Integrating client preferences for sustainable investment into financial institution legal duties … still a way to go

A review of progress towards integrating client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments

2° investing initiative

Executive Summary

Reorienting capital towards sustainable investment is critical to achieving sustainability goals in the real world. Ensuring a shift away from high-carbon, resource-intensive and polluting sectors, in a way which produces net benefits for workers and communities as part of a just transition, is critical to ensuring the financial system operates for the benefit of the planet and society.

The European Commission's *April Package* (published in 2021) contained six amending delegated acts which clarify financial institution legal duties to clients. These include regulatory changes to integrate client *sustainability preferences* into investment and insurance advice; update product governance rules to take account of sustainability related objectives of the target market for a financial product; and clarify that ongoing legal duties of financial institutions should take account of sustainability risks and sustainability factors.

These recast legal duties are a critical component of the Commission's sustainable finance strategy. They are conceived so that client preferences for sustainable investment are assessed at the point of entry for finance and then subsequent investment decisions should take account of these preferences and sustainability risks. And they are intended to serve dual objectives of harnessing client preferences for sustainable investment in support of policy objectives and at the same time increasing investor protection through improving financial institution legal duties to clients.

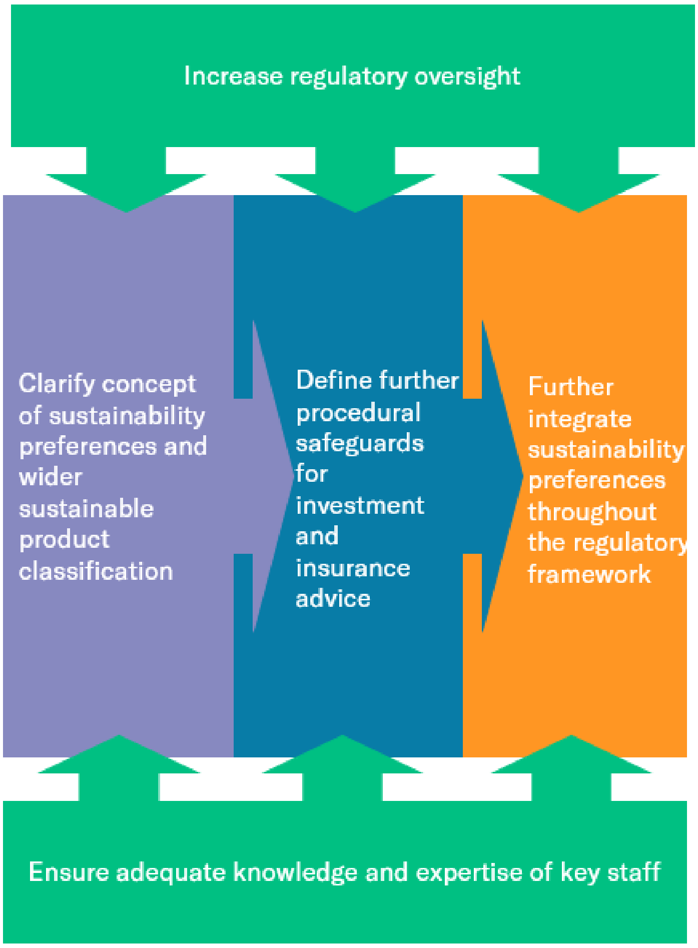
This paper analyses the extent to which these regulatory changes contribute to these dual objectives. It discusses first the current state of evidence in relation to client preferences for sustainable investment and how the market is responding. It then reviews the regulatory changes to comment on the extent to which client preferences for sustainable investment are integrated into financial institution legal duties during financial advice and ongoing management of client investments.

The legal analysis reveals that the extent to which client preferences for sustainable investment have been integrated into financial institution legal duties is variable.

- While the suitability assessment for investment and insurance advice must now include a mandatory assessment of client sustainability preferences, the process articulated for the revised suitability assessment affords plenty of opportunity for financial institutions to influence how clients understand and express their sustainability preferences. This potential for influence will undermine the objective of establishing a process where advisors must respond in a genuine manner to client preferences for sustainable investment.
- Integration of sustainability preferences into legal duties outside of the suitability assessment is patchy and incomplete. Only the insurance framework requires ongoing decision making to take account of sustainability preferences. There have been no regulatory changes to the pension framework. And for the framework for other retail products, ongoing legal duties are clarified by virtue of updating organisational requirements to include sustainability risks and sustainability factors – but there is no integration of sustainability preferences into these legal duties. In addition, there is regulatory uncertainty in relation to how sustainability related objectives in the product governance obligations intersect with the concept of sustainability preferences.
- Perhaps the most damming problem of all is the regulatory concept of sustainability preferences itself. This concept is effectively the foundation stone for how financial institution legal duties are supposed to accommodate client preferences for sustainable investment – but it is an inherently flawed definition. The definition does not accommodate impact-oriented products. And neither does the concept accommodate a client's wider sustainability motivations which are relevant to a comprehensive assessment of how a client want to invest in a sustainable manner. More broadly, the lack of clarity in this definition may result in variable approaches to how financial institutions categorise their products for clients. This variability will work against comparability across the market and will work against the consumer protection objective.
- Finally, there is a regulatory oversight gap. The planned route to integrating client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments relies on a level of regulatory oversight (in relation to the suitability assessment and otherwise) which may not exist.

The paper identifies recommendations which are a direct response to each of the identified weaknesses. First, it is imperative to clarify the concept of sustainability preferences and wider sustainable product categorisation so that the regulatory framework reflects a more accurate conception of client preferences for sustainable investment and a separate category for impact-oriented financial products. Then advisors must be properly incentivised to ensure they respond appropriately to client sustainability preferences through defining further procedural safeguards for the suitability assessment. Further integration of sustainability preferences throughout the financial regulatory frameworks and clarification of how sustainability related objectives intersects with the concept of sustainability preferences should ensure that legal duties are consistent across the board. Finally increased regulatory oversight and appropriate training for key staff can support and ensure the right enabling environment.

Schema of recommendations to improve integration of client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments



Given the stated objective in the April Package of clarifying financial institution legal duties to clients to take account of client preferences for sustainable investment, this paper demonstrates there is still a way to go before this objective is achieved.

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About

The 2° Investing Initiative (2DII) is an international, non-profit think tank working to align financial markets and regulations with the Paris Agreement goals.

Globally focused with offices in Paris, New York, Berlin, London and Brussels, 2DII coordinates some of the world's largest research projects on sustainable finance. Our team of finance, climate and risk experts develop research, tools, and policy insights to help financial institutions and regulators hasten and adapt to the energy transition.

In order to ensure our independence and the intellectual integrity of our work, we have a multi-stakeholder governance and funding structure, with representatives from a diverse array of financial institutions, governments and NGOs.

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Introduction

Reorienting capital towards sustainable investment is critical to achieving sustainability goals in the real world. Ensuring a shift away from high-carbon, resource-intensive and polluting sectors, in a way which produces net benefits for workers and communities as part of a just transition, is critical to ensuring the financial system operates for the benefit of the planet and society.

At the same time, individual preferences for sustainable investment are increasing. There is strong evidence that European citizens want to invest in line with environmental and social objectives. Ensuring that the financial system properly takes account of and responds to these individual preferences can support reorienting capital towards sustainable investment.

The European Commission's *April Package* (published in 2021) contained six amending delegated acts which clarify financial institution legal duties to clients. These include regulatory changes to integrate client *sustainability preferences* into investment and insurance advice; update product governance rules to take account of sustainability related objectives of the target market for a financial product; and clarify that ongoing legal duties of financial institutions should take account of sustainability risks and sustainability factors.

These recast legal duties are a critical component of the Commission's sustainable finance strategy. They are conceived so that client preferences for sustainable investment are assessed at the point of entry for finance and then subsequent investment decisions should take account of these preferences and sustainability risks. And they are intended to serve dual objectives of harnessing client preferences for sustainable investment in support of policy objectives and at the same time increasing investor protection through improving financial institution legal duties to clients.

This paper analyses the extent to which the regulatory changes contribute to these dual objectives. It discusses first the current state of evidence in relation to client preferences for sustainable investment and how the market is responding. It then reviews the regulatory changes to comment on the extent to which client preferences for sustainable investment are integrated into financial institution legal duties during financial advice and ongoing management of client investments. This analysis covers regulation at EU level and that of six Member States: Spain, Germany, Belgium, Luxembourg, France and the Netherlands.[1]

- Section 1 summarises 2DII's most recent research on client preferences for sustainable investment and how current market practice of advisors during financial advice is failing to respond to these client preferences for sustainable investment. It then explains the Commission's rationale behind amending financial institution legal duties during financial advice and ongoing management of client investments (as part of a broader package or sustainable finance regulation) to support climate and environmental goals.
- Section 2 provides a high-level summary of the regulatory framework which is relevant to understanding financial institution legal duties to clients in relation to their preferences for sustainable investment. It then articulates the regulatory changes included in the April Package which are designed to integrate client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.
- Section 3 identifies weaknesses which are already apparent in the regulatory changes to integrate client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.
- Section 4 identifies four recommendations to improve integration of client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.
- Section 5 sets out concluding remarks.

[1] These Member States are the focus countries for the LEVEL EEI project and were selected according to criteria defined for that project (including volume of savings, capacity to engage effectively in that jurisdiction etc.)

Section 1

Advancing sustainable finance through client preferences for sustainable investment

This section summarises 2DII's most recent research on client preferences for sustainable investment and how current market practice of advisors during financial advice is failing to respond to these client preferences for sustainable investment. It then explains the Commission's rationale behind amending financial institution legal duties during financial advice and ongoing management of client investments (as part of a broader package or sustainable finance regulation) to support climate and environmental goals.

1.1 Client preferences for sustainable investment are increasing

The last five years have seen a growth in public awareness of sustainability issues, especially climate change. This increasing societal awareness of environmental and social issues has altered the dynamics of multiple dimensions of consumer purchasing decisions – from grocery shopping to fashion to financial investment.

2DII research has contributed significantly to the emerging body of evidence pointing to the increasing importance of sustainability considerations in client investment decisions. Our first research in this area involved a series of quantitative and qualitative surveys conducted in France and Germany and identified that 65% to 85% of retail clients say they want to invest more sustainably when they are asked.[2] In this study, we also performed a review of third-party research on the same topic. This review revealed that our own findings are broadly aligned with other studies – stated interest in sustainable investment generally ranged from 50% to 80% of respondents with an average of 70%.

Our most recent research at the end of 2021 consisted of a survey in six European countries.[3] This was designed to increase the evidence base regarding household beliefs and preferences in relation to sustainable finance and reveal any variations in client preferences for sustainable investment and level of interest of European retail investor by country. Select results from this research[4] are replicated below.

Level of interest in sustainable finance

There is a strong positive correlation between interest in finance and interest in sustainable finance: the more someone is interested in finance, the more they also tend to be interested in sustainable finance. Indeed, many participants displayed a significant interest in both finance and sustainable finance.

Consistent with the review literature, we did not observe a clear relationship between interest in sustainable finance and sociodemographic factors such as age, gender, income or financial wealth. However, our results did reveal that participants with the strongest risk aversion were remarkably less interested in sustainable finance than other risk profiles.

Typical sustainability goals and topics

We asked a series of questions regarding the extent to which client investment decision making features one or more of the following financial/sustainability goals: (1) aligning investments and savings with values (*value alignment*); (2) achieving an impact in the real world (*achieving impact*); and (3) achieving maximum return for

[2] 2DII, 2020, A large majority of clients want to invest sustainably
[3] Denmark, Estonia, Germany, Greece, Ireland and Romania
[4] 2DII, 2022, What do your clients actually want?

a certain level of risk (*maximising return*). This enabled us to generate a typology of seven profiles, either pure (focussing on one goal only) or mixed (incorporating two or three goals).

The responses allow several important observations:

- In all countries, most participants fall in mixed profiles: from 50% in Denmark to 71% in Romania (60% on average).
- Among all profiles, the most represented profile mixes all three goals: 28% of European retail investors want to have it all!
- In all countries, the same three profiles are the most frequent (albeit in different orders): an exclusive focus on maximising return, a mix of value alignment and maximising return and a mix of value alignment, achieving impact and maximising return.
- Overall, maximizing return is the most frequently cited goal: from 62% in Ireland to 78% in Romania (68% on average). But just a small minority of participants *only* care about maximising returns (20% on average) leaving 80% having at least one sustainability goal.
- Value alignment is the second most cited goal: from 47% in Denmark to 75% in Romania (60% on average).
- Achieving impact, despite being the third most cited goal, is still important for a significant fraction of participants: from 35% in Denmark and Estonia to 61% in Romania (46% on average i.e. almost half of all participants).
- In all countries, the ranking of individual financial/sustainability goal is the same: maximizing return then value alignment and finally achieving impact.

In terms of sustainability topics that participants want to focus on (either through aligning investments and savings with values or achieving an impact in the real world) we proposed a list of 30 sustainability topics out of which participants could select a maximum of six topics. The list included environmental, social and ethical topics in equal proportions as in *Table 1* below.

Table 1: List of sustainability topics[5]

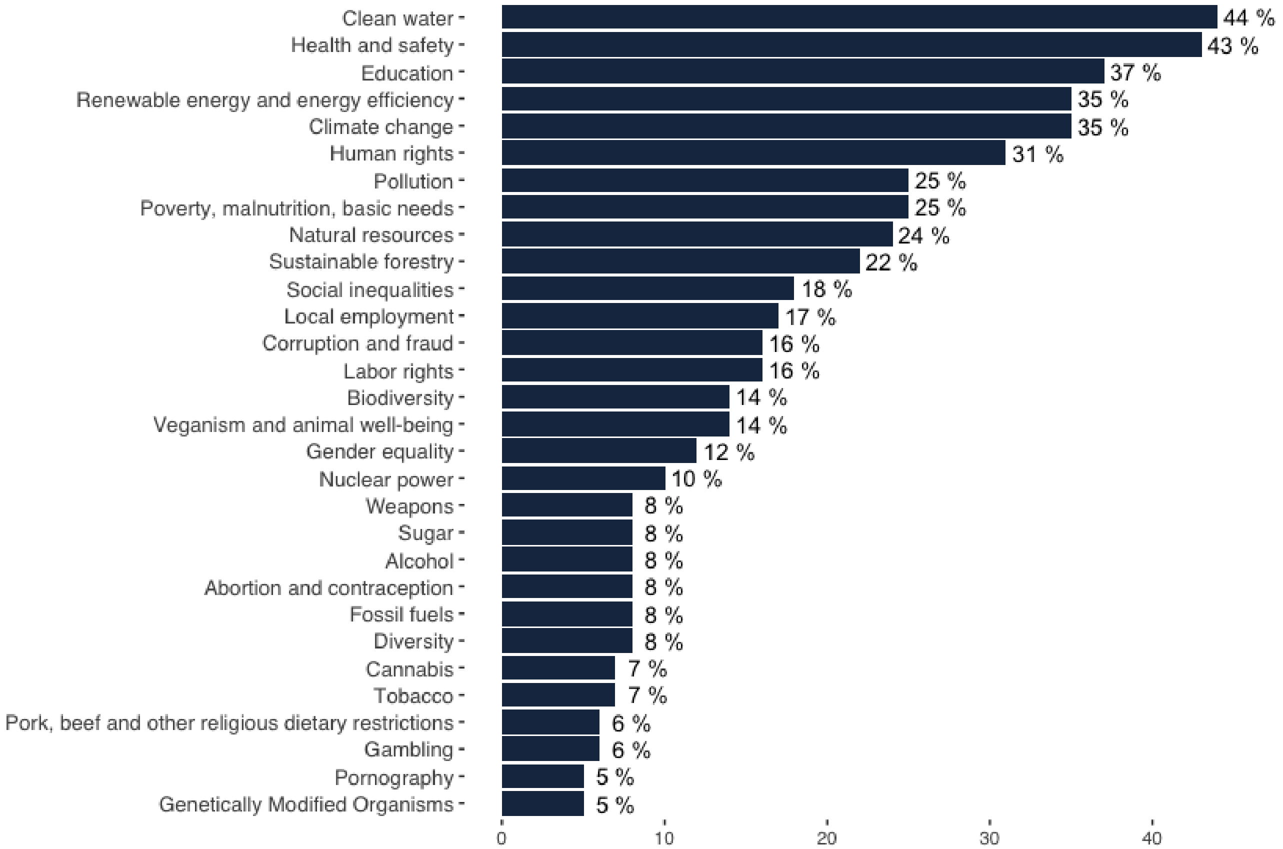
Environmental topics	Social and governance topics	Ethical topics
Climate change	Human rights	Veganism and animal well-being
Fossil fuels	Education	Weapons
Renewable energy and energy efficiency	Health and safety	Alcohol
Nuclear power	Gender equality	Sugar
Biodiversity	Diversity	Abortion and contraception
Pollution	Labour rights	Tobacco
Natural resources	Social inequalities	Cannabis
Clean water	Poverty, malnutrition, basic needs	Gambling
Sustainable forestry	Corruption and fraud	Pornography
Genetically Modified Organisms	Local employment	Pork, beef and other religious dietary restrictions

Figure 1 below illustrates what percentage of participants chose which topics to focus on. The top five topics comprised three environmental ones (Clean water, Renewable energy and energy efficiency and Climate change) and two social ones (Health and safety, Education). The least often chosen topics were ethical topics

[5] This list has been set based on existing topics for exclusion or promotion strategies observed on the market. However, it does not provide an exhaustive and exact view on sustainability topics existing on the market.

like Gambling, Pornography or Religious dietary restrictions. The prioritisation of focus on topics was largely similar across all countries.

