors alongside non-ESG factors in investment decisions, which will need to describe how ESG factors are incorporated in the investment process.

- "ESG-Focused" – Funds for which ESG factors are a significant or main consideration which will need to provide detailed disclosures including a standardized table of ESG strategy overview.

- "ESG Impact" – ESG-focused funds that seek to achieve a particular ESG impact, requiring disclosure on how progress on objectives measured is measured. This category consists of funds with strategies that have a stated goal that seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits, generally to target portfolio investments that drive specific and measurable environmental, social, or governance outcomes.

Investment advisers that consider ESG factors would be required to make similar disclosures in their brochures with respect to their consideration of ESG factors in the significant investment strategies or methods of analysis that they pursue and to report certain ESG information in their periodic SEC filings.

"The SEC proposes updating the "Names Rule" for funds, and a fund that considers ESG factors alongside, but not more centrally than, other non-ESG factors in its investment decisions would not be permitted to use ESG or similar terminology in the fund name."



Proxy voting or engagements

The SEC is also proposing that certain ESG-focused funds provide additional information on their impact strategies and key metrics to assess progress, with the expectation that funds using proxy voting or engagement with issuers significantly in implementing ESG strategy are to disclose additional information as applicable on proxy voting or ESG engagement activities.

Emissions reporting

ESG-focused funds with environmental factors in investment strategies would be required to disclose carbon footprint and weighted average carbon intensity of the portfolio. This proposal would provide investors seeking environmental-focused investments with specific, consistent and comparable qualitative information regarding the GHG emissions in the investment portfolio, with the aim that investors may make decisions to align with their own ESG goals and expectations. However, funds can disclose that they do not consider GHG emissions as part of the ESG strategy, and would not then be required to report the additional information on carbon footprint and carbon intensity. Funds that integrate ESG factors and consider GHG emissions would be required to disclose how the fund considers GHG emissions, including the methodology and data sources that the fund may use as part of its consideration of GHG emissions.

Updating “Names Rule” for funds

The existing SEC “Names Rule” currently requires funds to invest 80 per cent of their assets in the type of investments suggested by the fund name. The proposal would amend and update the current rule, including to require fund prospectus disclosure to define terms used in the fund’s name, and additional transparency requirements to report on how investments match the fund’s name or investment focus.

With respect to ESG, the proposed update addresses materially deceptive or misleading use of ESG terminology. Specifically, the SEC proposes that a fund that considers ESG factors alongside, but not more centrally than, other non-ESG factors in its investment decisions not be permitted to use “ESG” or similar terminology in the fund name. The SEC refers to such “integration funds” as funds where ESG factors are generally no more significant than other factors in the investment selection process, such that ESG factors may not be determinative in deciding to include or exclude any particular investment in the portfolio.

Public comment period for SEC fund proposals

There is a public comment period of 60 days following the publication of the SEC proposals. Comments may be submitted on the proposed rules at www.sec.gov/regulatory-actions/how-to-submit-comments.

Why broader ESG disclosures are important – EU rules and more

The pace of change has accelerated beyond climate issues into other ESG areas. Modelled on the TCFD, the recently published first beta version of the Taskforce on Nature-related Financial Disclosures framework provides a proto-type of practical guidance on nature-related risks and opportunity analysis to be incorporated into enterprise risk and portfolio management processes. In addition to the link between the effects of climate change or environmental issues on the one hand and human rights on the other, within the responsible investment community, for example the Principles for Responsible Investment and its report on "Why and How Investors Should Act on Human Rights", there are clear expectations for investors to integrate considerations of human rights issues into investment practices based on global standards.

As a fund manager addresses such questions and its position on ESG, it is a worthwhile exercise to also consider the organization's values and strategy, including understanding the values and expectations of its stakeholders, such as shareholders, investment management personnel and employees, and most importantly its investors. There is a strong sense of urgency around the climate crisis and the need to transition to a low-carbon economy, as well as greater awareness today of health and social issues, and the global UN Sustainable Development Goals. This has brought about more attention to the values, culture, community impact and corporate social responsibility of businesses, including investment managers.