Figure 1: Popularity of sustainability topics (all countries)[6]



Understanding of financial trade-offs

As articulated above, maximizing return is the most frequently cited goal of participants. Therefore, beliefs about what effect integrating sustainability factors has on financial returns will control retail investor demand for sustainable financial products. Overall, we find that 40% of participants expect an increase in financial return through integrating sustainability factors while 20% of participants anticipate a decrease.

[6] The list of sustainability topics has been set based on existing topics for exclusion or promotion strategies observed on the market. However, it does not provide an exhaustive and exact view on sustainability topics existing on the market. The ranking presented demonstrates popularity of certain topics rather than others (either for promotion or exclusion purposes).

Information Box: Overview of 2021 survey results

(1) There is a strong positive correlation between interest in finance and interest in sustainable finance

(2) Sociodemographic factors poorly explain interpersonal differences in interest in sustainable finance

(3) People with high risk aversion are significantly less prone to be interested in sustainable finance

(4) In terms of financial/sustainability goals, 60% of participants fall in mixed profiles

(5) In all countries, the ranking of financial/sustainability goals is the same: first maximizing return then value alignment and finally achieving impact

(6) Even if it comes third, achieving impact is still important for a significant fraction of people (46% on average i.e. almost half of all participants)

(7) Impact is more searched for when retail investors use their savings to generate a long-term increase in their wealth

(8) When they must make a trade-off between different financial/sustainability goals, most participants favour return more than achieving impact or value alignment

(9) The sustainability topics people want to see reflected in their savings (for achieving impact or value alignment purposes) are most frequently environmental or social topics compared to ethical topics

(10) There are twice as many participants expecting sustainable finance products to increase returns than participants expecting they will degrade returns

(11) Retail investors are less prone to accept giving up return to meet their sustainability goal if it is due to increased management fees

(12) There is a preference for financing green projects that are initiated by households and/or that take place in local areas

1.2 Inadequate financial advisor response to increasing client preferences for sustainable investment

2DII's mystery shopping programme[7] researches how financial advisors respond to the changing profile of client preferences for sustainable investment.[8] Our research was among the first to identify the systemic problem in existing market practice related to the integration of sustainability into the financial advice process – financial advisors rarely ask about environmental objectives of retail clients.[9] Our most recent mystery shopping campaign builds on earlier campaigns in France[10] and focussed on the extent to which financial advisors currently consider client preferences for sustainable investment in the months ahead of application of the MiFID amendments on sustainability preferences.[11]

The 2021 campaign[12] reveals that practices across European financial advisors are very heterogeneous, leaving clients vulnerable to variable service quality regarding sustainable finance. Select results from this research[13] are replicated below.

Financial advisor consideration of client preferences for sustainable investment

Our results show with no ambiguity that it is still far from systematic practice for financial advisors to proactively ask clients about their preferences for sustainable investment or their knowledge and experience on the topic.

On average at European level, sustainability objectives, or knowledge and experience of sustainable products are rarely assessed. However, there is variation at Member State level: financial advisors in Denmark and Germany perform better than in other countries especially regarding the assessment of sustainability objectives.

In relation to whether financial advisors consider client preferences for sustainable investment when they recommend a financial product, the financial advisor received the message clearly and reacted by proposing a sustainable product in only 55% of cases. In the remaining cases, financial advisors waited for multiple signals to propose adequate products or, even worse, failed to propose adequate products (either willingly or unwillingly).

And after repeatedly mentioning sustainability preferences, mystery shoppers interested in sustainability were only proposed products that were sustainable beyond any doubt in 50% of cases (see *Figure 2* below). Other mystery shoppers were proposed financial products with dubious sustainability features (15%), financial products that were clearly inadequate (24%) or no financial product at all (11%).

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[7] Our EU wide mystery shopping campaign with a focus on sustainable finance is one of the largest in the field (with over 900 visits planned between 2020-2024). This research project is supported by different European research programs from EIT Climate KIC (Elicit Sustainability Investment Preferences (ESIP)), Life IP (Finance ClimAct), Horizon 2020 (LEVEL EEI) and the German Federal Environment Ministry (Sustainable finance and consumer protection in Greece and Czechia (EUKI)).

[8] Mystery shopping is becoming common practice for European regulators dealing with consumer protection issues – and is gaining momentum as a tool in the finance sector to gauge financial institution behaviour in front of clients. In France, the AMF has been carrying out mystery shopping since 2011 to assess the conditions under which financial products are marketed. In Germany, starting in 2022, mystery shopping is expected to become a regular feature of BaFin's supervisory actions. And at EU level, ESMA has announced that it will co-ordinate mystery shopping on retail investment products as part of its key priorities for 2020-2022.

[9] 2DII, 2017, Non-Financial Message in a Bottle

[10] In the context of the Finance ClimAct project – 540 mystery shopping visits are planned in France by 2024.

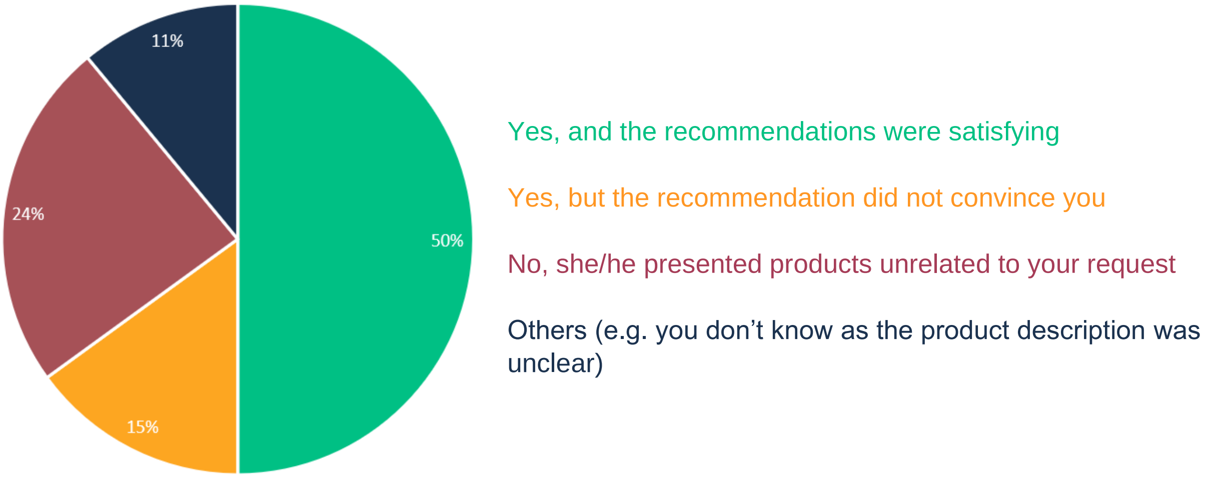
[11] Delegated Regulation (EU) 2021/1253

[12] A total of 210 visits carried out in Denmark, Estonia, Germany, Greece, Ireland and Romania and 90 visits in France.

[13] 2DII, 2022, Please Don't Let Them Be Misunderstood!

Figure 2: Financial advisor reactions to repeated expressions of a preference for sustainable products

After you expressed your preferences, did the advisor propose adequate sustainable products?



Financial advisor sustainability knowledge and ability to respond to impact-motivated clients

In terms of financial advisor sustainability knowledge, except in Denmark and Germany, only a minority of financial advisors appeared to be knowledgeable about sustainable finance concepts. Regarding financial advisor knowledge of green financial products, the situation is better. In all countries but Romania, most financial advisors displayed a decent knowledge of green financial products in general, or the specific green financial products proposed by their banks.

Still, the situation was far from being uniformly satisfying. Many shoppers reported a clear lack of knowledge of financial advisors regarding sustainable or green financial products. On several occasions, the lack of knowledge was made obvious due to an excess reliance on product factsheets or brochures. In the same vein, some financial advisors tried to back their proposals and hide their lack of deep knowledge by relying on vague arguments about the expertise or culture of their bank or by superficially referring to external sustainability labels.

When it comes to impact, in general terms this is the causal and additional outcome to the world in comparison with a counterfactual baseline scenario. When applied to companies, impact becomes company impact and is the additional outcome to the world caused by the company compared to a counterfactual (and hypothetical) scenario when the company would not exist. Similarly, investor impact is the additional outcome to the world compared caused by the investor compared to a counterfactual scenario when the investor (or funder in the case of financial institutions providing loans) would not exist.[14]

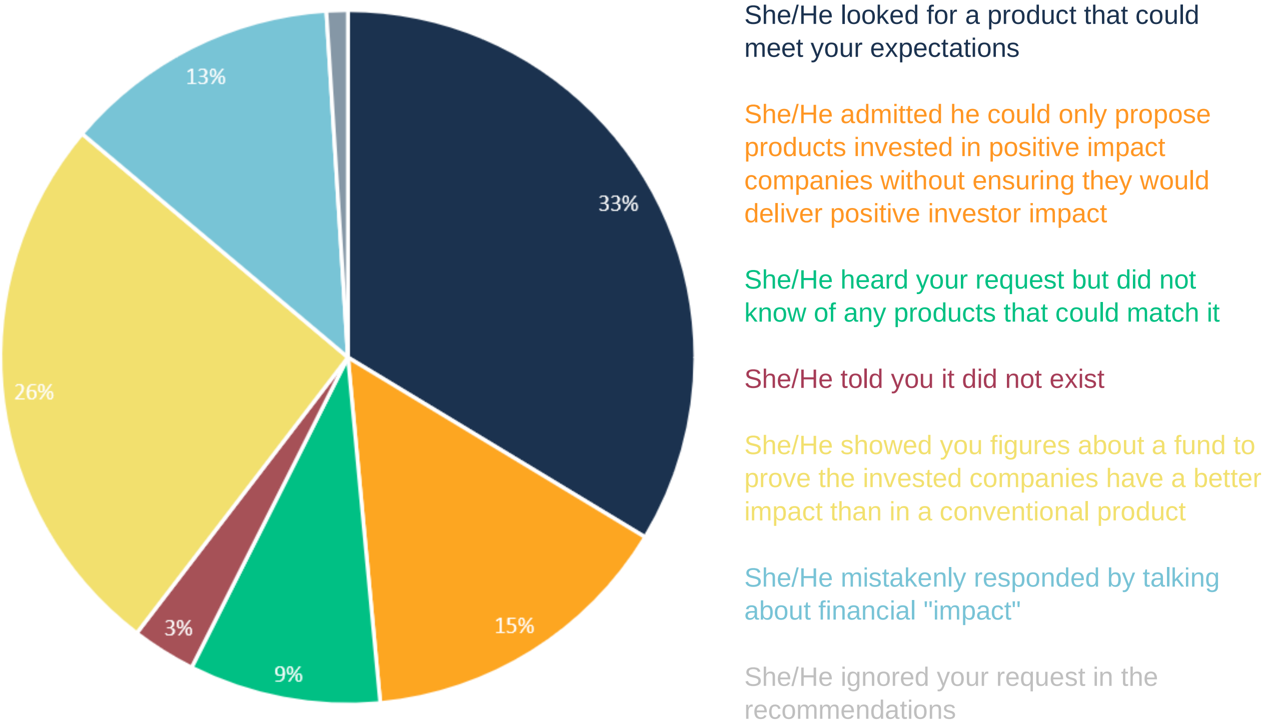
Investor impact thus corresponds to the change(s) induced through using different financial products in the impact of invested companies. Investor impact and invested companies' impact should always be segregated as being two different concepts not fully correlated across each other. An investor might indeed have no impact through investing (directly or indirectly) in positive impact companies. It occurs, for instance, when the investor takes over (directly or indirectly) another investor's stake in a company without affecting the companies' activities.

In relation to financial advisor expertise to understand the concept of investor impact and respond to impact-motivated investors adequately, the responses of financial advisors proved that the concept of investor impact is not understood by many advisors. The concept of investor impact is often confused with company impact

[14] If we apply the analysis at product level, product impact is the additional outcome to the world caused by the creation and the current use of the financial product compared to a counterfactual scenario when the product would not exist or not be used by investors.

(26%) or, worse, with financial performance (1%). Conversely, 15% could make the distinction between company impact and investor impact.

Figure 3: Financial advisor responses to client motivation for impact



When financial advisors were unable to respond to the mystery shoppers' questions about sustainability, they reacted in different ways. Some did not try to provide professional advice and recommended that the client do his/her own research on the internet, while others tried to find appropriate answers using web documentation (14%) or internal human resources during the appointment (12%) or after the appointment (11%). In some cases, the internal specialist the client was transferred to was of little help. Fortunately, in other cases, the internal specialist displayed valuable skills and could answer the client's questions.

Financial advisor influence on client expression of preferences for sustainable investment

According to mystery shoppers, a fairly common practice for financial advisors was to propose conventional financial products with which the financial advisors were probably more familiar and comfortable, even though they did not match the preferences expressed by the mystery shoppers. Some financial advisors appeared to operate in a default mode, neglecting to adapt their advice to the distinct profile of the potential clients they faced. The absence of sustainable products in the range of offer or the financial advisor's lack of knowledge in green or sustainable products seemed to contribute to those non-suitable recommendations.

Very rarely, financial advisors vividly argued against green investing, using general and undocumented statements. More often, financial advisors recommended not to fully invest green and diversify with conventional products, for risk management purpose.[15]

[15] If such recommendations are reasonable when green investing is made through sectoral thematic funds, it does not apply to sector-diversified low-carbon (or ESG) strategies. In addition, this practice raises significant concerns as to legal compliance.

1.3 Leveraging client preferences for sustainable investment in line with sustainability policy objectives

The changing profile of client preferences for sustainable investment provides considerable evidence that most retail investors would like to invest in a sustainable manner. But the financial advisor response to this changing profile of client preferences demonstrates that very few retail investors are currently afforded the opportunity to invest according to these preferences.

Reorienting capital flows through integrating client preferences for sustainable investment into financial institution legal duties

The Commission's 2018 *Action Plan on Financing Sustainable Growth*[16] articulated a comprehensive strategy to ensure the financial system supports broader sustainability policy objectives through advancing three objectives:

- 'reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- foster transparency and long-termism in financial and economic activity.'

Clarifying financial institution legal duties to clients is central to the Action Plan.

Action 4 relates to introducing a legal duty to consider client *sustainability preferences* during the investment and insurance advice process (through legislative changes and updating supervisor guidance). Action 4 recognises that by providing advice, investment firms and insurance distributors can play a central role in reorienting the financial system towards sustainability. Therefore by ensuring that financial advisors respond appropriately to the changing profile of client preferences for sustainable investment, the Commission is seeking to leverage these client preferences in support of the objective to reorient capital towards sustainable investment.

Action 7 targets financial institution legal duties in relation to including sustainability considerations in investment decisions and increasing transparency towards end-investors on how sustainability considerations are included in investment decisions. Action 7 does not target the financial advice process itself but is conceived so that financial institutions continue to act in the best interests of their end-investors/beneficiaries and in support of the objective to reorient capital towards sustainable investment.

Both of these actions are conceived to support reorienting capital towards sustainable investment. And at the same time, they should be understood as addressing consumer protection issues caused by the current failure to properly take account of client preferences for sustainable investment at multiple stages of the investment chain.

[16] The Action Plan builds upon the recommendations in the Final Report from the EU High-Level Expert Group on Sustainable Finance. 2DII were a member of the High-Level Expert Group on Sustainable Finance and instrumental in ensuring that the Final Report illustrated that the absence of a specific requirement to ask clients about client preferences for sustainable investment during the financial advice process means that many clients do not express these preferences which in turn leads to lower observable demand and reduced supply for sustainability oriented financial products.

Next phase for EU sustainable finance policy making

The Action Plan is now commonly referred to as establishing the foundations for the EU sustainable finance framework. At the time of its release, it identified a yearly investment gap of almost €180 billion to achieve the EU's climate and energy targets.[17] And since the Action Plan, a succession of policy initiatives has revealed an ever-increasing investment gap for Europe to achieve its climate and environmental goals. Each policy initiative cites a different investment challenge, for example, the European Green Deal Investment Plan, released in January 2020, plans to mobilise €1 trillion of sustainable investments over the next decade.[18] And the 2030 climate target plan, from September 2020, reveals that the EU needs to invest approximately €350 billion more every year in the period 2021-2030 to meet 2030 climate and energy targets than it did in the period 2011-2020.[19]

As the quantum of these figures for the investment gap becomes ever larger, there is increased recognition that the scale of the investment challenge is well beyond the capacity of the public sector. Therefore, the objective for the sustainable finance framework to channel private financial flows into relevant economic activities becomes ever more critical. In this context, the recast financial institution legal duties to clients are key to channelling private financial flows towards sustainable investment.

The next phase of EU sustainable finance policy making is therefore crucial. The *Strategy for Financing the Transition to a Sustainable Economy* takes up the mantle of developing the sustainable finance framework to reflect an evolved understanding of what is needed to meet EU sustainability goals and the changing global context. This Strategy includes a focus on empowering retail investors to access sustainable finance opportunities and seeking improvements in the level of sustainability expertise of financial advisors. In addition, the first ever *Retail Investment Strategy* (expected later in 2022), the review of MiFID II/MiFIR all provide opportunities to address consumer protection issues and leverage the emerging profile of client preferences for sustainable investment to support wider sustainability objectives. As the precise detail of the specific actions under these strategies is being developed, the findings in this paper should assist.

[17] Furthermore, according to estimates from the European Investment Bank (EIB), the overall investment gap in transport, energy and resource management infrastructure has reached a yearly figure of €270 billion.
[18] European Commission, 2020, The European Green Deal Investment Plan and Just Transition Mechanism explained
[19] European Commission, 2020, Stepping up Europe's 2030 climate ambition Investing in a climate neutral future for the benefit of our people

Information Box: Importance of retail investors for reorienting finance towards sustainable investment

Retail investors can be generally described as individual, non-professional investors who buy and sell securities or invest in financial products (such as investment funds, pensions, or insurance products).[20] While the concept of a retail investor is easy to understand, it is nevertheless difficult to precisely delineate. There are several different pieces of EU legislation which relate to retail investors (see *A complex regulatory framework governing financial institution legal duties to clients*), each of which may have different nuances in relation to its specific conception of retail investors. However, all legislation emphasises a difference between retail investors and professional investors.

According to Eurostat, total financial assets of households in the EU were valued at €32,157 billion in 2020. The financial assets of households were composed mainly by insurance, pensions and standardised guarantees (33%), currency and deposits (32%) and equity and investment fund shares (30%). This stock of financial assets increases every year by household net financial savings, which amounted to around €300 billion in the years prior to the pandemic and increase threefold in 2020-2021.

In the context of the investment gap discussed above, these figures show that retail investors can have a significant contribution in reorienting finance towards sustainable investment.

With a specific focus on energy efficiency, the Commission has estimated the funding gap over the next decade to be at €310 billion per annum.[21] When we add investment needs for renewable energy and energy efficiency, the total funding gap amounts to around 100% of annual financial savings (27% of annual total savings) by EU households (in a non-pandemic period), even before considering the upgraded targets. Such a funding gap will be filled only if a radical reorientation of private savings is implemented.

[20] 2DII, 2020, Retail clients want to vote for Paris, p.5. This is in line with the EU's Glossary of useful terms linked to markets in financial instruments.
[21] Even before the adoption of the more ambitious 50-55% GHG emissions reduction target in the 2030 climate target plan.

Section 2

Regulatory landscape for financial institution legal duties to clients

This section provides a high-level summary of the regulatory framework which is relevant to understanding financial institution legal duties to clients in relation to their preferences for sustainable investment. It then articulates the regulatory changes included in the April Package which are designed to integrate client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.

2.1 A complex regulatory framework governing financial institution legal duties to clients

Financial institution legal duties to clients are included in several pieces of EU legislation which govern the main categories of financial products and services which retail clients can access. Overall, this framework is intended to provide a minimum level of harmonisation for retail clients across different Member States in terms of access to services and products, product oversight and governance, consumer protection and empowerment etc.[22]

But the patchwork of several pieces of legislation (see *Table 2* below) means it is complex to understand the framework in its entirety – particularly in terms of how different pieces of legislation intersect and overlap with each other.

Each piece of legislation may have a different scope (for example, some legislation might articulate a product framework while other legislation defines distribution rules) which means that a financial product may be subject to the regulatory provisions of more than one piece of legislation. In addition, legislation will have been implemented in different timeframes (and will therefore be subject to different review and evaluation periods), through several different delegated and implementing acts, and fall under the supervisory mandate of different EU supervisors (ESMA and EIOPA).

In this paper we use the term *regulatory silo* to refer to the collection of relevant regulation and delegated regulations and directives which comprise the regulatory framework denoted by terms such as MiFID, IDD etc. In addition, the *terms* used in each regulatory silo may differ. By way of example, MiFID refers to the 'client or potential client' whereas IDD refers to the 'customer.' There are numerous examples where different regulatory silos use different terminology to refer to essentially the same thing. For readability reasons, we have tried to rationalise use of different terms where possible, but we concede that this may work against the accuracy of legal references.

[22] See BETTER FINANCE, 2022, Individual Redress Tools for Retail Investors

Table 2: Key regulatory silos governing the main categories of financial products and services which retail clients can access

Regulatory silo	Summary of scope
MiFID[23]	Establishes the regulatory requirements applicable to investment firms providing investment services or activities in the EU. MiFID sets out a list of investment activities and services that require authorisation when conducted in respect of specified financial instruments. The specified investments to which MiFID applies includes collective investment undertakings (i.e. funds including either UCITS or AIFs respectively – see below) as well as other investment products that fall within the definitions of transferable securities, options, futures, swaps, contracts for difference, derivatives and emission allowances.
UCITSD[24]	Sets out a harmonised regulatory framework for a type of open-ended investment fund (or collective investment scheme) called a UCITS. A UCITS is established and authorised in accordance with UCITSD and can then be marketed and sold to retail investors. A central facet of the UCITSD regime is the ability to market and distribute a fund to investors throughout the EEA by using a passport (without the need to seek multiple different authorisations). UCITSD sits alongside AIFMD (see row below) in terms of fund regulation in the EU.
AIFMD[25]	Introduces a harmonised regulatory framework for EU-domiciled managers of alternative investment funds (**AIFs**). An AIF is a non-UCITS *collective investment undertaking* that raises capital from several investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors.[26] This definition catches non-UCITS funds such as hedge funds, private equity funds, investment companies and real estate funds and others.
IDD[27]	Aims to ensure a level playing field among all participants involved in the sale of insurance products. It is also designed to strengthen policyholder protection and make it easier for firms to trade cross-border.
Solvency II[28]	Provides the framework for the EU solvency and supervisory regime for insurers and reinsurers. Solvency II fundamentally reformed capital requirements for insurers and reinsurers, taking into account developments in insurance, corporate governance, risk management, reporting and prudential standards.
IORP II[29]	Comprises a directive on the activities and supervision of institutions for occupational retirement provision (**IORPs**). IORP II was intended as a first step in developing an internal market for occupational retirement provision throughout the EU. Key provisions include the introduction of a prudent person rule for investing pension assets and a requirement for schemes to invest predominantly on regulated markets.

[23] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
[24] Directive 2009/65/EU of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
[25] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
[26] Article 4(1)(a) AIFMD
[27] Directive 2016/97/EU of the European Parliament and of the Council of 20 January 2016 on insurance distribution
[28] Commission Delegated Regulation 2015/35/EU of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)
[29] Directive 2016/2341/EU of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs)

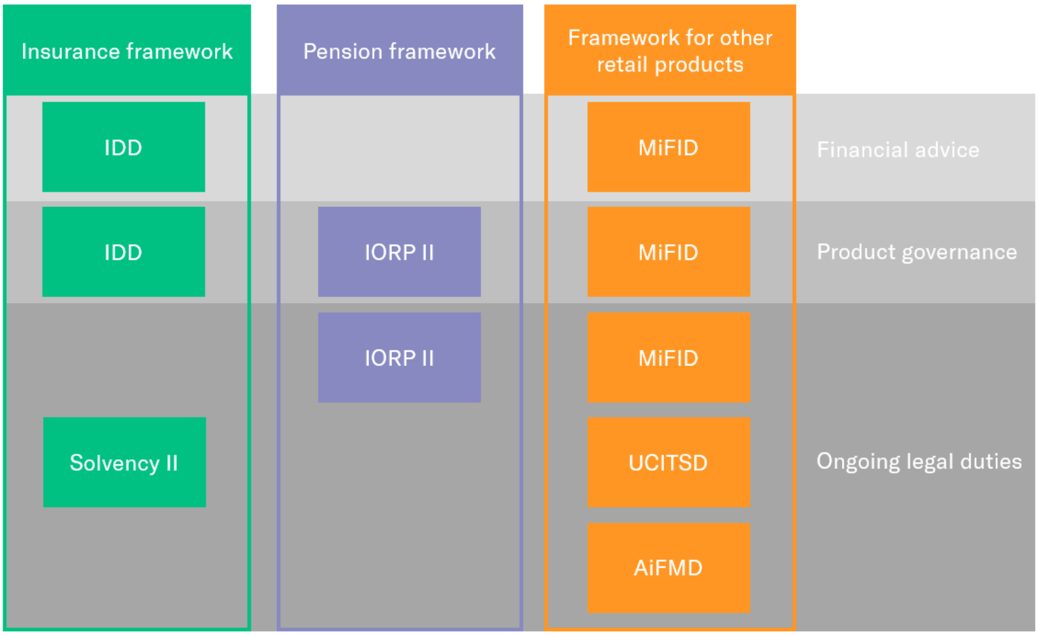
Note that *Table 2* does not cover all the EU legislation relevant to all possible financial products and services which retail clients can access. For example, it does not cover the Consumer Credit Directive[30], Mortgage Credit Directive[31], pan-European Personal Pension Product regulation[32] and others.

Figure 4 below seeks to illustrate one way in which these pieces of legislation can be understood to intersect and overlap with each other. It demonstrates that there are three principal *regulatory frameworks* – the *insurance framework*, the *pension framework* and the *framework for other retail products*. And that further:

- For the insurance framework, IDD contains provisions which apply to what might generically be called the financial advice process (among other things) and product governance, while Solvency II contains provisions relating to ongoing management of client investments.
- For the pension framework, IORP II establishes the regulatory framework for relevant pension schemes (there is no EU-level regulation in relation to private pension schemes). This is a product-based framework and contains provisions which relate to product governance and ongoing management of client investments. In the pension framework, the financial advice process does not exist in the same way as for insurance products and other retail products.
- For the framework for other retail products, MiFID II contains provisions relating to the distribution and financial advice processes, product governance and ongoing management of client investments. UCITSD and AIFMD also govern the ongoing management of relevant client investments.

Note that this is a simplified diagram for illustrative purposes relevant to the line of enquiry of this paper (and is not meant to be accurate to an exhaustive degree). Note also that clients may choose to invest their money in ways which are not governed by any of these pieces of legislation.[33]

Figure 4: Illustration of one way the key regulatory silos can be understood to intersect and overlap with each other

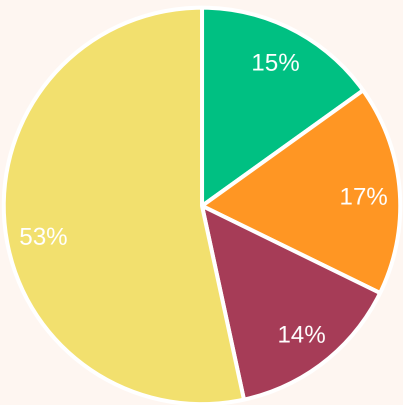


[30] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC
[31] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010
[32] Regulation (EU) 2019/1238 of the European Parliament and of the Council of 20 June 2019 on a pan-European Personal Pension Product (PEPP)
[33] For example, community investing, crowdfunding etc. Please see 2DII, 2022, What do your clients actually want?

Information Box: Relative size of markets for insurance, pensions and other retail products

It is difficult to precisely ascertain the relative amounts invested under the insurance framework, the pension framework and the framework for other retail products (as these frameworks are conceptualised in this paper). Therefore the following figures should be interpreted as an approximation of the relative amounts invested under the insurance framework, the pension framework and the framework for other retail products.

Figure 5: Relative amounts invested under the insurance framework, the pension framework and the framework for other retail products at EU level (Source: Eurostat)



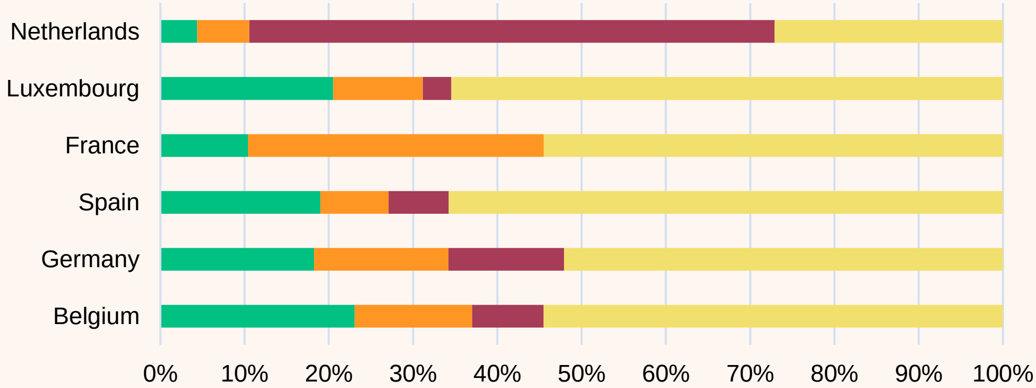
Estimate of amount invested in framework which applies to other retail products (Eurostat data fields: Debt securities, Listed shares and Investment fund shares)

Estimate of amount invested in insurance framework (Eurostat data fields: Life insurance)

Estimate of amount invested in pension framework (Eurostat data field: Pension funds)

Amount invested in other frameworks (Eurostat data fields: Currency and deposits and Others)

Figure 6: Variation in relative amounts invested under the insurance framework, the pension framework and the framework for other retail products by Member State (Source: Eurostat, Legend as for Figure 5)



In terms of variation of the relative amounts invested under each framework across the Member States covered in this paper, notable observations include:

- The amount invested under the pension framework is far higher in the Netherlands than for any other Member State covered by this paper; and
- For all Member States except the Netherlands, the combined investment under the insurance framework, the pension framework and the framework for other retail products is still less than half of total household investment.

2.2 Regulatory changes at EU level to integrate sustainability into financial institution legal duties

Last year's *April Package* contained the formal regulatory changes to integrate client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.

Billed as an 'ambitious and comprehensive package of measures to help improve the flow of money towards sustainable activities across the European Union,'[34] the April Package included six amending delegated acts.[35] These target each of the frameworks articulated in *Figure 4* (except for the pension framework) and cover:

- **introduction of *sustainability preferences* into investment and insurance advice:** financial institutions must include an assessment of client sustainability preferences during the suitability assessment which must be conducted prior to recommending financial products to clients;
- **integration of sustainability factors into product oversight and governance:** financial institutions must consider sustainability factors in financial product manufacture and distribution; and
- **clarification of ongoing legal duties:** financial institutions must consider sustainability risks and factors in ongoing management of client investments.