At the same time, increasingly one considers it as part of a manager's fiduciary duty and risk management to consider relevant ESG issues, amid an expanding range of evolving ESG-related business risks, operational risks, regulatory risks, litigation risks or other factors that may affect enterprise value of underlying portfolio companies. As more asset owners and investors not only seek financial returns but are also concerned with the values, impact and outcomes of their investments, such asset owners and investors require their investment managers to demonstrate responsible investment policies and processes that meet such expectations. Some recent trends also suggest potential reputation risk for managers regarded by the market as not applying appropriate ESG criteria in investment decisions.

Amid growing demands from investors for transparency on climate-related risks or ESG credentials of fund products, there are more requirements on and scrutiny globally of fund managers' entity level and product level disclosures. Specifically, the EU Sustainable Finance Disclosure Regulation (**SFDR**) came into effect in March 2021, with more detailed technical requirements to come.

The UK will be developing sustainable disclosure requirements (**SDR**) to be published mid-2022, to give UK consumers further clarity into the products in which they invest. Fund managers will need to demonstrate how ESG is considered in structuring product investment strategies or policies, and/or in the investment management and risk management processes, in order to be able to label products as sustainable.

Comparing product labelling requirements

EU SFDR (applicable to EU managers/EU funds and non-EU funds marketing into EU)	Hong Kong requirements for retail ESG funds and FMCC requirements
"Article 6" – funds specifically labelled as not integrating sustainability factors into the investment process. "Article 8" – funds that promote, among other characteristics, environmental or social characteristics or a combination of those characteristics, provided that the companies in which investments are made follow good governance practices. "Article 9" – funds with (Taxonomy-aligned) sustainable investment objectives. Also requirements on fund managers to assess and disclose sustainability risks under SFDR, group/entity sustainability investment policies and strategies. Reporting on sustainability impact to be expected of all financial market participants ("Principal Adverse Impacts"). More detailed technical requirements are being issued.	Description of ESG focus – list of ESG criteria used to measure the attainment of the ESG focus. Description of the ESG strategy(ies), the binding elements and significance of the strategy(ies) in the investment process. How such strategy(ies) are implemented in the investment process on a continuous basis. Summary of the process of considering ESG criteria (and whether an exclusion policy is adopted by the ESG Fund). Asset allocation – the expected or minimum proportion of securities or other investments of the ESG Fund (in terms of net asset value) that are commensurate with the ESG focus. How ESG focus is measured and monitored through the lifecycle of the ESG Fund, methodologies adopted, engagement policies (if any), description of the sources and processing of ESG data, or applicable assumptions. Annual assessment and reporting (Under FMCC, Hong Kong ROOF fund managers required to make appropriate entity level and fund level disclosures on governance, investment management and risk management, based on the relevance and materiality of climate-related risks. Large Fund Managers with AUM > HK$8 billion to report on portfolio carbon footprint (Scope 1 & Scope 2) (and Scope 3 if data available).

Proposed UK SDR rules (UK managers/UK funds, and marketing to UK investors)	US SEC proposes new categories of ESG funds and new required ESG disclosures
"Impact" – products with the objective of delivering net positive social or environmental impact alongside financial return. "Aligned" – products with sustainability characteristics and a high proportion of underlying assets meet the sustainability criteria set out in the UK green taxonomy. "Transitioning" – products with sustainability characteristics that do not yet have a high proportion of underlying assets meeting the UK green taxonomy sustainability criteria but are aiming to do so. Disclosures to include details of the objectives of the products (particularly any sustainability objectives), investment strategy around achieving such objectives, approach to investment stewardship and the proportion of assets allocated to sustainable investments. Detailed disclosures to sophisticated investors such as institutional investors will need to include product level details consisting of information on data sources and quality, contextual and historical information regarding investments, further information about the UK green taxonomy alignment with investment strategy and information about benchmarking and performance.	"ESG Integration" – funds that integrate ESG factors alongside non-ESG factors in investment decisions, which will need to describe how ESG factors are incorporated in the investment process; "ESG focused" – funds for which ESG factors are a significant or main consideration, which will need to provide detailed disclosures including a standardized table of ESG strategy overview. "ESG Impact" – ESG-focused funds that seek to achieve a particular ESG impact, requiring disclosures on how progress on objectives is measured. This category consists of funds with strategies that have a stated goal that seeks to achieve a specific ESG impact or impacts that generate specific ESG-related benefits, generally to target portfolio investments that drive specific and measurable environmental, social or governance outcomes. ESG-focused funds with environmental factors in investment strategies are to disclose carbon footprint and weighted average carbon intensity of the portfolio. However, funds can disclose that they do not consider GHG emissions as part of the ESG strategy, and would not then be required to report the additional information on carbon footprint and carbon intensity. Funds that integrate ESG factors and consider GHG emissions would be required to disclose how the fund considers GHG emissions, including the methodology and data sources that the fund may use as part of its consideration of GHG emissions. The SEC "Names Rule", which requires funds with certain names to have 80 percent of assets in investments consistent with the name, is proposed to be updated, including to require fund prospectus disclosure to define terms used in the fund's name, and additional transparency requirement to report on how investments match fund's name or investment focus. The SEC proposes to require that a fund that considers ESG factors alongside, but not more centrally than, other non-ESG factors in its investment decisions not be permitted to use "ESG" or similar terminology in the fund name.

Future-proofing your organization's resilience

Fund managers should seize this crucial opportunity to future-proof their organization's resilience, assess fast evolving ESG standards, law and regulations, and anticipate investors' growing expectations, to position themselves ahead of the curve not just on climate issues, but more broadly on how they are considering ESG issues. For example, we suggest starting with the questions outlined below.

Fund managers need to understand and get on top of the industry shift now underway, through strategic review and peer-group benchmarking, to appreciate the challenges and opportunities that come with the global transition to a more sustainable global economy. It is more critical than ever for fund managers to be proactive in considering the regulatory framework and requirements that now apply to the management and disclosure of climate-related risks and ESG issues, the compliance implications in investment and risk management processes, and the impact on product offerings and on product development.

ESG strategy and investor expectations	Operational processes	Reporting and disclosure
• To what extent are your clients asking about your approach to ESG? How has that changed over the last 12 months? • Does your organisation factor in all or any of the 17 United Nations Sustainable Development Goals? Are you considering the performance of portfolio companies against the UN Global Compact Commitments? • Have you signed up to the Principles for Responsible Investment? • Which ESG topics are important to your organisation? Beyond carbon emissions do you consider other environmental concerns, such as biodiversity, water scarcity, marine protection, circular economy?	• How would you describe your current approach to ESG? From "we are actively discussing the topic" to "we have integrated ESG considerations across all our assets"? • How are ESG issues incorporated into your investment decision processes, due diligence or risk modelling? What internal or external data sources or infrastructure do you use to support your ESG integration or risk modelling? • How are social or governance issues around fair employment practices, modern slavery, diversity and inclusion, bribery and corruption considered in your investment strategy or processes? • Do you have a policy on engaging with portfolio companies?	• How well equipped are you to respond to the new requirements in relation to disclosing climate-related risks? • How ready or confident are you to articulate whether you are seeking to achieve positive environment or social outcomes through your investment portfolios? Or whether you are addressing negative environment or social impact of portfolio companies through stewardship and engagement? • Do you have a voting policy? Do you currently vote at the shareholder meetings of companies you own? From "no" to "yes" in all geographies where feasible to do so". • Are you confident that your investor disclosures do not expose you to the risk of accusations of "greenwashing"?

How Dentons can help?

Our experience in supporting clients with their ESG requirements spans all types of organizations, markets and industry sectors. Wherever you are on your ESG journey, Dentons can help – anywhere in the world.

Our extensive ESG legal offering is further strengthened by the recent launch of Dentons Global Advisors, an elite multidisciplinary advisory firm that provides integrated strategic counsel and support for clients facing complex opportunities and challenges spanning commercial, reputational, financial, regulatory, geopolitical and governance dimensions. The teams at Dentons and DGA have a wealth of experience in assisting fund managers of retail or private funds, across different asset classes and investment strategies.

Our work has included assessing relevant climate-related or ESG legal and regulatory requirements, related compliance and disclosures, as well as providing support on insights, strategy and communications of fund managers' ESG and responsible investment approach, narratives and reporting.