Financial institution legal duties in these delegated acts are conceived so as to 'integrate sustainability considerations into the investment, advisory and disclosure processes in a consistent manner across sectors.'[36] In addition, financial institution legal duties are conceptualised in a way which seeks to ensure consistency with the Sustainable Finance Disclosure Regulation[37] (**SFDR**) and the Taxonomy Regulation.[38]

Table 3: Relevant EU sustainable finance regulation to be articulated with April Package regulatory changes

Taxonomy Regulation	The Taxonomy Regulation provides businesses and investors with a common classification to identify what economic activities can be considered environmentally sustainable through providing a substantial contribution to one of six environmental objectives: • climate change mitigation; • climate change adaptation; • sustainable use and protection of water and marine resources; • transition to a circular economy; • pollution prevention and control; • protection and restoration of biodiversity and ecosystems. The Taxonomy Regulation (complemented by the Sustainable Finance Disclosure Regulation) also requires disclosures of the extent to which a financial product finances activities that are classified as environmentally sustainable (i.e. what has come to be known as the degree to which a financial product can be considered as taxonomy aligned).

[34] https://ec.europa.eu/info/publications/210421-sustainable-finance-communication_en
[35] Also included in the April Package was the first delegated act under the Taxonomy Regulation in relation to the technical screening criteria for climate change mitigation and adaptation together with a proposal for a new Corporate Sustainability Reporting Directive to replace/revise the Non-Financial Reporting Directive.
[36] Explanatory Memorandum, Delegated Regulation (EU) 2021/1253
[37] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector
[38] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

Sustainable Finance Disclosure Regulation	The SFDR introduces disclosure requirements for financial institutions at organisation, service and product level. In addition to complementing the Taxonomy Regulation by requiring disclosures relating to the taxonomy alignment of certain financial products, the SFDR also requires disclosure of other sustainability related information. The SFDR also categorises financial products according to the degree of sustainability related ambition for that product. • Article 6 products do not pursue sustainable investment but may or may not integrate sustainability risk into the investment process. These are generally not marketed as having any sustainability credentials. • Article 9 products (often referred to as dark green products) have sustainable investment as an objective and their underlying assets will always be in sustainable investment. • Article 8 products sit between the other two categories and are those that promote environmental or social characteristics. They may or may not pursue sustainable investments and may invest in a wide range or underlying assets.

Introduction of sustainability preferences into investment and insurance advice

For the framework which applies to other retail products, under MiFID firms providing investment advice and portfolio management services (in scope FIs) are required to carry out a suitability assessment to obtain the necessary information about: (a) the clients' investment objectives including risk tolerance; (b) ability to bear risks and therefore financial loss; and (c) experience and knowledge.[39] The assessment is to help in scope FIs ensure that financial products / services they recommend are suitable for client circumstances.

For the insurance framework, IDD requires insurance intermediaries and insurance undertakings which provide advice (in-scope FIs) to carry out a suitability assessment prior to recommending specific insurance-based investment products to clients.[40] The scope of the IDD suitability assessment is near identical to the scope of the MiFID II suitability assessment.[41]

MiFID suitability assessments to consider sustainability preferences

The MiFID Amendments[42] integrate client preferences in terms of sustainability to the MiFID suitability assessment.[43] This change introduces a mandatory assessment of client *sustainability preferences* so that advisors must include questions on client sustainability preferences. Further, it requires that any financial product recommendation must take account of sustainability preferences expressed by the client.

The concept of *sustainability preferences* is supposed to ensure that only financial instruments that have some level of sustainability-related materiality are eligible for recommendation to clients who express sustainability preferences. It is defined as follows:

'sustainability preferences' means a client's or potential client's choice as to whether and, if so, to what extent, one or more of the following financial instruments shall be integrated into his or her investment:

[39] Article 54(2) Delegated Regulation (EU) 2017/565 and Article 25 Directive 2014/65/EU
[40] Article 9(2) Delegated Regulation (EU) 2017/2359
[41] The differences between the IDD and MiFID suitability assessments are: (a) the IDD suitability assessment obligation applies to insurance intermediaries and insurance undertakings which provide advice, whereas the MiFID suitability assessment obligation applies to MiFID firms which provide investment advice, as well as those which provide portfolio management services, and (b) IDD applies to insurance-based investment products, whereas MiFID applies to financial instruments.
[42] Delegated Regulation (EU) 2021/1253
[43] Through amendments to Article 54 Delegated Regulation (EU) 2017/565

> *(a) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in environmentally sustainable investments as defined in Article 2, point (1), of [the Taxonomy Regulation];*
> *(b) a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in sustainable investments as defined in Article 2, point (17), of [SFDR];*
> *(c) a financial instrument that considers principal adverse impacts on sustainability factors where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client*[44]

IDD suitability assessments to consider sustainability preferences

The IDD Amendments[45] expand the scope of IDD suitability assessments to similarly include client sustainability preferences,[46] and defines sustainability preferences.[47] Both the obligation and the definition are drafted in near-identical language to the MiFID Amendments.

Integration of sustainability factors into product governance obligations

For the framework which applies to other retail products, MiFID II contains product governance obligations to ensure that financial institutions which manufacture and distribute financial instruments act in the end client's best interests during the life cycle of these products or services (i.e. manufacture to distribution). The rules are intended to provide better oversight that financial products are being produced and sold to the right type of end client and provide greater management information between manufacturers and distributors to assess this.

At a general level, manufacturers are required to: (a) ensure that the product they manufacture is designed to meet the needs of an identified target market (identified at a sufficiently granular level); (b) ensure that the distribution strategy for the product is compatible with the identified target market; and (c) take reasonable steps to ensure that the product is distributed to the identified target market. Distributors are required to: (a) understand the financial instruments they distribute to clients; (b) identify the target market (at a sufficiently granular level) and assess the compatibility of the product with the needs of target market and taking into account whether the manufacturer's identified target market is appropriate; and (c) have in place a distribution strategy to ensure that financial instruments are distributed only when this is in the best interests of the clients.[48]

For the insurance framework, IDD has similar product governance rules to MiFID and requires the product approval process for each insurance product to identify the target market and the group of compatible customers. The target market shall be identified at a sufficiently granular level, taking into account the characteristics, risk profile, complexity and nature of the insurance product.

MiFID product governance obligations to integrate sustainability factors and sustainability related objectives

The MiFID Product Governance Amendments[49] require *sustainability factors* to be considered in the product approval process and the product governance and oversight arrangements for each financial instrument.[50] The concept of sustainability factors is defined by referring to how that phase is defined in the SFDR[51] which provides the following definition:

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[44] Article 1(1) Delegated Regulation (EU) 2021/1253
[45] Delegated Regulation (EU) 2021/1257
[46] Article 2(3) Delegated Regulation (EU) 2021/1257
[47] Article 2(1) Delegated Regulation (EU) 2021/1257
[48] Art 24(2) Directive 2014/65/EU. Chapter III of Delegated Directive (EU) 2017/593 lays down further details on the product oversight and governance process for both manufactures and distributors.
[49] Delegated Directive (EU) 2021/1269
[50] Recital 5 Delegated Directive (EU) 2021/1269
[51] Article 1(1) Delegated Directive (EU) 2021/1269

'sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters[52]

When product manufacturers identify the potential target market[53] for a financial instrument, and are specifying the types of clients whose needs, characteristics and objectives the financial instrument is compatible with, the MiFID Product Governance Amendments require *sustainability-related objectives* to be considered as a type of objective.[54] Further, investment firms should determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market by examining (among other things) the financial instrument's sustainability factors.[55] Therefore product manufacturers should specify to which group of clients with sustainability-related objectives the financial instrument is supposed to be distributed, and determine that the financial instrument's sustainability factors is consistent with the target market.[56]

The MiFID Product Governance Amendments also require product manufacturers to:

- review on a regular basis whether the instrument they manufacture remains consistent with the needs, characteristics and objectives, including sustainability related objectives of the target market[57]; and
- present an instrument's sustainability factors in a transparent manner to distributors.[58]

With respect to product distributors, the MiFID Product Governance Amendments require product distributors to:

- include sustainability related objectives in their product governance arrangements for ensuring that the financial instruments they distribute are compatible with the needs, characteristics and objectives of the target market;[59]
- review on a regular basis whether the instrument they distribute remain consistent with the needs, characteristics and objectives, including sustainability-related objectives of the target market.[60]

IDD product governance obligations to integrate sustainability factors and sustainability related objectives

The IDD Amendments (in as much as they relate to product governance obligations) introduce similar changes to require sustainability factors to be considered in the product approval process and the product governance and oversight arrangements for insurance products.[61] Although there are differences compared to the MiFID Product Governance Amendments, the IDD Amendments integrate the same concepts of sustainability factors and sustainability related objectives.

With respect to manufacturers specifically, the IDD Amendments require manufacturers to:

- take into account sustainability related objectives of the customers belonging to the target market when designing insurance products;[62]
- ensure that staff involved in designing and manufacturing insurance products has the necessary skills, knowledge and expertise to properly understand the sustainability-related objectives of customers belonging to the target market;[63]

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[52] Article 2(24) Regulation (EU) 2019/2088
[53] As the target market should be set at a sufficient granular level, a general statement that a financial instrument has a sustainability-related profile would not be sufficient. Target market assessments will vary from instrument to instrument but will largely focus on the risk profile of the product, the type of investor which the product is suitable for and importantly the type of investor the product is not suitable for (i.e. the negative target market).
[54] Article 1(2)(a) Delegated Directive (EU) 2021/1269
[55] Article 1(2)(b) Delegated Directive (EU) 2021/1269
[56] However, investment firms are not required to identify groups of clients with whose needs, characteristics and objectives the financial instrument with sustainability factors is not compatible with (i.e. a negative target market does not need to be identified) (Recital 7, Delegated Directive (EU) 2021/1269). This is to help ensure that financial instruments with sustainability factors remain easily available for clients that do not have sustainability preferences.
[57] Article 1(2)(d) Delegated Directive (EU) 2021/1269
[58] Article 1(2)(c) Delegated Directive (EU) 2021/1269
[59] Article 1(3)(a) Delegated Directive (EU) 2021/1269
[60] Article 1(3)(b) Delegated Directive (EU) 2021/1269
[61] Recital 5 Delegated Directive (EU) 2021/1257
[62] Article 1(2) Delegated Regulation (EU) 2021/1257
[63] Article 1(2) Delegated Regulation (EU) 2021/1257

- include sustainability-related objectives as part of its product testing and review process;[64] and
- provide distributors with information to enable distributors to identify customers for whom the insurance product is not compatible with their sustainability-related objectives. [65]

With respect to distributors specifically, the IDD Amendments require distributors to:

- ensure that sustainability-related objectives are taken into account in product distribution arrangements;[66] and
- inform the manufacturer and where appropriate amend their distribution strategy for an insurance product where they become aware that the insurance product is not in line with the sustainability-related objectives of the target market.[67]

Clarification of ongoing legal duties

Ongoing legal duties are conceived in different ways for each regulatory framework. For the framework which applies to other retail products, MiFID articulates provisions in relation to general organisational requirements, risk management and conflicts of interest. AIFMD and UCITSD contain similar provisions and additionally cover due diligence, resources and management control. These provisions are conceived to ensure in scope FIs implement the correct organisational procedures and processes to act in their clients' best interests.

For the insurance framework, Solvency II contains similar provisions and in addition sets out the prudential framework for insurance and re-insurance undertakings and a prudent person principle (**PPP**). This PPP defines what assets the relevant undertaking can invest in, how the portfolio should be managed, and makes the interests of policyholders a priority.

Integration of sustainability risks and factors into organisational requirements under MiFID, AIFMD and UCITSD

The MiFID Amendments, AIFMD Amendments[68] and UCITSD Amendments[69] contain specific provisions to integrate sustainability risks and sustainability factors into the existing provisions in relation to general organisational requirements. These operate so that sustainability risks and sustainability factors should be considered in the same way as other risks and factors in the relevant organisational procedures and processes.

The concept of sustainability factors is defined by referring to how that phase is defined in the SFDR (as above) and so too is the concept of sustainability risk:

'sustainability risk' means 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[70]

Among other things, the MiFID Amendments require in scope FIs to:

- take into account sustainability risks when complying with existing organisational requirements;[71] and
- ensure the risk management policy takes account of sustainability risks.[72]

Among other things, the UCITSD Amendments require in scope FIs to:

[64] Article 1(2) Delegated Regulation (EU) 2021/1257
[65] Article 1(4) Delegated Regulation (EU) 2021/1257
[66] Article 1(5) Delegated Regulation (EU) 2021/1257
[67] Article 1(6) Delegated Regulation (EU) 2021/1257
[68] Commission Delegated Regulation (EU) 2021/1255
[69] Commission Delegated Directive (EU) 2021/1270
[70] Article 2(22) Regulation (EU) 2019/2088
[71] Article 1(2) Delegated Regulation (EU) 2021/1253
[72] Article 1(3) Delegated Regulation (EU) 2021/1253

- take into account sustainability risks in their decision-making procedures and organisational structure / reporting lines functions and responsibilities;[73]
- ensure relevant persons retain the necessary resources and expertise for the effective integration of sustainability risks;[74]
- integrate sustainability risks in the management of UCITS.[75]

Among other things, the AIFMD Amendments require in scope FIs to:

- take into account sustainability risks when complying with their due diligence requirements;[76]
- ensure the risk management policy which manages exposure to sustainability risks;[77]
- take into account sustainability risks in their decision-making procedures and organisational structure / reporting lines, functions and responsibilities;[78] and
- ensure senior management is responsible for integration of sustainability risks in its supervisory activities.[79]

Further, both the UCITSD Amendments and the AIFMD Amendments specify that where in scope FIs consider principal adverse impacts of investment decisions on sustainability factors (as described in the SFDR), the in-scope FIs must take into account such principal adverse impacts when complying with the other requirements articulated in the amending legislation. By and large the UCITSD Amendments and the AIFMD Amendments have sought to make the equivalent changes to UCITSD and AIFMD respectively. However, because the UCITSD and AIFMD are drafted slightly differently to begin with, there may be differences in the way these changes manifest.

Integration of sustainability risks and factors and sustainability preferences into Solvency II

The Solvency II Amendments[80] contain specific provisions to integrate sustainability risks into the existing requirements on procedures and organisation of firms.

In addition, the delegated act integrates the management of sustainability risks into the PPP by requiring that insurance and reinsurance undertakings take into account sustainability risks in their risk management procedures.[81] Insurance and reinsurance undertakings are further required to ensure their investment strategy and decisions reflects the sustainability preferences[82] of their customers as taken into account in the product approval process.[83]

[73] Article 1(2) Delegated Directive (EU) 2021/1270
[74] Article 1(3) Delegated Directive (EU) 2021/1270
[75] Article 1(4) Delegated Directive (EU) 2021/1270
[76] Article 1(2) Delegated Regulation (EU) 2021/1255
[77] Article 1(5) Delegated Regulation (EU) 2021/1255
[78] Article 1(6) Delegated Regulation (EU) 2021/1255
[79] Article 1(7) Delegated Regulation (EU) 2021/1255
[80] Delegated Regulation 2021/1256/EU
[81] Article 1(6) Delegated Regulation (EU) 2021/1257
[82] Article 1(1) Delegated Regulation 2021/1256/EU
[83] Recital 6 and Article 1(6) Solvency II Amendments

2.3 Regulatory changes at Member State level to integrate sustainability into financial institution legal duties

EU law is supra-national and how a piece of EU legislation becomes part of a Member State's national law depends on the type of legislation. EU regulations are directly applicable so come into force and are legally binding without any action on the part of the Member State.[84] EU directives are not directly applicable, and Member States must enact national implementing legislation by the transposition deadline to give effect to them.[85]

For each Member State covered by this paper, Annex 1 provides information on regulatory oversight and enforcement powers in relation to sustainability related financial regulation together with actual cases of enforcement powers being exercised and sustainability enforcement trends. We are still in the transition period for all the delegated acts in the April Package, therefore it is not possible to comment on enforcement trends in relation to these specific regulatory changes. However, it is possible to discern a divergence in relation to the extent to which sustainable finance, climate risk etc. is integrated into each national financial regulator's general oversight mandate and investor protection responsibilities. For example, the financial regulators in Germany and France have indicated a commitment to taking an active role in this area and have released various related guidance documents – whereas financial regulators in other Member States have remained largely silent. And we hypothesise that this divergence is more pronounced when looking at all Member States across the EU.

[84] The delegated regulations referred to in this paper are binding in their entirety and directly applicable in all Member States from 1 August 2022 (for the AIFMD Amendments) or 2 August 2022 (for the MiFID II Amendments, IDD Amendments and Solvency II Amendments).
[85] For the delegated directives referred to in this paper, Member States are required to adopt the laws, regulations and administrative provisions necessary to comply and apply those provisions from 1 August 2022 (for UCITSD Amendments) and 22 November 2022 (for MiFID II Product Governance Amendments).

Section 3

Weak integration of client preferences into financial institution legal duties

This section identifies weaknesses which are already apparent in the regulatory changes to integrate client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.

3.1 Impact-oriented financial products are not properly accommodated in the concept of sustainability preferences

The introduction of the concept of *sustainability preferences* into investment and insurance advice[86] is the regulatory change which is intended to integrate client preferences for sustainable investment into the financial advice process. Therefore understanding this concept of sustainability preferences is critical as it is the (single) conceptualisation in the regulatory framework of the (multiple) ways in which client preferences for sustainable investment can exist.

As illustrated above, the regulatory concept of sustainability preferences is articulated as the extent to which a client wants their financial instruments to:

- pursue investments in economic activities that qualify as environmentally sustainable under the Taxonomy Regulation;
- pursue sustainable investments as defined under the SFDR; and/or
- consider principal adverse impacts on sustainability factors under the SFDR.

While this definition is built around concepts such as *greenness* and *sustainability*, 2DII research[87] (as summarised in *Section 1.1 Client preferences for sustainable investment are increasing*) reveals that client preferences for sustainable investment[88] can equally be about aligning with specific personal values, or a desire to achieve an impact in the real world alongside financial performance. For some clients, investing in a financial product which falls under one of the three categories of sustainability preference may not be sufficient to satisfy broader sustainability expectations for their investments.

An alternative way of illustrating the issue is that there are other financial instruments which pursue sustainability related objectives but would not ordinarily fall under the definition of sustainability preferences. This is most clearly illustrated in the case of impact-oriented financial instruments i.e. those which have an objective of delivering additional, intentional and measurable environmental or social impact alongside a financial return. This is different to simply investing in an economic activity that contributes to an environmental or social objective as defined in SFDR. While the former is about investor impact (the change brought about by the investor) the latter is about investee company impact.[89]

There is a huge amount of uncertainty in relation to how impact-oriented financial instruments are accommodated (if at all) in the regulatory concept of sustainability preferences. This uncertainty is apparent in

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[86] As per the MiFID Amendments and the IDD Amendments
[87] 2DII, 2020, A large majority of clients want to invest sustainably and 2DII, 2022, What do your clients actually want?
[88] Note that in this paper we use the term 'client preferences for sustainable investment' to refer to a holistic understanding of client objectives and motivations to invest sustainability – whereas 'sustainability preferences' refers to the concept articulated in the regulatory definition.
[89] See 2DII, 2021, Sustainable Finance and Market Integrity and 2DII, 2022, Fighting greenwashing … what do we really need, for further discussion of the difference between genuine impact-oriented financial products and the categories of financial product outlined in the SFDR.

terms of legal interpretation of the definition of sustainability preferences and the SFDR definitions upon which the definition of sustainability preferences is reliant. And it is also apparent in terms of market behaviour and how financial institutions are self-certifying their products according to SFDR.

Integrating client preferences for sustainable investment into investment and insurance advice relies on a definition of sustainability preferences which does not accommodate impact-oriented financial instruments and does not provide clarity to an already confused marketplace. Assessing sustainability preferences will not reveal if a client is impact-oriented and cannot result in recommending an impact-oriented financial product. As a result there is a high risk of mis-selling to nearly half of clients who are interested in achieving impact.

3.2 Concept of sustainability preferences lacks clarity

In addition to the failure to accommodate impact-oriented financial instruments, there is broader uncertainty associated with the regulatory concept of sustainability preferences.

Prior to the introduction of the concept of sustainability preferences in the April Package, the principal way of categorising financial products according to sustainability criteria was through the categories established in SFDR.

- Article 6 products do not pursue sustainable investments and are therefore not considered a sustainable financial product (but may integrate sustainability risk into the investment process).
- Article 9 products (often referred to as dark green products) have sustainable investment as an objective and their underlying assets will be in sustainable investments.[90]
- Article 8 products (often referred to as light green products) sit between Article 6 and Article 9 products. These products promote, amongst other characteristics, environmental or social characteristics, or a combination of those characteristics and can invest in a wide range of underlying assets (some of which may not themselves qualify as sustainable investments e.g. hedging instruments, unscreened investments for diversification purposes etc.)

There is mounting criticism that this categorisation of financial products articulated in SFDR is unclear. Indeed, the ESAs were compelled to write to the Commission requesting clarification of the meaning of ‘promotion’ in the context of Article 8 products and the application of Article 9.[91] In addition, there is a variety of evidence that market practice which is evolving in relation to SFDR product categorisation is variable across different Member States and is in some cases seeing many financial products being certified as Article 8 products while demonstrating very poor sustainability credentials.[92]

To compound this existing confusion, it is implicit in these regulatory changes that not all Article 8 products should be able to be recommended to a client who expresses sustainability preferences.[93] To ensure that only financial instruments that have some level of sustainability-related materiality may be recommended to clients who express clear sustainability preferences, the definition of sustainability preferences departs from a simple correlation to Article 8 and Article 9 categories. The key point here is that sustainability preferences are not

[90] With the exception that underlying assets may also be for specific purposes such as hedging or liquidity (although there are currently limited rules and guidance on the product design, strategies, methodologies, and thresholds to be applied in such circumstances).
[91] https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relating_to_sfdr_application.pdf
[92] Morningstar, 2021, Global Sustainable Fund Flows: Q3 2021 in Review
[93] The explanatory memorandum to the MiFID Amendments recognises that ‘[w]hilst financial products referred to in Article 9 of the SFDR must pursue the objective of sustainable investments … financial products that fall under Article 8 of the SFDR might integrate different strategies, even including those that, despite claiming environmental, social and governance (ESG), socially responsible investing (SRI) or sustainability orientation, might lack sustainability-related materiality.’

defined as a simple preference for the different product categories established in the SFDR, but rather different types of financial product categories established in the SFDR *may* match sustainability preferences if they satisfy the criteria in the definition of sustainability preferences (and this is a separate assessment to categorisation for SFDR purposes). But given the existing momentum behind SFDR product categorisation and current market behaviour in this area, there is a risk that this feature of the definition of sustainability preferences might be lost, and investment firms might pursue a strategy of matching categories of sustainability preferences with SFDR categories of financial products.

There are several additional areas where the concept of sustainability preferences lacks clarity and where there may be a risk of highly variable market practice:

- If a client has expressed a desire to incorporate sustainability preferences in its investment, to what extent is it necessary to distinguish between the different categories of sustainability preference in order to make a financial product recommendation?
- What is the effect of clients being free to choose the minimum proportion to be invested in accordance with the criteria or qualitative or quantitative elements to be considered?

And, to make a similar point to the concern that impact-oriented financial products are not accommodated in the concept of sustainability preferences, just looking at the regulatory concept of sustainability preferences may not capture all the granular aspects or how some clients want to invest their money. Some clients may have specific priorities for their investments such as wanting to: focus on one or more of the Sustainable Development Goals (SDGs); avoid financing certain economic sectors such as fossil fuels, arms, tobacco, alcohol, gambling etc. or avoid financing certain companies which are known to be involved in controversies in relation to environmental standards or human rights violations, corruption, tax avoidance etc. This more granular level of detail may not be accommodated with a sole focus on sustainability preferences.

Information Box: Wider sustainability motivations

We use the term *wider sustainability motivations* to refer to broader client preferences for sustainable investment which are not covered by the regulatory concept of *sustainability preferences*.

Wider sustainability motivations therefore cover aspects such as the sustainability goal (i.e. achieving impact, value alignment and/or maximising return as discussed in *Section 1.1 Client preferences for sustainable investment are increasing*) and specific sustainability features which a client may want to support or avoid beyond those mentioned in the regulatory concept of sustainability preferences.

2DII's research programme has sought to improve the evidence base as to what sustainability motivations clients have, what outcomes clients expect and why, and how these expectations intersect with the range of financial products available which integrate sustainability features in product design.[94]

The definition of sustainability preferences tries to ensure only genuinely sustainable financial products are eligible for recommendation. But the lack of clarity in this definition may result in variable approaches to how financial institutions categorise their products for clients. And the concept does not capture many aspects of how clients want to invest sustainably (i.e. wider sustainability motivations). This variability will work against comparability across the market and will work against the consumer protection objective.

[94] See 2DII, 2020, A Large Majority of Retail Clients Want to Invest Sustainably, 2DII, 2022, What do your clients actually want?

3.3 Risk of influence for investment and insurance advice

The revised process articulated for the suitability assessment affords plenty of opportunity for an adviser – either unwittingly or wittingly – to influence how clients understand and express their sustainability preferences and wider sustainability motivations. There are two key areas where this undue influence can occur: (1) the explanation of sustainability preferences; and (2) the financial product recommendation.

For clients to be able to articulate and advocate effectively in relation to their own sustainability preferences and wider sustainability motivations, they must be provided with an adequate explanation of sustainability preferences and wider sustainability motivations.[95] Without an adequate explanation being provided to the client, any assessment of the client's own sustainability preferences and wider sustainability motivations will be inherently flawed.

This explanation is a key area where advisors may introduce unconscious bias in the way that sustainability preferences and wider sustainability motivations are articulated. This can then influence how clients themselves view and articulate their own sustainability preferences and wider sustainability motivations. An unconscious bias can: be driven by various factors including the existence of an inducement to recommend certain financial instruments or the advisor's knowledge and preconceptions about different financial instruments; or relate to different aspects of sustainability oriented financial instruments (cost, financial return, level of risk etc.). In addition, clients can be influenced through an explanation which does not relate to all financial instruments available on the market but is instead geared towards the financial instruments that the advisor is able to recommend.

In relation to the financial product recommendation, where an investment firm is unable to recommend a product which matches the client sustainability preferences (as originally expressed), the client may be given the opportunity to adapt its sustainability preferences in order that the advisor can make a recommendation. This means that clients may be influenced to adapt sustainability preferences to the product range of the advisor rather than maintain the sustainability preferences as originally expressed and seek out suitable financial products elsewhere on the market.

This flexibility is particularly concerning considering our latest research from the 2021 mystery shopping campaign (as summarised in *Section 1.2 inadequate financial advisor response to increasing client preferences for sustainable investment*).[96] This revealed a fairly common practice for advisors was to propose conventional financial products with which the advisors were probably more familiar and comfortable, despite these financial products not matching the preferences expressed by the mystery shoppers.[97]

The revised suitability assessment procedure affords plenty of opportunity for advisors to influence how clients express their sustainability preferences. Considering current market practice of advisors, this potential for influence may undermine the objective of establishing a process where advisors must respond in a genuine manner to client sustainability preferences.

[95] As recognised in Recital 6 of the MiFID Amendments and Recital 12 of the IDD Amendments.
[96] In addition, at ESMA's open hearing in relation to its consultation on revisions to its Guidelines on certain aspects of MiFID II suitability requirements, there was quite significant pushback expressed by financial institutions.
[97] At the same time, the current draft amendments to ESMA's Guidelines on certain aspects of MiFID II suitability requirements in our opinion provide insufficient procedural safeguards to address this issue.

3.4 Uneven integration of the concept of sustainability preferences throughout the regulatory framework

Notwithstanding concerns associated with the regulatory concept of sustainability preferences, there are further issues associated with uneven integration of the concept throughout the financial regulatory framework.

There is now a mandatory assessment of client sustainability preferences in both investment and insurance advice. But the extent of integration of sustainability preferences into financial institution legal duties covered by other parts of the regulatory framework (e.g. product governance and ongoing legal duties) is unclear.

The concept of sustainability preferences is most comprehensively integrated in the insurance framework (please refer to *Figure 4*). In terms of ongoing legal duties, 'insurance and reinsurance undertakings shall take into account the potential long-term impact of their investment strategy and decisions on sustainability factors and, where relevant, *that strategy and those decisions of an insurance undertaking shall reflect the sustainability preferences of its customers* taken into account in the product approval process.'[98] This provision sits alongside the other regulatory changes which integrate the concepts of sustainability risks and sustainability factors into existing organisational requirements.

This means that the regulatory framework which governs ongoing legal duties of insurance firms in relation to insurance-based investment products, includes the concepts of *sustainability risk*, *sustainability factors* and *sustainability preferences*. Decision making must take account of not just sustainability risks and factors, but also sustainability preferences. Once a client has invested money in a suitable insurance product which matches sustainability preferences, the ongoing management of that insurance product should therefore reflect those sustainability preferences.

However, the concept of sustainability preferences is less integrated in the framework which applies to other retail products (please refer to *Figure 4*). The regulatory changes to clarify ongoing legal duties[99] have no mention of the concept of sustainability preferences. There are targeted amendments to introduce the concepts of *sustainability risks* and *sustainability factors* into existing organisational requirements. But there is no similar provision that the investment strategy and decisions must take account of sustainability preferences. Therefore, for the framework for other retail products there is no regulatory provision which states that ongoing management of that financial product should reflect sustainability preferences expressed by a client.

And there are no regulatory changes at all which relate to the pension framework. Therefore the concept of sustainability preferences does not feature at all in the pension framework and there is no regulatory provision which states that ongoing management of a pension product should reflect sustainability preferences expressed by a client.

At EU level, considering the data about the relative proportion of investment under the pension framework, insurance framework and the framework for other retail products (see *Information Box: Relative size of markets for insurance, pensions and other retail products*) this means that client sustainability preferences are only comprehensively integrated in financial institution legal duties for approximately 17% of household investment. And at Member State level, the variation in relative amounts invested under the insurance framework, pension framework and the framework for other retail products results in similar variability in the extent of integration of client sustainability preferences in financial institution legal duties.

In relation to product governance obligations, the regulatory changes[100] integrate the concept of sustainability factors and introduce the concept of *sustainability related objectives* into the existing framework of provisions for manufacturers and distributors. In both the insurance framework and the framework for other retail

[98] Article 1(6) Delegated Regulation (EU) 2021/1256
[99] As reflected in the MiFID Amendments, UCITSD Amendments and AIFMD Amendments
[100] In the MiFID Product Governance Amendments and the IDD Amendments

products, sustainability related objectives are not a defined concept. Rather it should be understood in the context of *broader objectives* (also not defined in the original legislation) which might apply to clients in the target market for a financial instrument.

The impact of this is not clear. On the face of it, the concept of sustainability related objectives should/could encompass many different aspects of client preferences for sustainable investment which are not accommodated in the regulatory concept of sustainability preferences (e.g. what we refer to in this paper as wider sustainability motivations). As articulated above, the definition of sustainability preferences is flawed – both in its failure to accommodate impact-oriented financial products and in its broader lack of clarity and/or specificity to reflect clients' wider sustainability motivations. Therefore, for the product governance amendments to refer to sustainability related objectives instead of sustainability preferences, this may permit the product governance rules to reflect a better synergy with clients' wider sustainability motivations.

On the other hand, it is perhaps not the case that this was the Commission's intention. For example, ongoing legal duties in the insurance framework refer to '*the sustainability preferences of its customers taken into account in the product approval process*'[101] when as demonstrated above there is no mention of the concept of sustainability preferences in product governance obligations for insurance products. This then begs the question as to how sustainability related objectives referred to in the product governance requirements intersects with sustainability preferences of clients? Are they the same or different? At the very least this is an area where there is regulatory uncertainty.

Only the insurance framework requires ongoing decision making to take account of sustainability preferences. There have been no regulatory changes to the pension framework. And for the framework which applies to other retail products, ongoing legal duties are clarified by virtue of updating organisational requirements to include sustainability risks and sustainability factors – but there is no integration of sustainability preferences into these legal duties. In addition, there is regulatory uncertainty in relation to how sustainability related objectives in the product governance obligations intersect with the concept of sustainability preferences.