Compliance and related policies

ESG strategy and agility assessments

ESG financing

ESG reporting and disclosure

ESG implementation and change management

ESG due diligence

ESG product offering and product development

Let’s discuss

We’re looking forward to discussing your specific ESG journey.

Guy Norfolk
guy.norfolk@dentons.com

Guy Norfolk is a Partner at Dentons, and Head of Dentons' Global Asset Management and Investment Funds Group based in London. Guy has over 20 years' experience across all aspects of fund manager matters including: corporate development and M&A, fund products, commercial arrangements, corporate governance and regulatory change. He also has a strong fund investor side practice, across all alternative asset classes.

Vivien Teu
vivien.teu@dentons.com

Vivien Teu is a Partner at Dentons Hong Kong, Head of Asset Management & ESG, a member of the Dentons’ Asset Management and Investment Funds Leadership Group and Dentons’ Global ESG Steering Group. She has over 20 years' experience advising investment managers on strategic legal and regulatory matters including funds formation and investment, cross-border market access and distribution, growth and expansion.

Owen McLennan
owen.mclennan@dentons.com

Owen McLennan is a Partner at the Investment Funds and Asset Management practice and based in Edinburgh. Owen’s experience covers a wide breadth of investment and funds work, acting regularly both for fund sponsors on fund formation and institutional investors on fund investments. Owen's experience includes advising the UK FCDO on its MOBILIST programme (UK Government's investment into funds that promote the global sustainable development goals) and numerous European DFIs on their investments into impact funds, as well as regulatory advice for asset managers and funds on the ESG agenda.

Dina Lorentz
dina.lorentz@dentons.com

Dina Lorentz is the Senior Business Development Manager Banking & Finance Europe, a specialist in Sustainable Finance & Impact Investing, and a member of Dentons' Global ESG Steering Group based in Berlin. Dina also serves as a Member of the Board to the Federal Initiative Impact Investing (Germany) and is a Co-author and Lecturer at the Frankfurt School of Finance & Management for Sustainable Finance and Impact Investing.

Jennifer Walmsley
jennifer.walmsley@dentonsglobaladvisors.com

Jennifer Walmsley is a Partner at Dentons Global Advisors based in London with 20 years' experience in ESG at an investor, regulator and advisor level. She established the ESG practice at Teneo in London, was formerly Head of ESG at Hermes Investment Management and led investor relations at the UK Financial Reporting Council. She has advised some of the largest investment managers and asset owners globally on creating and implementing responsible investment strategies.

Walter Van Dorn
walter.vandorn@dentons.com

Walter Van Dorn is a Partner at Dentons in New York, a member of the Corporate Department and a member of the Global ESG Steering Group at Dentons. He advises funds, investment advisers, underwriters and other financial institutions on US securities regulation and capital market transactions, including under the Securities Act and Exchange Act, as well as the Investment Company Act, Investment Advisers Act and Sarbanes-Oxley Act. He has practiced as a securities lawyer in New York, London, Hong Kong and Washington, DC. Earlier in his career, Walter was Special Counsel in the Office of International Corporate Finance at the US Securities and Exchange Commission.