3.5 Poor regulatory oversight of financial institution compliance with legal duties

Regulators and supervisors have a key role in creating a regulatory environment which supports integrating client preferences for sustainable investment into financial institution legal duties through monitoring compliance and other oversight activities.

In relation to financial institution legal duties during financial advice, as revealed above, the revised suitability assessment procedure affords plenty of opportunity for advisors to influence how clients express their sustainability preferences. Considering our observations about current market practice of advisors and the level of expertise on sustainability issues, this potential for influence will undermine the objective of establishing a process where advisors must respond in a genuine manner to client preferences for sustainable investment. There is still scope for recalcitrant investment firms to not get fully behind the step change required for compliance.

Regulatory oversight to monitor that advisors are responding appropriately to the regulatory changes is crucial. But the general obligation of competent authorities in respect of on-going supervision[102] is very broadly

[101] Article 1(6) Delegated Regulation (EU) 2021/1256
[102] Article 22 Directive 2014/65

drafted. There are no explicit provisions which relate to regulatory oversight of the suitability assessment and any regulatory oversight which does occur will be largely dependent on record keeping obligations which apply to financial institutions.

For other financial institution legal duties discussed in this paper, the situation is broadly similar. Generally, the legislation is drafted to that supervision by competent authorities is proportionate and considers the nature, scale, complexity and diversity of entities and circumstances falling within scope of the legislation. This permits a variable oversight practice and culture.

This variability is exacerbated by the fact that at EU level there are two separate supervisors with oversight responsibilities – ESMA and EIOPA. By way of example, at the time of writing this paper both supervisors are in the process of developing separate guidance for how to comply with regulatory changes for the suitability assessment for investment and insurance advice respectively.

And the variability is further exacerbated by the fact that at Member State level there will be different national regulators with oversight responsibilities. Annex 1 sets out further details on the national regulators at Member State level and a summary of regulatory oversight trends. We are still in the transition period before the regulatory changes discussed in this paper become operative, therefore it is not possible to comment on enforcement trends in relation to these specific regulatory changes. However, it is possible to discern a divergence in relation to the extent to which sustainable finance, climate risk etc. is integrated into each national financial regulator's general oversight mandate and investor protection responsibilities. And we hypothesise that this divergence is more pronounced when looking at all Member States across the EU. Currently, while financial regulators in some Member States have taken active steps in relation to climate change considerations within their supervisory mandate, financial regulators in other Member States have remained largely silent.

The planned route to integrating client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments relies on a level of regulatory oversight (in relation to the suitability assessment and otherwise) which may not exist. Addressing this oversight gap is critical to create an enabling environment which is compatible with integrating sustainability considerations.

Section 4

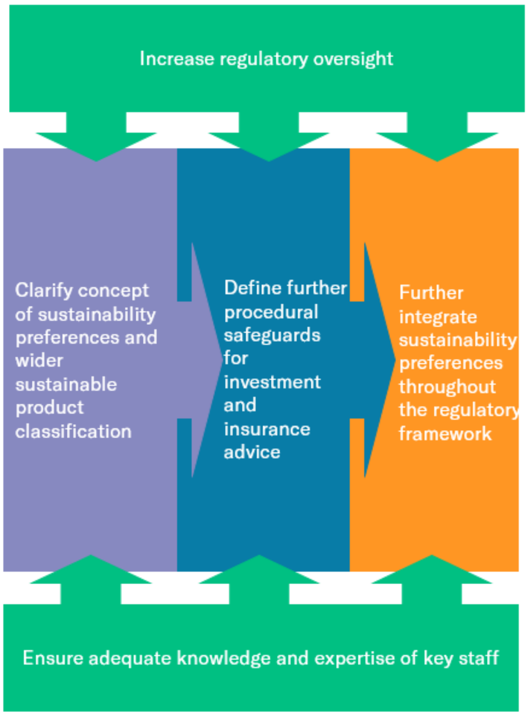
Recommendations

This section identifies recommendations to improve integration of client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.

The previous section identified several weaknesses in the current extent of integration of client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments. These weaknesses range from flaws in the regulatory concept of sustainability preferences, to incomplete integration of the concept of sustainability preferences throughout all financial institution legal duties and potential risks from inadequate regulatory oversight of financial institution compliance with these revised legal duties.

The recommendations identified in this section of the paper are a direct response to each of the identified weaknesses and are structured around the schema articulated in *Figure 7* below. They are structured so that through clarifying the definition of sustainability preferences, the regulatory framework reflects a more accurate conception of client preferences for sustainable investment. Then through ensuring further procedural safeguards for the suitability assessment, advisors are properly incentivised to ensure they respond appropriately to client preferences for sustainable investment. And further integration of sustainability preferences ensures that legal duties in all frameworks is consistent. Finally increased regulatory oversight and ensuring appropriate training for advisors can support and ensure the right enabling environment.[103]

Figure 7: Schema of recommendations to improve integration of client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments.



[103] Note also that (as referred to in our sister paper: 2DII, 2022, Fighting greenwashing … what do we really need?) 2DII is conducting an ongoing programme of interviews with relevant stakeholders to complement the theoretical review in the two papers. The purpose of this interview programme is to develop practical analysis of the specific challenges raised by the legal analysis contained in the two papers. The legal analysis contained in this paper has so far been discussed with over 25 relevant stakeholders (financial institutions, experts and regulatory authorities) and we are continuing the interview programme for the legal analysis in the sister paper.

4.1 Clarify concept of sustainability preferences and wider sustainable product classification

The concept of sustainability preferences is the (single) conceptualisation in the regulatory framework of the (multiple) ways in which client preferences for sustainable investment can exist. But because of the poor definition of sustainability preferences, there are weaknesses associated with how financial institution legal duties to clients are conceived right from the outset.

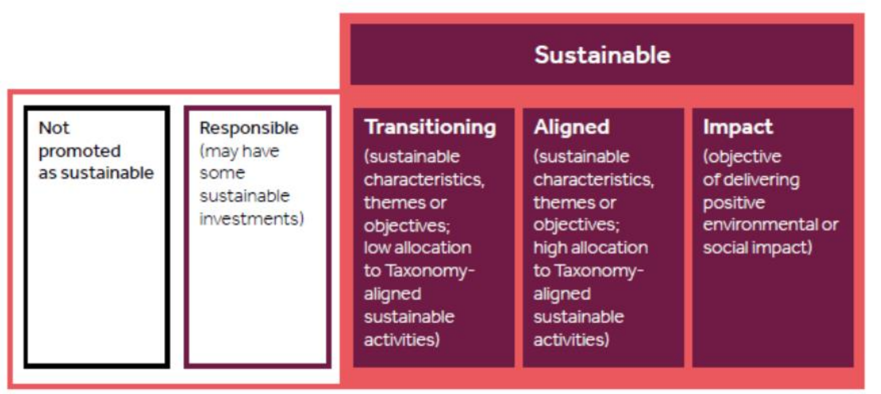
According to the regulatory concept, client preferences for sustainable investment is a preference for one or more of three types of financial product. But this concept does not accommodate impact-oriented financial instruments – therefore assessing sustainability preferences will not reveal if a client is impact-oriented and cannot result in recommending an impact-oriented financial product (see *Section 3.1 Impact-oriented financial products are not properly accommodated in the concept of sustainability preferences*). And neither does the concept accommodate a client's wider sustainability motivations (see *Section 3.2 Concept of sustainability preferences lacks clarity*).

Clarifying the concept of sustainability preferences to counter the above-described weaknesses will also require an improved approach to wider sustainable product classification than currently described in the SFDR. Absent an improved method of sustainable product classification, much of the regulatory architecture to support the improved concept of sustainability preferences will be missing.

The approach to wider sustainable product classification must create a separate category for impact-oriented financial products. In the UK, the FCA has recently consulted on a proposed approach to a sustainable product classification and labelling system[104] and there are several aspects to the FCA's policy proposals which can serve as inspiration for improving the EU approach to sustainable product classification.

First, the proposed approach differentiates between *Impact* financial products (that aim to deliver positive environmental or social impact) and other types of sustainable financial products such as *Transitioning* and *Aligned* investment products (which can have varying degrees of sustainability). Second, the FCA is planning to develop detailed minimum criteria which are linked to tangible product features which determine how to categorise each financial product. For example, both *Sustainable-Transitioning* and *Sustainable-Aligned* are structured with underlying assets meeting sustainability criteria set out in the forthcoming UK Taxonomy, but the minimum proportion for *Sustainable-Aligned* is set at a higher level than for *Sustainable-Transitioning*.

Figure 8: FCA's proposed approach to sustainable product classification and labelling system



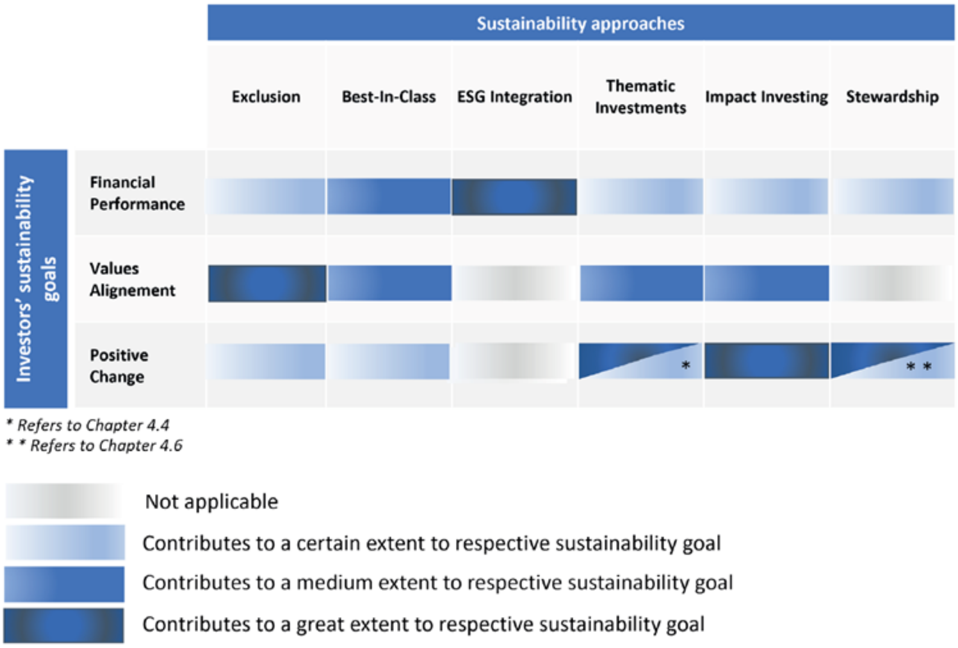
[104] FCA, 2021, Discussion Paper (DP21/4) Sustainability Disclosure Requirements (SDR) and investment labels

This proposed approach to sustainable product classification appears to offer significant scope for a framework which effectively articulates impact-oriented products as a separate category and is easier to use for both financial institutions and clients (e.g. simplification through ensuring the proportion invested in suitable underlying assets is included in the product classification criteria rather than clients choosing the minimum proportion to be invested in accordance with the criteria).

And an approach to sustainable product classification which is predicated on tangible product features can enable clarification of the concept of sustainability preferences so that it can accommodate a better conception of client sustainability goals (see *Section 1.1 Client preferences for sustainable investment are increasing*).

In Switzerland, the Asset Management Association Switzerland (AMAS) and the Swiss Sustainable Finance (SSF) have recommended an approach to integrate sustainability across the asset management value chain including at entity level, product level and the point of sale or distribution level from the end-client perspective.[105] Their recommendations include: (a) definitions of various sustainable investment approaches; (b) minimum criteria for implementation of each sustainable investment approach and related disclosures; and (c) a methodology for matching each sustainable investment approach to three main investor sustainability goals. The three main investor sustainability goals (i.e. positive change, values alignment and financial performance) are aligned with the sustainability goals articulated in *Section 1.1 Client preferences for sustainable investment are increasing*. These recommendations are also in line with the concept of wider sustainability motivations introduced earlier (see *Section 3.2 Concept of sustainability preferences lacks clarity*).

Figure 9: Matrix illustrating suitability of different sustainability approaches for different investors' sustainability goals (AMAS/SSF 2021)



105 AMAS/SSF, 2021, How to Avoid the Greenwashing Trap: Recommendations on transparency and minimum requirements for sustainable investment approaches and products

The AMAS and SSF recommendations emphasise that, without a specific focus on matching sustainable investment approaches to investor sustainability goals, there is a high risk of systematic mismatch between client expectations and the product characteristics of recommended financial products. Therefore, the matching of sustainable investment approaches to investor sustainability goals should be key information for the design of a financial product's sustainable investment strategy (e.g. asset managers should ask themselves the question which investor sustainability goal the financial product should target), product disclosures (the suitability of the financial product to the three main investor sustainability goals should be presented and easy to understand for the client) and product distribution (financial advisor who should assess the suitability of a financial product for the client's sustainability goals).

The AMAS and SSF recommendations show that tangible product features can be linked to client sustainability goals. Therefore, improving EU sustainable product classification to create a separate category for impact-oriented products and clarify existing product categories so that they are linked to much more tangible product features (see above) would in turn permit a definition of sustainability preferences which both reflects this improved sustainable product classification and at the same time facilitates matching client sustainability goals to tangible product features associated with each category of financial product.[106]

While the FCA's proposed approach and the AMAS and SSF recommendations can serve as a source of inspiration, further work is required in relation to articulating the specific criteria to define each category of financial product and sustainability approach. This further work would also need to draw from and be consistent with existing concepts in EU sustainable finance regulation such as "taxonomy alignment", "sustainable investment", "principal adverse impact" etc.

In the EU framework, the question arises as to what point it makes sense (or becomes an imperative) to revisit sustainable product categorisation under SFDR and the concept of sustainability preferences.

As mentioned, the ESAs have requested clarification of the financial product classification under SFDR. While the Commission has responded to this request, that response has not shed much light on the topic. In addition, it remains to be seen what effect the departure in the MiFID Amendments and IDD Amendments from a simple correspondence to Article 8 and Article 9 which is evident in the definition of sustainability preferences will have. Furthermore, the regulatory technical standards under SFDR have only recently been released[107] and further delegated acts for the Taxonomy Regulation are still being developed.

Therefore there are a lot of moving pieces in relation to existing financial product classification under SFDR and market behaviour in response. Currently, the review period articulated in the SFDR is 30 December 2022 but, given the various delays associated with other sustainable finance regulation, it seems unlikely the Commission will comply with that initial timescale. What is clear though is that this is still an area with a high degree of regulatory uncertainty and this review of the SFDR is an opportunity to provide clarification.

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[106] Note however that 2DII's work in relation to developing a default suitability assessment questionnaire and guidance (see *Information Box: A default suitability questionnaire and guidance*) demonstrates that integrating client financial/sustainability goals across the asset management value chain as better practice and is not in conflict with the existing regulatory environment.
[107] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/sustainability-related-disclosure-financial-services-sector_en As at the date of this paper, this legislation is now subject to scrutiny by the European Parliament and the Council. They are scheduled to apply from 1 January 2023.

In addition, the Commission has indicated in its *Strategy for Financing the Transition Towards a Sustainable Economy* that it will look to set minimum sustainability criteria for financial products that fall under Article 8 SFDR in order to guarantee minimum sustainability performance of such products. This is a further opportunity to provide clarification on sustainable product categorisation under SFDR. The Commission should broaden the scope of activity to include both Article 8 and Article 9 financial products and, once this is completed, the definition of sustainability preferences should be amended accordingly to ensure consistency.

The Commission should use upcoming opportunities (e.g. in relation to setting minimum sustainability criteria for financial products or otherwise) to improve sustainable product categorisation to create a separate category for impact-oriented financial products and clarify the concept of sustainability preferences to improve the foundation for how financial institution legal duties to clients are conceptualised.

4.2 Detail further procedural requirements for investment and insurance advice

There are two key areas where clients can be subject to undue influence in relation to how clients understand and express their sustainability preferences and wider sustainability motivations: (1) the explanation of sustainability preferences; and (2) the financial product recommendation.

This risk of influence means that clients are hindered in their ability to advocate effectively in relation to their own sustainability preferences. This further undermines how financial institution duties to clients are conceptualised. Detailing further procedural requirements for the suitability assessment procedure can limit the risk of undue influence by advisors.

As there is no opportunity to revise the amending regulation for the time being, ESMA and EIOPA guidance should provide as much further detail and guidance as possible to support consumer protection objectives.

This supervisory guidance should articulate the different components of what constitutes an *adequate* explanation of sustainability preferences and wider sustainability motivations to the client. In our opinion, the components should include: the link between financial investment and the environment and society; environmental, social and governance aspects, different types of sustainable financial instruments available on the market; different categories of sustainability preferences, articulation between sustainability preferences and other investment objectives and wider sustainability motivations not covered by the regulatory concept of sustainability preferences.

To ensure that explanation of sustainability preferences covers all the necessary components of what constitutes an *adequate* explanation, financial institutions should develop explanatory materials to ensure the explanation is effective. This allows financial institutions to tailor the explanatory materials so they are unique to the financial institution but would also support controls to check if the explanation was adequately provided. Supervisory guidance should articulate that developing explanatory materials can assist financial institutions comply with their legal obligations.

In relation to the process articulated for the financial product recommendation, the supervisory guidance should explain that where financial institution is unable to recommend a financial product which satisfies client sustainability preferences as originally expressed, the financial institution should state that suitable financial products may be available elsewhere on the market as part of the process of offering the client the opportunity to amend its sustainability preferences. Without this, there is hardly any incentive for financial institutions to adapt the product range because clients can simply be directed towards the products in the range and be influenced to adapt their sustainability preferences. And furthermore, the conceptualisation of legal duties is critically flawed.

In the absence of any clarification of the definition of sustainability preferences, the supervisory guidance should articulate that it is good practice to assess a client's wider sustainability motivations (not addressed by the regulatory concept of sustainability preferences) which are relevant to implement better practice for a comprehensive assessment of all sustainability related aspects associated with client investments.

However, national financial regulators also have a role to play in ensuring the suitability assessment is conducted in the right way and with a faithful adherence to the intended regulatory changes. National financial regulators are directly responsible for ensuring the appropriate degree of regulatory oversight and there is nothing to prevent their own publishing of guidance and supervisory expectations regarding the conduct of the suitability assessment. In this regard, our recent mystery shopping research[108] sets out seven more detailed recommendations about specific topics which regulator guidance or supervisory expectations could focus on.

To ensure that financial institution legal duties to clients are correctly conceptualised, EU supervisors and national regulators should seek to detail further procedural safeguards for the suitability assessment so that clients express sustainability preferences free from any influence by advisors.

[108] 2DII, 2022, Please Don't Let Them Be Misunderstood!

Information Box: A default suitability questionnaire and guidance

Although ESMA and EIOPA guidance to accompany the new suitability assessment requirements can articulate procedural requirements to a degree, the guidance from these supervisors is nevertheless likely to remain high level.

2DII outreach to financial institutions and what we have observed at public events[109] leads us to believe that many financial institutions are struggling to progress on implementing the organisational changes required to comply with the new suitability assessment requirements. Anecdotal evidence suggests that the current state of knowledge among financial institutions is not what it should be to ensure implementation is successful and supportive of the overarching policy objective.

As a result, there is a risk that high level guidance will not do enough to assist financial institutions bring about the step change in behaviour required to ensure compliance with the new requirements and an appropriate degree of market harmonisation in this area will not be achieved.

To address this concern and support the Commission's reform agenda in this area, a working group established under the Finance ClimAct project in France is working to develop a default suitability assessment questionnaire and guidance on how to adequately assess client sustainability preferences and wider sustainability motivations. The working group is led 2DII and Finance for Tomorrow (F4T) and has approximately 20 members comprising a mix of financial institutions, civil society organisations, academic institutions and regulatory authorities.

The objective behind developing the questionnaire and guidance is to go a step further than the supervisory guidance to help financial institutions comply with the regulatory changes, fill gaps identified and implement a didactic approach to assessing sustainability preferences and wider sustainability motivations.

The working group has released consultation drafts of the suitability assessment questionnaire and guidance for stakeholder feedback. The consultation drafts will then be finalised to account for stakeholder feedback and ensure consistency with the final version of the ESMA Guidelines.

The goal of the Finance ClimAct Project is to contribute to the implementation of French and European policies for sustainable finance, in line with the European Green Pact and France's National Low Carbon Strategy.

ADEME leads the consortium which includes Ministry of the Environment's Commissioner General for Sustainable Development (CGDD), the French financial market authority (AMF), the French prudential authority (ACPR), 2DII and F4T as well as other private sector partners.

The project is running from 2019-2024 and has a total budget of €18 million.

[109] For example, ESMA's open hearing on the review of the ESMA Guidelines on certain aspects of the MiFID II suitability requirements held on 18 March 2022

4.3 Further integrate sustainability preferences throughout the regulatory framework

Currently, the level of integration of sustainability preferences into financial institution legal duties outside of the suitability assessment is variable. In the insurance framework, the concept of sustainability preferences is integrated into ongoing investment decisions alongside integrating sustainability risks and sustainability factors into existing organisational requirements. But for the framework for other retail products there is no regulatory change to include sustainability preferences in ongoing investment decisions and the regulatory changes relate only to integrating sustainability risks and sustainability factors into existing organisational requirements. And for the pension framework, there have been no regulatory changes to clarify financial institution legal duties.

Therefore further integration of the concept of sustainability preferences in legal duties is required to ensure a harmonised approach throughout the regulatory framework.

The pension framework already requires financial institutions to invest in accordance with prudent person rules which define what assets the financial institution can invest in, and that assets should be invested in the long-term best interest of members and beneficiaries. It would be relatively simple to integrate the concept of sustainability preferences here.[110] What is potentially more difficult (although still readily achievable) is establishing a means by which members and beneficiaries can express their sustainability preferences as currently there is no equivalent of the suitability assessment as for insurance and investment advice.

The Commission has indicated in its *Strategy for Financing the Transition Towards a Sustainable Economy* that it will assess the need to broaden the concept of the 'long-term best interests of members and beneficiaries' to ensure the pension framework better reflects members and beneficiaries' sustainability preferences and broader societal and environmental goals.

Exploring possible avenues to require IORPs to consider members and beneficiaries' sustainability preferences in their investment decisions is necessary to ensure more comprehensive integration of sustainability preferences in all financial institution legal duties to clients. But the analysis in this paper shows that sustainability preferences still need to be further integrated into the framework which applies to other retail products (notably MiFID, UCITSD and AIFMD).

For the product governance rules, the regulatory uncertainty in relation to how sustainability related objectives should intersect with sustainability preferences needs clarification. On the face of it, the concept of sustainability related objectives should/could encompass many different aspects of client preferences for sustainable investment which are not accommodated in the regulatory concept of sustainability preferences (e.g. what we refer to in this paper as wider sustainability motivations). However, further work is required to understand how sustainability related objectives should be understood in the context of these regulatory changes to the product governance rules and further how these should intersect with the regulatory concept of sustainability preferences.

In addition to the proposals to integrate sustainability preferences into the pension framework, the Commission should also complete the integration of sustainability preferences throughout the financial regulatory frameworks and clarify how sustainability related objectives intersects with the concept of sustainability preferences.

[110] In a like manner to the integration of sustainability preferences under Solvency II Amendments

4.4 Increase regulatory oversight and ensure adequate knowledge and expertise of key staff

The regulatory changes discussed in this paper are subject to the existing regulatory oversight provisions. These are very broadly drafted at EU level which permits a variable oversight practice and culture at national level. There is a risk that currently the level of regulatory oversight may be too low to effectively monitor compliance or provide the desired incentives for financial institutions to implement the regulatory changes.

Addressing any regulatory oversight gap is critical to create an enabling environment which is compatible with integrating sustainability considerations into financial institution legal duties. EU supervisors and national regulators should assess what regulatory tools are available to set supervisory expectations and ensure compliance with the regulatory changes.

As identified in a previous recommendation, both ESMA and EIOPA are due to release guidance on how to comply with the new suitability assessment requirements. This guidance should provide as much further detail as possible to support consumer protection objectives.

However, this guidance will only apply to the new suitability assessment requirements. For the other regulatory changes, these supervisors should assess what supervisory tools could be relevant. ESMA has a practice of releasing Q&As as an additional form of guidance on the acts within ESMA's remit. ESMA also publishes Strategic Orientation documents which set out ESMA's future focus and objectives over a defined period. The most recent Strategic Orientation document[111] stated that ESMA will co-ordinate mystery shopping on retail investment products, develop retail risk indicators and collect analyse and report on consumer trends. Each of these tools can assist with setting supervisory expectations and ensuring compliance with regulation.

EU supervisors should also review the regulatory oversight practices of national regulators to assess if supervision is sufficient to ensure proper implementation of the regulatory changes and coordinate supervisory actions.

National regulators can look to their own toolbox for how to set expectations around compliance through their regulatory mandates. Possible actions might include (depending on the jurisdiction) releasing supervisory statements, so called "Dear CEO letters" or articulating a specific focus in thematic reviews. National regulators in some jurisdictions are also starting to carry out mystery shopping campaigns (e.g. the AMF in France has been carrying out mystery shopping since 2011 to assess the conditions under which financial products are marketed[112]).

There are various activities therefore that can be an effective way of setting supervisory expectations in relation to the regulatory changes discussed in this paper. And although the regulatory changes discussed in this paper are subject to the existing regulatory oversight provisions, supervisors and regulators can communicate a specific focus for their supervisory activities. Given the novel nature of the regulatory changes discussed in this paper, articulating a specific focus on compliance with these new requirements is clearly warranted.

Supervisors and regulators can also play a role in ensuring relevant staff have adequate levels of knowledge and expertise to carry out their role. This is relevant for staff involved in material aspects of the suitability process, as well as staff who are responsible for key aspects of the organisational requirements which have been clarified to take account of sustainability risks and sustainability factors.

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[111] ESMA, 2020, ESMA Strategic Orientation 2020-22 (published following the outcome of the ESAs Review granting ESMA new powers and responsibilities)

[112] https://www.amf-france.org/en/news-publications/news-releases/amf-news-releases/first-mystery-shopping-campaigns-under-mifid-ii-amf-examines-practices-11-retail-banks

In relation to staff involved in material aspects of the suitability process, the regulatory changes require that financial institutions have in place adequate procedures and policies to ensure they understand sustainability features – but there is very little detail about what specifically is required. And, in the *Strategy for Financing the Transition to a Sustainable Economy*, the Commission states that it 'will encourage greater retail investor engagement by seeking improvements in the level of sustainability expertise of financial advisors, subject to further assessment.' The Commission should broaden the scope of activity to seek improvements in the level of sustainability expertise of not just financial advisors, but all key staff who are responsible for the organisational requirements which have been updated to integrate sustainability risks and sustainability factors. EU supervisors and/or national regulators are the natural choice to oversee a training and certification programme in relation to sustainability knowledge and expertise.

Supervisors and regulators should examine what tools they can use to set supervisory expectations and ensure compliance with the regulatory changes. The Commission, supervisors and regulators should implement measures to ensure sustainability expertise of all staff involved in the suitability process and which are responsible for key aspects of organisational requirements which take account of sustainability risks and sustainability factors.

Information Box: MyFairMoney

2DII developed an independent and non-commercial online platform "MyFairMoney" to help retail investors to invest their savings more sustainably. Thanks to the funding support by the European Commission and the German, French and Swiss Environmental Ministries, MyFairMoney will be replicated in all European Member States to become the leading independent information platform for retail investors on sustainable finance. The platform includes information material on sustainable finance, a surveillance tool to check financial advisor practices with legal requirements, an online questionnaire to determine an individual sustainability profile and an extensive database with sustainability information on 9,000 public retail funds.

The next step will be to reach out to retail investors across Europe and create an online community of sustainability-oriented retail investors and beneficiaries who will run based on a surveillance tool on MyFairMoney 'real' financial advice visits and document the outcomes. This action will create a permanent citizen-based monitoring system on the compliance of financial advice under the new MiFID/IDD requirements. The group will also constitute a potential sounding board for the authorities and the industry to test new concepts of products and ideas.

Section 5

Conclusion

Clarifying financial institution duties to clients is a cornerstone of the Commission's sustainable finance agenda and is intended to leverage client preferences for sustainable investment in support of reorienting capital towards sustainable investment. The six amending delegated acts in the *April Package* are the regulatory changes in response to this objective. But the legal analysis in this paper reveals a variable extent to which client preferences for sustainable investment have been integrated into financial institution legal duties.

While the suitability assessment for investment and insurance advice must now include a mandatory assessment of client sustainability preferences, the process articulated for the revised suitability assessment affords plenty of opportunity for financial institutions to influence how clients understand and express their sustainability preferences. This potential for influence will undermine the objective of establishing a process where advisors must respond in a genuine manner to client preferences for sustainable investment.

Integration of sustainability preferences into legal duties outside of the suitability assessment is patchy and incomplete. Only the insurance framework requires ongoing legal duties to take account of sustainability preferences. There are no regulatory changes to the pension framework. And for the framework for other retail products, ongoing legal duties are clarified by virtue of updating organisational requirements to include sustainability risks and sustainability factors – but there is no integration of sustainability preferences into these legal duties. In addition, there is regulatory uncertainty in relation to how sustainability related objectives in the product governance obligations intersect with the concept of sustainability preferences.

Perhaps the most damming problem of all is the regulatory concept of sustainability preferences itself. This concept is effectively the foundation stone for how financial institution legal duties are supposed to accommodate client preferences for sustainable investment – but it is an inherently flawed definition. The definition does not accommodate impact-oriented products and neither does the concept accommodate a client's wider sustainability motivations. More broadly, the lack of clarity in this definition may result in variable approaches to how financial institutions categorise their products for clients. This variability will work against comparability across the market and will work against the consumer protection objective.

Finally there is a regulatory oversight gap. The planned route to integrating client preferences for sustainable investment into financial institution legal duties during financial advice and ongoing management of client investments relies on a level of regulatory oversight (in relation to the suitability assessment and otherwise) which may not exist. Addressing this oversight gap is critical to create an enabling environment which is compatible with integrating sustainability considerations.

The recommendations in this paper are a direct response to each of the identified weaknesses. First, it is imperative to clarify the concept of sustainability preferences and wider sustainable product categorisation so that the regulatory framework reflects a more accurate conception of client preferences for sustainable investment and a separate category for impact-oriented financial products. Then advisors must be properly incentivised to ensure they respond appropriately to client sustainability preferences through defining further procedural safeguards for the suitability assessment. Further integration of sustainability preferences throughout the financial regulatory frameworks and clarification of how sustainability related objectives intersects with the concept of sustainability preferences should ensure that legal duties are consistent across the board. Finally increased regulatory oversight and appropriate training for key staff can support and ensure the right enabling environment.

Given the objective of clarifying financial institution legal duties to clients to take account of client preferences for sustainable investment, there is still some way to go before this objective is achieved.

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UCITS

Directive 2009/65/EU of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) **(UCITSD)**

Directive 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company

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AIFMD

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IDD

Directive 2016/97/EU of the European Parliament and of the Council of 20 January 2016 on insurance distribution (**IDD**)

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IORP II

Directive 2016/2341/EU of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs) (IORP II)

Annex 1: Summary of regulatory oversight trends in select Member States

Spain

Regulatory oversight of ESG financial regulation

The Comisión Nacional del Mercado de Valores (**CNMV**) collaborates with other national supervisors led by the Ministry of Economy and Business and with participation from the Bank of Spain, the Directorate General for Insurance and Pension Funds (**DGSPF**) and the Climate Change Office in order to coordinate and oversee the enforcement of ESG financial regulation:

- CNMV acts as the national competent authority for entities that are covered by ESMA;
- The Bank of Spain is responsible for regulating European Central Bank (**ECB**) entities; and
- DGSPF is responsible for regulation at a local level.

CNMV was granted further supervisory and enforcement powers in relation to ESG by virtue of Directive 2017/828/EU (**SRD II**).