Let's discuss

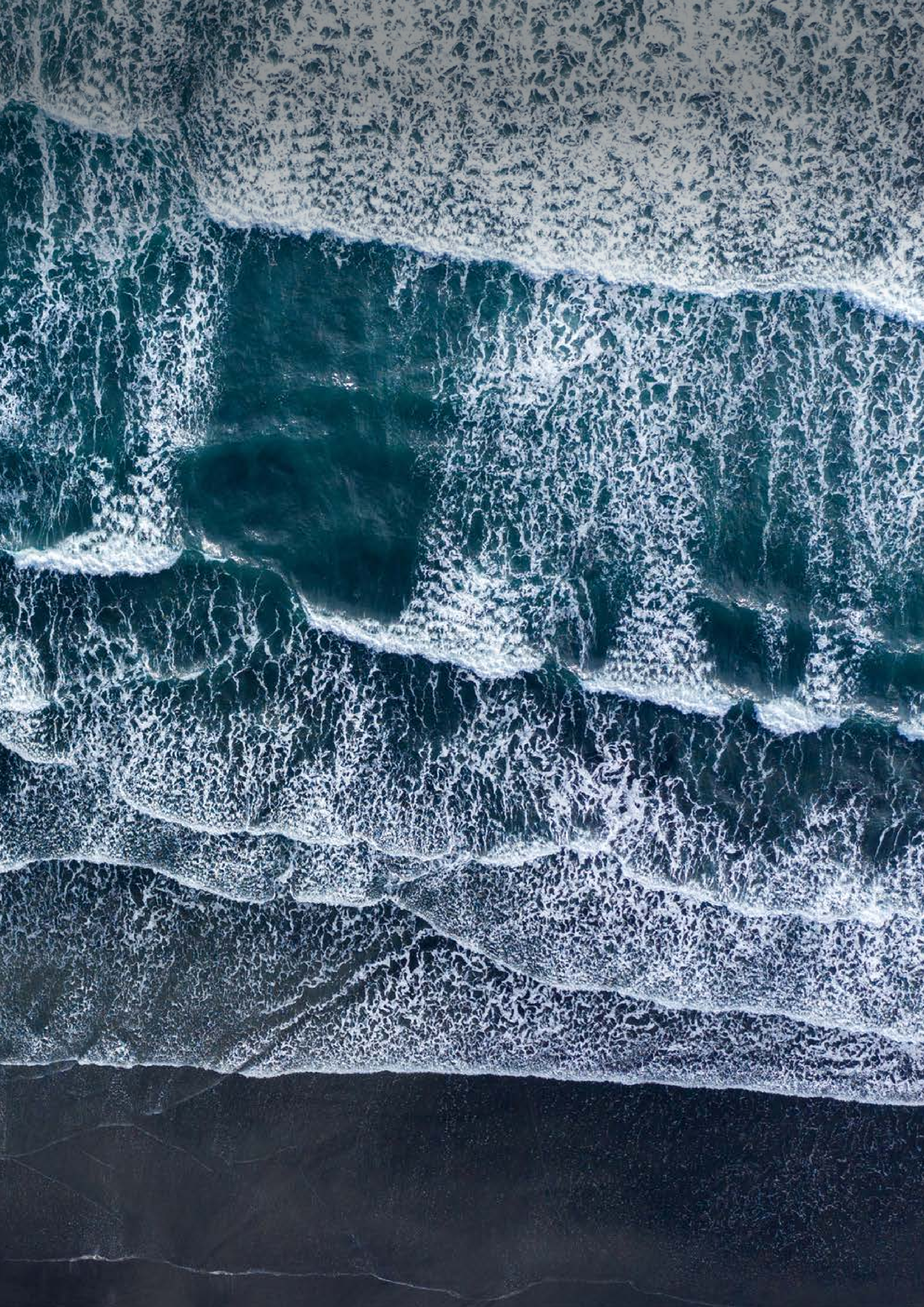
We're looking forward to discussing your specific ESG journey.

Wendell Faria
wendell.faria@dentons.com

Wendell Faria is a Partner at Dentons in Washington, D.C. and a member of the Corporate and Capital Markets practices. He focuses on the regulation of investment companies and investment advisers, general securities regulation, and the structuring and operation of private investment funds, including hedge funds, private equity funds, and real estate funds. In addition, Wendell frequently advises clients on status questions and opinions issued under the Investment Company Act. Wendell also advises on status questions arising under the "covered fund" provisions of the Volcker Rule. Earlier in his career, Wendell was Deputy Chief and the Acting Chief of the Office of Insurance Product at the US Securities and Exchange Commission, Division of Investment Management.

Kimberly Kriger
kimberly.kriger@dentonsglobaladvisors.com

Kimberly Kriger is a Partner at Dentons Global Advisors based in New York. She has more than 20 years of strategic communications experience, often in rapidly evolving, high stakes business and legal matters for public companies, private equity firms, schools and private institutions. She is a trusted advisor to senior leaders and boards of directors. She brings an informed clients first approach to address corporate, financial, and mission critical situations with capital markets concerns or reputational vulnerabilities that require effective communications to key stakeholders.



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