CNMV's regulatory focus to date has been the issuance of guidance and statements (as opposed to new regulations of legislation), as demonstrated by the following activity:

- In February 2021, CNMV issued a statement that it will apply the proportionality principle when supervising the compliance of SFDR; and
- As part of the 2021 Activities Plan, CNMV announced that it will work on integrating climate risk monitoring into its prudential, conduct and macro prudential supervision functions. It also stated that it will contribute to studies and research to assess climate-related risks and their implications for the stock market and wider financial system, as well as identifying measures and policies to combat them.
- Last June, CNMV published guidelines regarding the application of SFDR and the Taxonomy Regulation. The guidelines noted that they will evolve to take into account the European Commission's interpretation of the regulations.

However, entering into force in May 2021, the Law on Climate Change and Energy Transition 7/2021 requires CNMV, the Bank of Spain and DGSPF to submit a joint report every two years on the degree of alignment of the financial sector with the goals of the Paris Agreement and the EU, as well as an assessment of the risk to the system. The report will be published and sent to the Congress of Deputies and the Senate.

Credit institutions, insurance companies and companies issuing securities admitted to trading on regulated markets that need to publish disclosures in accordance with the Directive 2014/95/EU (**NFRD**) will also need to publish an annual report assessing the financial impact on society of the risks associated with climate change generated by exposure to its activity including: (i) risks of transition to a sustainable economy and (ii) measures adopted to address these risks. Further guidance and regulations in this area are expected.

Enforcement powers in relation to ESG financial regulation

CNMV has information gathering and investigative powers by virtue of SRD II and NFRD. As noted above, CNMV have stated that it will apply its supervisory powers in a proportionate manner which suggests that in the near future its focus will be helping companies comply with the ESG financial regulation requirements rather than taking enforcement action against them.

Actual cases of enforcement powers being exercised in relation to ESG misconduct

To date, we are not aware of any use of these enforcement powers in relation to ESG.

ESG trends in relation to regulatory enforcement

Similarly, we are not currently aware of any trends in relation to regulatory enforcement as far as it concerns ESG regulations.

Germany

Regulatory oversight of ESG financial regulation

The Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*), (**BaFin**) is responsible for the oversight and enforcement of ESG financial regulation.

Enforcement powers in relation to ESG financial regulation

BaFin is authorised to take measures that are appropriate and necessary to monitor compliance with SFDR, the Taxonomy Regulation and the delegated acts and technical implementing and regulatory standards of the European Commission.

This includes the following measures:

- In the event that it is necessary for its monitoring and supervision purposes, BaFin may:
    - obtain information from anyone it deems appropriate;
    - demand the submission of documents and the provision of copies of such documents;
    - request existing recordings of telephone conversations and data transmissions; and
    - summon and interrogate persons.
- Auditors shall provide BaFin with information and documents upon request to the extent necessary for the investigation. The auditors' duty to provide information shall be limited to facts that have come to their knowledge in the course of the audit.
- In addition, BaFin may issue orders that are appropriate and necessary to remedy or prevent non-compliance, e.g. creating compliance structures and dismissing of directors, etc.

There is no exhaustive list of possible measures that BaFin can take however it must ensure that its measures are appropriate and necessary.

Actual cases of enforcement powers being exercised in relation to ESG misconduct

To date, we are not aware of any use of these enforcement powers in relation to ESG - noting that the use of investigatory powers in particular may not be publicly notified.

ESG trends in relation to regulatory enforcement

BaFin is committed to taking an active role in this area as demonstrated by the following publications:

- Guidance Note on Dealing with Sustainability Risks dated 15 January 2020; and
- Consultation 13/2021 – Draft BaFin guideline for sustainable investment funds dated August 2021.

It remains unclear as to what extent BaFin will actively enforce ESG-related rules at this point due to the novelty of this regulatory area and their limited activity to date.

Belgium

Regulatory oversight of ESG financial regulation

The Financial Services and Markets Authority (**FSMA**) are responsible for the oversight and enforcement of ESG financial regulation in Belgium.

Enforcement powers in relation to ESG financial regulation

The FSMA have the following powers, which it may exercise in order to investigate potential breaches of the relevant ESG regulations, or to enforce actual breaches:

- In order to aid investigations FSMA can:
    - request information and documents;
    - perform on-site investigations;
    - request reports from the auditors of the entity under investigation; and
    - summon and hear any person.
- In cases of infringement of the regulations, FSMA can:
    - order the person responsible for the infringement to remedy the situation e.g. requiring the offender to publish a corrective statement where they have made a misleading statement in respect of their sustainability credentials;
    - publish a public statement on its website informing the public of the infringement (i.e. a censure);
    - prohibit the marketing of financial products or the marketing of financial products in certain form in Belgium;
    - impose fines; and
    - impose periodic penalty payments until the infringement stops.

Actual cases of enforcement powers being exercised in relation to ESG misconduct

To date, we are not aware of any use of these enforcement powers in relation to ESG.

ESG trends in relation to regulatory enforcement

Similarly, we are not currently aware of any trends in relation to regulatory enforcement as far as it concerns ESG regulations.

Luxembourg
Regulatory oversight of ESG financial regulation

The *Commission de Surveillance du Secteur Financier* (the **CSSF**) is the supervisory authority responsible for the oversight of supervised entities of the financial sector in Luxembourg.

The CSSF also undertakes supervisory enforcement work in relation ESG (as far as it relates to regulated financial institutions), which it identifies as a fundamental area of regulatory focus.

Enforcement powers in relation to ESG financial regulation

The CSSF is granted wide supervisory and investigative powers to exercise its functions, pursuant to Article 147 of the law of 17 December 2010 relating to undertakings for collective investment, as amended (the **2010 Law**), and Article 50 of the law of 12 July 2013 on alternative investment fund managers, as amended (the **2013 Law**). These powers include the right to:

- access any document and create a copy;
- require any person to provide information and, if necessary, to summon and question any person with a view to obtaining information;
- carry out on-site inspections or investigations, by itself or by its delegates, of persons subject to its supervision;
- require existing recordings of telephone conversations, electronic communications or other data traffic records held by a UCI, management company, investment company, depositary or any other entity regulated by the CSSF;
- require the cessation of any practice that is contrary to the provisions adopted in implementation of the 2010 Law and the 2013 Law;
- request the freezing or the sequestration of assets by the president of the district court in Luxembourg acting on request;
- pronounce the temporary prohibition of exercising professional activities against the persons subject to its prudential supervision, as well as the members of administrative, governing and management bodies, employees and agents linked to these persons;
- require authorised AIFMs, investment companies, management companies, statutory auditors or depositaries to provide information;
- adopt any type of measure to ensure that AIFMs, investment companies, management companies or depositaries continue to comply with the requirements of the 2010 Law and the 2013 Law;
- require the suspension of the issue, repurchase or redemption of units of the UCI or AIF in the interest of the unitholders or of the public;
- withdraw the authorisation granted to a UCI, a management company, an AIFM or a depositary;
- transmit information to the State Prosecutor for criminal proceedings; and
- instruct approved statutory auditors or experts to carry out verifications or investigations of persons subject to the 2010 Law and the 2013 Law.

The CSSF is empowered to issue sanctions and other administrative measures on financial market participants authorised as supervised entities that includes regulated funds, management companies/AIFMs, depositaries and their management/governing bodies pursuant to Articles 148 and 149 of the 2010 Law and Article 51 of the 2013 Law.

For UCIs and management companies authorised under the 2010 Law, sanctions include:

- a public statement which identifies the nature of the infringement and person responsible;
- an order requiring the person responsible to cease conduct;
- in the case of a UCI or a management company, suspension or withdrawal of the authorisation of the UCI or the management company;
- a temporary or, for repeated serious infringements, a permanent ban against a member of the management body of the management company or of the UCI or against any other natural person

employed by the management company or the UCI who is held responsible, from exercising management functions in those or in other such entities; and
- administrative fines.[113]

For AIFMs under the 2013 Law, the CSSF may impose the following sanctions:
- a warning;
- a reprimand;
- a fine between EUR 250 and EUR 250,000; and
- in the cases for failure to respond to, inter alia inspection powers of the CSSF or injunctive measures by the CSSF:
- a temporary or definitive prohibition on carrying out operations or activities, as well as any other restrictions on the activity of the person or entity;
- a temporary or definitive prohibition on acting as directors, managers or conducting persons, whether de jure or de facto, of persons or entities subject to the supervision of the CSSF.

When imposing a penalty, the CSSF must consider the nature, duration and severity of the infringement alongside the historical record of the person being sanctioned, the damage caused to third parties and the potential benefits or gain and/or those effectively deriving from the infringement.

Actual cases of enforcement powers being exercised in relation to ESG misconduct

To date, we are not aware of any use of these enforcement powers in relation to ESG – noting that the use of investigatory powers in particular may not be publicly notified.

ESG trends in relation to regulatory enforcement

Similarly, we are not currently aware of any trends in relation to regulatory enforcement as far as it concerns ESG regulations.

[113] In the case of a legal person, an administrative fine of up to EUR 5,000,000 or of a maximum amount of 10 % of the total annual turnover of the legal person according to the last available accounts approved by the management body. Where the legal person is a parent undertaking or a subsidiary of the parent undertaking which has to prepare consolidated financial accounts in accordance with Directive 2013/34/EU, the relevant total annual turnover shall be the total annual turnover or the corresponding type of income in accordance with the relevant EU law in the area of accounting according to the last available consolidated accounts approved by the management body of the ultimate parent undertaking. In the case of a natural person, an administrative fine of up to EUR 5,000,000. Alternatively, a fine can be imposed that is at least twice the amount of the benefit derived from the infringement of the law where that benefit can be determined.

France

Regulatory oversight of ESG financial regulation

The Financial Market Authority (**AMF**) is responsible for the oversight and enforcement of ESG financial regulation for the financial market. The Prudential Supervisory and Resolution Authority (**ACPR**) and the Bank of France are responsible for the oversight and enforcement of ESG financial regulation for the banking and insurance sector.

- AMF acts as the national competent authority for entities that are covered by ESMA;
- ACPR acts as the national competent authority for entities that are covered by EBA and EIOPA;
- The Bank of France is responsible for regulating European Central Bank (**ECB**) entities.

These three institutions published recent papers and positions about sustainable finance

- Both AMF and the Bank of France have created a Commission of Climate and Sustainable Finance.
- Every year ACPR and AMF published a common report which monitors and evaluates the climate commitments of market players: Sectoral policies and exposure of players to fossil fuels.
- This year, one of the five priorities for AMF is sustainable finance and the fight against greenwashing.

Since 2011, asset managers must specify in their annual report how criteria relating to compliance with social, environmental and governance quality objectives are taken into account in their investment policy. With the transposition of SFDR, this obligation became more important by adding more information to their investment policy and an extra-financial performance statement.[114]

In 2019, the French law n° 2019-486 (**Loi Pacte**) creates the obligation to propose in life insurance at least one unit of account labelled SRI, one unit of account labelled “green” and another one labelled “solidarity”. Moreover, every year the client must receive information concerning the policy for integrating environmental and social impacts into the management of the contract's euro fund, as well as the amounts invested in labelled funds.

Enforcement powers in relation to ESG financial regulation

AMF is monitoring compliance with SFDR, the Taxonomy Regulation, and the delegated acts and technical implementing and regulatory standards of the European Commission.

Actual cases of enforcement powers being exercised in relation to ESG misconduct

To date, we are not aware of any use of these enforcement powers in relation to ESG.

ESG trends in relation to regulatory enforcement

AMF is committed to taking an active role in this area as demonstrated by the following publications:

- In July 2020, AMF published a position concerning information that must be provided by collective investments incorporating extra-financial approaches. The position recommendation sets out the information on the inclusion of non-financial criteria that French collective investment schemes and foreign funds authorised to be marketed in France may disclose. These provisions are set out in the various regulatory documents (key investor information documents, prospectus) and commercial document consultation.[115]
- The general regulation of AMF specify that distributors must ensure compliance with the applicable provisions stemming from Directive 2014/65/EU of 15 May 2014, including those relating to client information, assessment of the suitability or appropriateness of the financial instrument for the client, incentives and the identification and management of conflicts of interest.[116]

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[114] L 533-22-1 et D 533-16-1 du code monétaire et financier
[115] AMF, DOC-2020-03
[116] Article 313-20 du règlement général de l’AMF

- In 2019 AMF published a position concerning suitability preferences. The AMF position incorporates ESMA's guidance on certain aspects of MiFID II matching requirements. Thus, AMF currently presents as a good practice the collection of environmental, social, and governance preferences of the clients in the suitability assessment.[117]
- AMF also published a guide on carbon footprint offsetting by collective investment collective investment schemes.[118]

[117] AMF, DOC-2019-03
[118] https://www.amf-france.org/sites/default/files/contenu_simple/guide/guide_professionnel/Guide%20sur%20la%20compensation%20de%20l%27empreinte%20carbone%20par%20les%20organismes%20de%20placement%20collectif.pdf

Netherlands

Regulatory oversight of ESG financial regulation

The Netherlands Authority for the Financial Markets (Stichting Autoriteit Financiële Markten) (**AFM**) is responsible for the oversight and enforcement of ESG financial regulation.

Enforcement powers in relation to ESG financial regulation

The AFM is authorised to take measures that are appropriate and necessary to monitor and enforce compliance with the SFDR, the Taxonomy Regulation and the delegated acts and technical implementing and regulatory standards of the European Commission.

This includes the following measures:

- informal measures:
  - an instructive conversation; and
  - an informal instruction.
- formal measures:
  - formal instructions;
  - orders to perform, or refrain from, specified acts subject to a penalty; and
  - penalties.

In exercising the above powers, the AFM has various rights as a supervisory authority on the basis of administrative law, including the right to obtain information and documents from anyone deemed necessary or conducive for the AFM's supervision purposes, the right to access information and documents, and the right to enter premises. In addition, everybody is reasonably required to cooperate with the AFM unless a legal duty of confidentiality applies.

The above measures and rights are subject to general principles of administrative law applying to the acting of the AFM (e.g. the principle of proportionality).

Actual cases of enforcement powers being exercised in relation to ESG misconduct

To date, we are not aware of any use of these enforcement powers in relation to ESG - noting that the use of enforcement powers may not be publicly notified as action may be ongoing and may not be subject to public disclosure yet.

The AFM has performed an exploratory industry wide investigation into SFDR compliance by the funds industry in 2021. The outcome hereof shown that compliance is sub-standard in respect of transparency (often too generic) and in respect of sustainability (indicating the potential of greenwashing). While this is not yet to be classified as enforcement action by the AFM, enforcement action often starts with industry wide investigations that indicate non-compliance, following which the AFM targets specific parties which may result into enforcement action if individual non-compliance is established. It may therefore be expected that this exploratory investigation will be followed-up by further AFM action which may include enforcement action, also because the AFM has indicated that its 2022 priorities include taking on greenwashing.

ESG trends in relation to regulatory enforcement

The AFM is committed to taking an active role in this area and has made taking on greenwashing as one of its priorities for 2022. The AFM has a webpage on its website available setting out the rules and AFM action including:

- a position paper on the AFM's view on sustainability; and
- guidance letters to the financial industry on properly dealing with the new EU regimes on ESG.

While technically not regulatory enforcement, it is probably important to also note the civil law litigation/enforcement trend of recent years in the Netherlands where it relates to sustainability:

- In 2019, the Dutch State has been finally ordered by the courts in The Hague and Supreme Court to reduce its greenhouse gas emissions by at least 25% by 2020 compared to 1990. This was a civil law judgement based on several international treaties including the ECHR and the UN Climate Treaty. This judgement paved the way for action against private parties.
- In 2021, Shell was ordered by the District Court in The Hague to reduce its carbon dioxide emissions by 45% by 2030 compared to 2019. This civil law procedure was initiated by climate interest groups, including Milieudefensie and Greenpeace. The District Court has based its judgement on an unwritten due diligence standard applying to Shell further to the concept of tort under the Dutch Civil Code. Shell has appealed to the Court of Appeal and appeal is now pending. However, based on the District Court's judgement, Milieudefensie has announced to start similar legal proceedings or claims against 30 other large companies, including ABN AMRO, Ahold, AkzoNobel, ExxonMobil and Schiphol Airport.

The above may serve as an indication that enforcement of (mandatory) legal principles may also be enforced by private parties and individuals. It is therefore conceivable that also compliance with ESG financial regulation can be enforced by private parties.